Santander

The monetary tightening cycle is coming to an end

Evidence of lower inflationary pressures in the US leads the Fed to slow down the pace of the rate hikes. The Central Bank finalises the hiking process in Chile, and cuts could start in April.

Highlights

- **Global inflationary pressures ease after declines in commodity prices and the normalisation of supply chains.** The US CPI surprised on the downside for a second month in November. The Federal Reserve raised its benchmark rate by 50 basis points, in line with expectations, and aimed to conclude the hiking cycle with additional increases totalling 75 basis points.

- **Further tightening of global financial conditions leads to a recovery in asset prices.** The dollar has depreciated by more than 6% globally, long-term rates have fallen back, and stock markets are recovering, except in Latin America, where political factors have hindered progress.

- **In Chile, October activity declined somewhat less than expected (-1.2% YoY) due to a rebound in the mining sector**. Nevertheless, the economy's fundamentals suggest a further contraction in the coming months. For November, we estimate a decline in activity of -2.7% YoY, bringing the year to a close with a growth of 2.5%.

- **The November CPI (1%) exceeded market expectations, reversing October's surprise.** Nevertheless, we expect inflation to decline significantly in the coming months due to lower external cost pressures, falling fuel prices, the exchange rate appreciation and lower domestic dynamism. The CPI will close in 2022 at 12.6% and 2023 at around 5%.

- **Financial assets continued to rise in the month, albeit with fluctuations.** The local exchange rate appreciated, and long-term rates declined amid looser external financial conditions and a lower local risk premium.

- **The Central Bank maintained the MPR at 11.25% in its last meeting of the year.** This inflationary surprise and the somewhat hawkish tone of the Monetary Policy Report (IPoM) considerably reduce the likelihood of a rate cut in January, as anticipated by the market. We estimate that the first cut will occur in April 2023, to end the year with the rate at around 6.25%. This implies more aggressive declines than expected in the IPoM.

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Global assets rebound due to prospects of Fed tapering

In recent weeks, markets have continued to exhibit significant volatility associated with changing expectations regarding the behaviour of the Federal Reserve and major central banks. After the

second consecutive downward surprise in US CPI as of the date this report was issued (total CPI: 0.1% MoM vs 0.3% expected in November; 0.4% MoM vs 0.6% expected in October; core CPI: 0.2% MoM vs 0.3% expected in November; 0.3% MoM vs 0.5% expected in October), which brought the annual price change to 7.1%, the markets internalised the possibility of a less tight monetary policy for the future.

Nevertheless, at its December meeting, the FOMC raised the benchmark rate by 50 bps, as expected, but pointed to further hikes by a total of 75 basis points in the future, bringing the target rate to 5.1% (4.6% estimated in September). In addition, the Fed adjusted its inflation projections upwards, implicitly acknowledging greater persistence despite lower expected growth (0.5% for 2023 vs 1.2% previously) and in a context of a still-strengthening labour market. At the press conference, Chairman Jerome Powell ruled out that cuts are being contemplated, clarifying that, for now, the aim is to reach sufficiently restrictive rates. Signs of the approaching end of the monetary tightening cycle partially offset the hawkish bias of this shift in outlook.

Against this background, long-term rates in the major economies have fallen by more than 30 bps on average, with US10Y again hovering around 3.5% (after rising above 4.2% in October). The dollar depreciated by more than 6% in multilateral terms during the month (DXY: 103.5 points), and volatility declined (VIX: -4 points), leading to a rebound in international stock indices (MSCI global: +8%; MSCI emerging markets: +7%; China: +6%). The Eurozone and US markets led the way with gains of around 7%. However, after Jerome Powell's speech, there could be reversals in these results. Conversely, Latin American stock markets declined by 8% on average, impacted by a 9% drop in Brazil and, to a lesser extent, by a 1% decline in Peru. In the first case, some statements by the elected authorities regarding the future government's fiscal commitment have generated controversy. In contrast, in the second, the political situation following the dismissal of President Pedro Castillo has taken its toll.

The European Central Bank's decision will be released today, and the UK Central Bank's decision tomorrow, among other central banks of reference, which are also expected to moderate the restrictive monetary stance exhibited in recent times, given the lower inflationary pressures already observed (Eurozone CPI: 10% YoY vs 10.6% previously; UK CPI: 10.7% YoY vs 11.1% previously).

After higher annualised growth in 3Q22 (GDP: 2.9% vs 2.6% previously), led by personal consumption (1.7% vs 1.4%), US activity figures have shown some dynamism in October (industrial orders: 1% vs 0.7% MoM expected; durable goods orders: 1.1% vs 1% expected). Developments in the labour market were rather mixed. On the one hand, private job creation showed no clear direction (ADP: 127K vs 200K expected; non-farm payrolls: 263K vs 200K expected), while the unemployment rate remained at 3.7%. The latest figures for initial jobless claims were in line with projections, showing a slight increase (from 226K previously to 230K). In the future, preliminary confidence indicators for December show some improvement (U. Michigan index: 59.1 vs 56.8 previously).

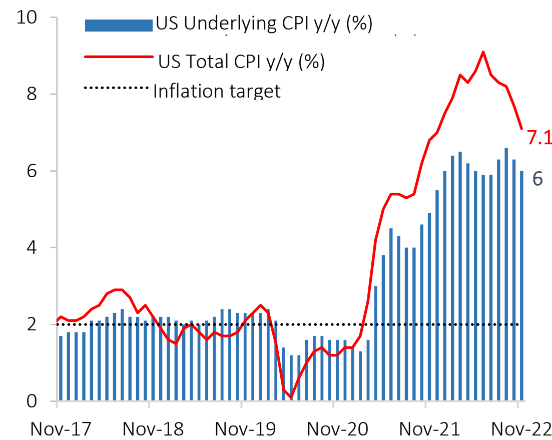
In Europe, although GDP growth confirmed a surprising upward trend in 3Q22 (2.3% YoY vs 2.1% estimated), some leading indicators for 4Q22 lead to caution (October retail sales: -2.7% YoY vs 0% previous), in line with November PMI indices (manufacturing: 47.1 vs 47.3 previous; services: 48.5 vs 48.6 previous) that are still in contractionary territory. Therefore, concerns remain about a more significant contraction in activity in the coming quarters.

China's economy has experienced one of the most volatile scenarios since the pandemic began, with Covid-19 cases on the rise - amid a population with low vaccine coverage - and progress and setbacks in its zero-tolerance policy. Nevertheless, the zero-tolerance policy had to be eased in response to strong public protests, sharp adjustments in financial asset prices and disappointing activity figures. November's foreign trade data precisely reflected the effect of the strict quarantines (exports: -8.7% YoY vs -3.9% expected; imports: -10.6% YoY vs -7.1% expected), which confirmed the signals observed in October (retail sales: -0.5% YoY vs 2.5% previous; industrial production: 5% YoY vs 6.3% previous). Similarly, last month's PMI indices fell back further into negative territory (manufacturing: 48 vs 49.2 previously; services: 46.7 vs 48.7 previously).

The prolonged war in Ukraine - with no sign of an apparent solution - continues to push the risks to global fuel prices upwards. Nonetheless, recessionary fears and sanctions suggested by the European Union, with a cap on the price of Russian oil at US$ 60 per barrel, have led to a downward adjustment in the price of crude oil amid a new escalation of geopolitical conflicts.

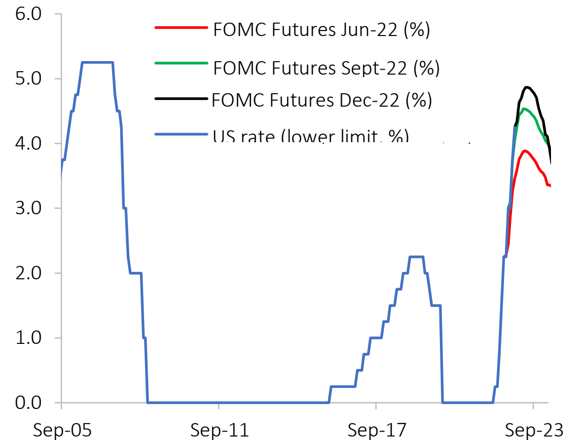
In contrast, copper prices have tended to rise due to the easing of global financial conditions, the change in China's containment policies and fears of tight supply, with inventories falling. Thus, the metal's price went from around US$3.6 per pound a month ago to values close to US$3.9 per pound.

November US CPI confirms a turning point in the inflationary trend



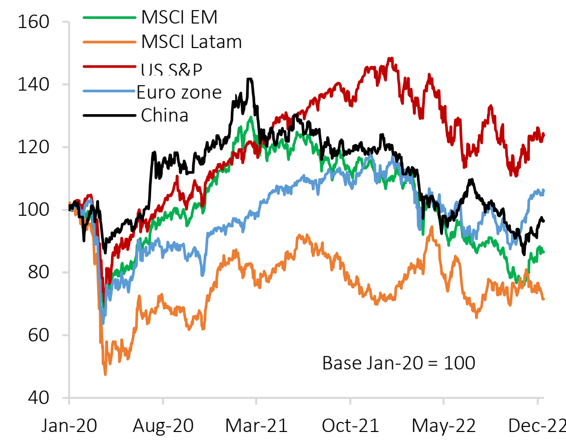
Source: Bloomberg and Santander

Lower inflationary pressures prompt Fed to slow the pace of rate hikes



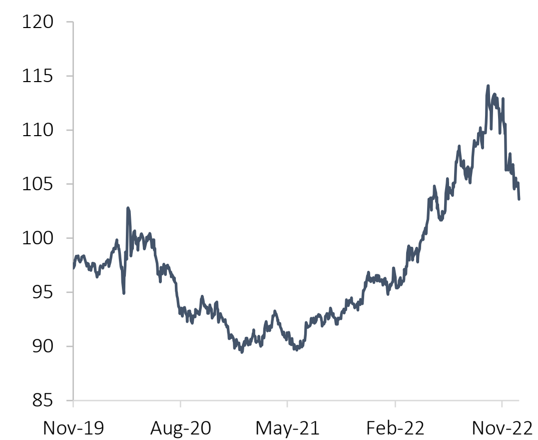
Source: Bloomberg and Santander

Excluding the Latin American region, international stock market indices rebound in the month



Source: Bloomberg and Santander

The dollar depreciated sharply in multilateral terms.



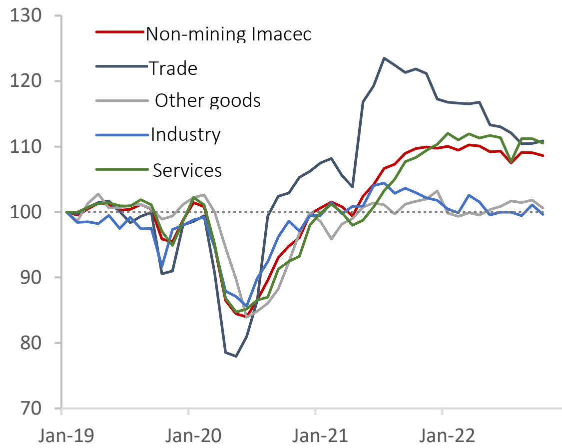
Source: Bloomberg and Santander

The economy loses ground but somewhat slower than expected

The October Imacec (-1.2% YoY) confirmed the loss of momentum that the economy has been showing for several months. However, the moderation was less than anticipated, in large part due to a recovery in mining activity (6.4% MoM seasonally adjusted) after a weak performance during the year. Non-mining activity fell for the third consecutive month (-0.4% MoM seasonally adjusted in October), highlighting the declines in manufacturing (-1.4% MoM seasonally adjusted) and other goods (-1.2% MoM seasonally adjusted). Demand-side sectors had mixed results in the month, with a contraction in the services sector (-0.4% MoM seasonally adjusted) and a rebound in trade (0.4% MoM seasonally adjusted) associated with specific factors.

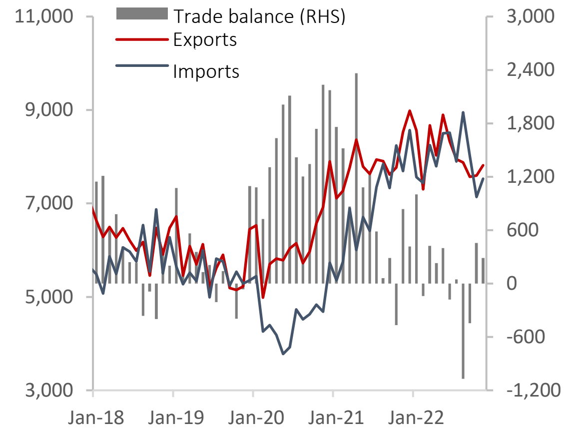
Foreign trade figures for October and November showed a reversal, following the sharp deterioration of the trade balance in August and September. Imports rebounded in November but without compensating for the significant drop in October due to increases in energy goods. Imports of consumer and capital goods declined.

Non-mining sectors maintain a downward trend



Source: Central Bank and Santander

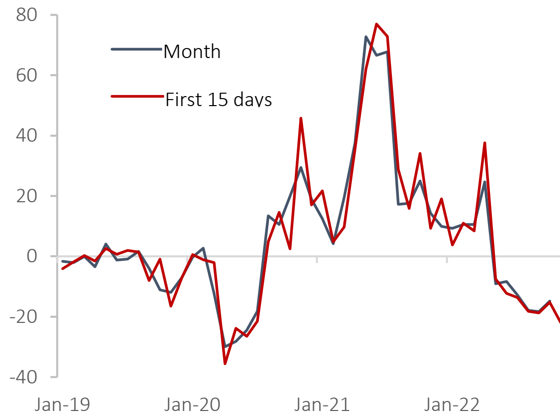
Trade balance remains in surplus despite rising imports



Source: Central Bank and Santander

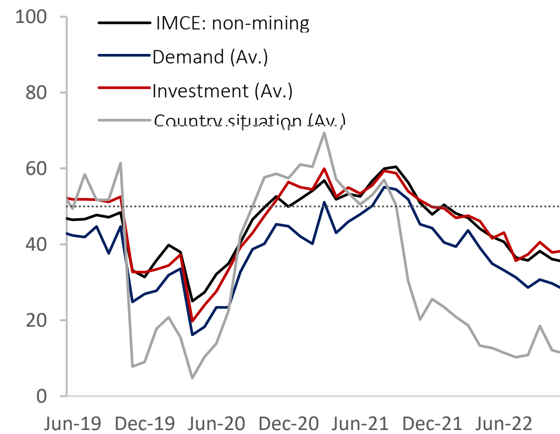
In the future, the economy will continue to decelerate due to subdued consumption and investment due to tight financial conditions and still high levels of uncertainty. Partial data for November point to a significant contraction in activity. The Central Bank's daily retail trade data suggest a year-on-year fall of more than 20% in the first half of the month; vehicle imports show a significant decline; the consumer confidence index hits a near two-year low, and business confidence retreats. The mining sector is unlikely to repeat the progress seen in October, as it is already around its historical levels and cannot improve much further due to its structural conditions.

The first days of November point to a significant drop in retail trade



Source: Central Bank and Santander

Business confidence remains in pessimistic territory



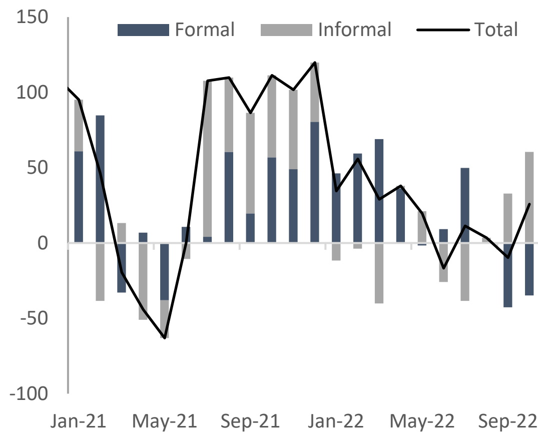
Source: ICARE and Santander

For November, we estimate a fall in activity of 2.7%. This would close the year with an expansion of around 2.5%. In 2023, we will see monthly declines in the first quarter, followed by growth, although negative annual changes will continue to be observed for much of the year. Thus, we maintain our projected GDP decline of 1.2% in 2023.

Despite marginal employment improvement, the labour market remains weak

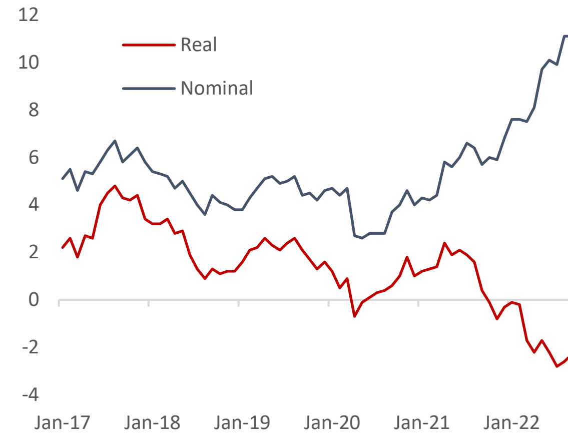
The August-October period showed a rebound in employment, with a net creation of 25.8 thousand jobs, influenced by seasonal factors. The labour participation rate remains low, leaving the unemployment rate unchanged at 8%. Despite this, the labour market continued to weaken, further destroying formal jobs.

New jobs in the informal sector of the economy



Source: National Institute of Statistics and Santander

Real wages begin to slow their decline



Source: National Institute of Statistics and Santander

Nominal wages in October continued the trend of previous months with double-digit growth, albeit with a slight deceleration (10.9% YoY vs 11.1% in September). In real terms, wages continued to fall, accumulating a decline of 2.5% over the year. This, coupled with the stagnation of employment in recent months, has led to a further deterioration in the wage bill.

Labour demand remained weak in November. Despite a seasonal increase, Internet job advertisements remained below their historical average. Something similar was observed in the SENCE Labour Observatory (SABE) figures, where a monthly increase in the number of announcements and vacancies was reported, but with a very significant annual drop (-43.4% and -45.1%, respectively). At the same time, the SABE shows an increase in the number of applicants and applications, so wage pressures will continue to fall.

Local markets remain highly volatile

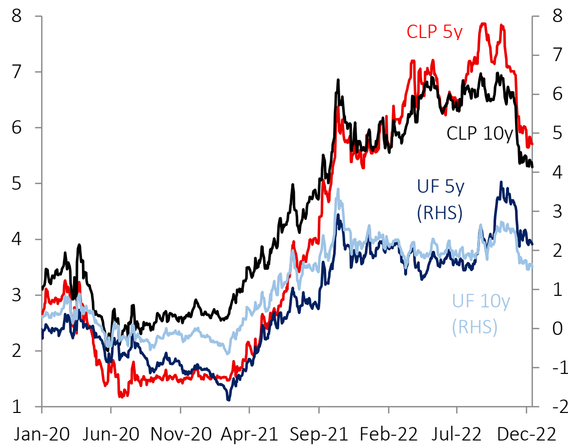
Local markets have been marked by external news, marginal local activity, and inflation data. Ten-year sovereign bond rates fell 60 bps to 5.4%, a level not seen since September of the previous year, a significant retreat from the early October highs of 7%. The same maturity repricing rate declined by a similar amount to 1.6%. The adjustment in rates was due to the fall in international benchmarks, lower activity expectations and, consequently, an easing of monetary policy and a lower risk premium (CDS 10y: 164 bp; -34 bp). This last element is ratified by the recent decision of the Fitch agency to maintain the sovereign rating at A- and with a stable outlook.

The favourable return of local fixed income allowed for significant capital gains in bond portfolios. The more conservative type E pension fund posted a historical return of 7% in November, and there was a developing inflow of non-residents into local fixed income (stock: MMUS$7,300 in October).

The exchange rate also strengthened during the month, standing close to $870 (-4%) at the close of this report. Global factors, such as the weakening of the dollar and the recovery of copper prices, and local factors, such as reduced political uncertainty, have influenced this. However, the downward trajectory has not been without fluctuations. The large current account deficit in the third quarter of 2022, which became known in mid-October, introduced volatility and temporarily interrupted the currency's appreciation trend.

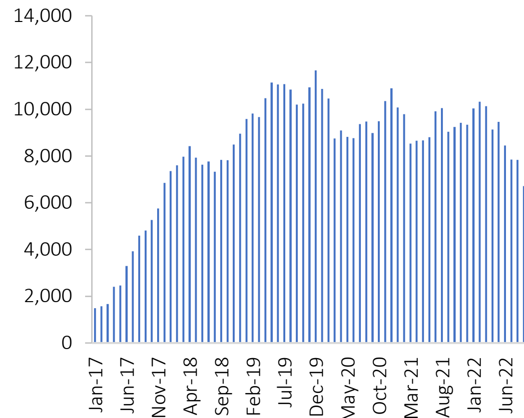
For the future, our central scenario assumes that local political uncertainty remains relatively high but lower than a few weeks ago as the constitutional discussion proceeds within predefined boundaries. Furthermore, the international dollar is likely to moderate the depreciating trend of the last few days, given the tone of the recent Fed meeting. Therefore, we expect the exchange rate to remain around current levels at the close of this report. In any case, new injections of liquidity or a worsening of the international scenario are risk factors that could reverse the trajectory of local financial assets and the exchange rate, in particular.

Significant fall in long-term rates



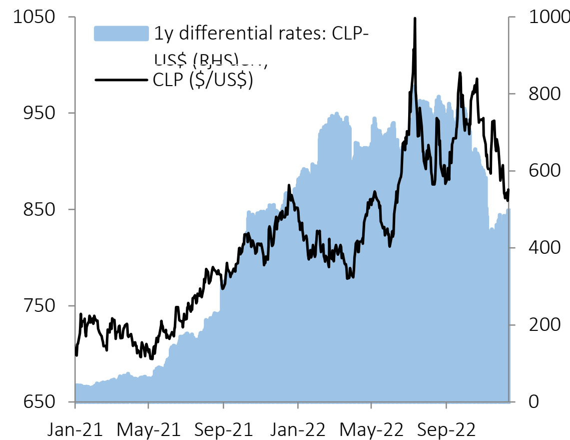
Source: Bloomberg and Santander

Incipient increased non-resident appetite for sovereign bonds



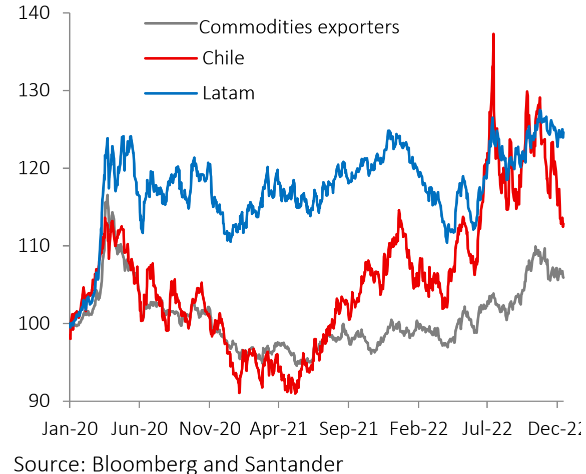
Source: Central Bank and Santander

The exchange rate appreciates despite the falling interest rate differential...



Source: Bloomberg and Santander

...outperforming comparable currencies



Source: Bloomberg and Santander

November CPI surprises on the upside

With a monthly change of 1%, the November CPI was well above market expectations (Bloomberg 0.5%; Santander 0.5%), bringing its annual change to 13.3% (12.8% in October). In addition, the non-volatile CPI rose 0.9%, bringing its annual change to 11% (10.8% on the previous record).

Surprises were widespread, with price increases linked to tradable goods (alcohol, clothing and household goods) standing out. This was despite an exchange rate that appreciated compared to October (-5%). The inflation diffusion index (the percentage of items in the basket that increase in price) rose again and registered a new annual high of 73%, showing that price pressures remain latent despite the already weak economy and where consumption has moderated.

Nevertheless, it is important to note that the strong November rise perfectly offsets the surprise in October, when the core CPI rose by only 0.1%. Therefore, the month's increase could reflect some one-off events, such as the reversal of special sales, such as *Cyber Monday*.

We expect inflation to continue to decline significantly in the future. In the external scenario, the reduction in maritime freight costs and the decrease in the price of oil and fuels stand out. Added to this is the appreciation of the exchange rate associated with global factors. Furthermore, domestic demand will continue to shrink, contributing to lower price pressures.

For December, we preliminarily estimate a CPI change between 0% and 0.2%, bringing inflation to close the year between 12.5% and 12.7%. We expect a sharp decline next year, bringing the CPI to close at around 5%.

MPR remains at 11.25% and the rate cut cycle is postponed

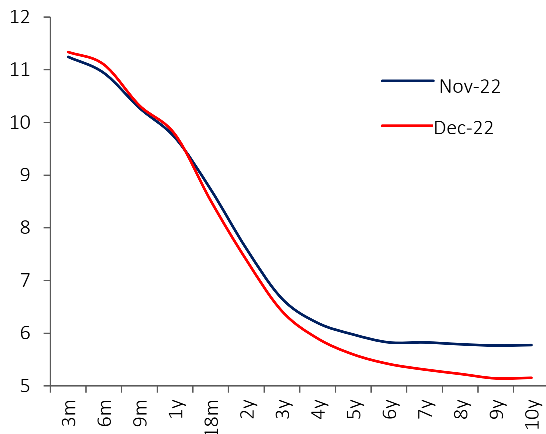
In the run-up to the last Monetary Policy Meeting (MPM) of the year, the market - in a broad consensus - had internalised the end of the rate hike cycle and discounted that the first MPR cut would occur as early as the beginning of January.

The Council confirmed the first point at the December MPR by maintaining the rate at its maximum level of 11.25%. Nevertheless, both the neutral bias of the statement, a relatively hawkish tone of the IPoM, with a path for the MPR with very moderate reductions, as well as the surprising CPI in November considerably diminished the possibility of a policy rate cut in January, postponing the decision to the April meeting.

Nevertheless, should our scenario for inflation materialise, we estimate that when the process starts, the Council will be relatively aggressive in lowering the MPR, closing the year with a rate substantially lower than that envisaged in the middle of the range presented in the IPoM.

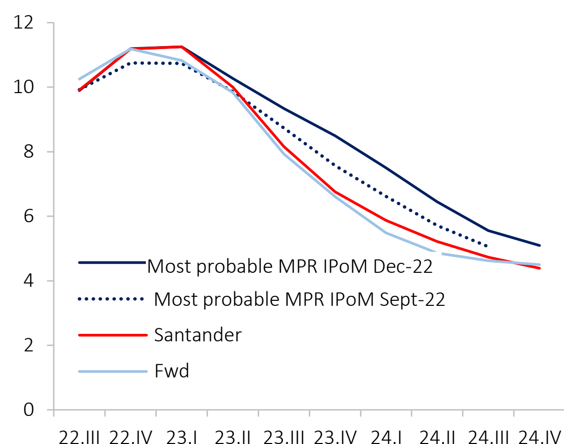
We assess that, with inflation falling steadily and the economy in recession, the Central Bank's projections, which implicitly imply real ex-post rates rising in the coming quarters to levels above 5.5%, are implausible. This would mean maintaining tight financial conditions for a very long time, risking over-adjustment of the economy, with a deeper contraction of activity next year, a slower recovery by 2024, and inflation falling below the target over the policy horizon.

Long-term swap rates fall ahead of future monetary easing



Source: Bloomberg and Santander

IPoM broker suggests a more gradual rate cut than the market's estimate



Source: Bloomberg, Central Bank and Santander

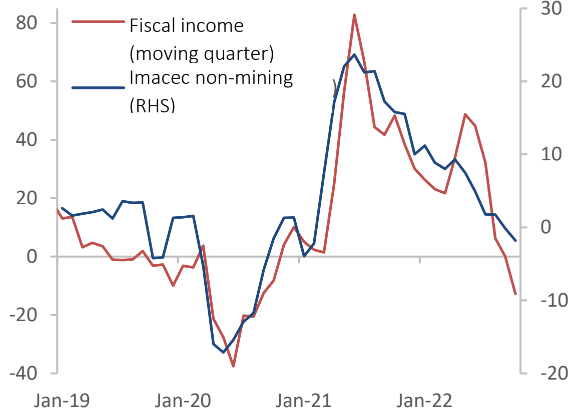
Economic slowdown begins to take its toll on fiscal coffers

Fiscal revenues fell by 16.6% in real terms in October, mainly affected by the fall in tax revenues (-22.8% in real terms) and CODELCO contributions (-89% in real terms). The slowdown in the economy has caused VAT receipts to fall by 19.6% in real terms, accounting for slightly less than half of the change in tax revenues. This is in addition to the fall in specific taxes, affected by the change in the accounting of the diesel tax rebate. In contrast, revenues benefited from the lithium contract, whose price remains at record levels, contributing US$ 1.113 billion in the month.

On the other hand, spending continued the trend of previous months, with an annual fall of 30% in real terms. Almost the entire contraction is explained by the lower component of subsidies and grants (-59.6% real YoY) after the cessation of state aid due to the pandemic.

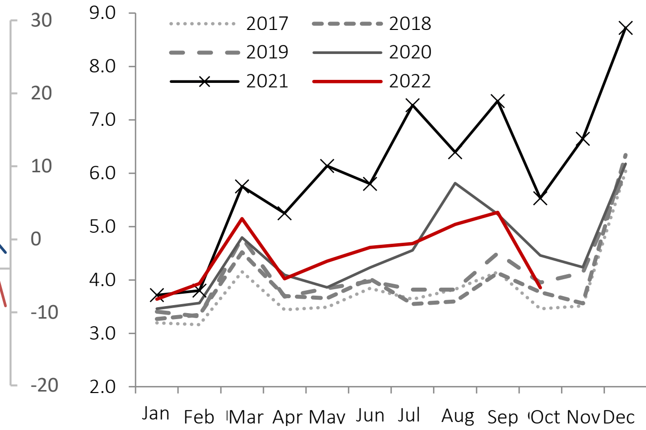
The fiscal surplus has started to moderate and will likely end the year somewhat lower than previously estimated, at around 1.3% of GDP. Thus, gross public debt will end the year slightly above 36% of GDP, similar to the previous year.

Tax revenues will deteriorate along with the shrinking economy.



Source: DIPRES, Central Bank and Santander

Fiscal spending remains restrained, with a sharp drop due to a decline in subsidies.



Source: Dipres and Santander

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MACROECONOMIC PROJECTIONS

National Accounts	2016	2017	2018	2019	2020	2021	2022 P	2023 P
GDP (% real var. YoY)	1.8	1.4	4.0	0.8	-6.0	11.7	2.5	-1.2
Domestic demand (% real var. YoY)	1.9	2.9	5.0	1.0	-9.3	21.6	2.4	-4.2
Total consumption (% real var. YoY)	4.1	3.8	3.6	0.7	-7.2	18.2	3.1	-3.2
Private consumption (% real var. YoY)	3.3	3.6	3.8	0.7	-8.0	20.3	2.7	-4.1
Public consumption (% real var. YoY)	7.6	4.7	3.1	0.5	-4.0	10.3	5.0	0.7
Gross fixed capital formation (% real var. YoY))	-2.4	-3.3	6.5	4.7	-9.3	17.6	3.0	-4.7
Exports (% real var. YoY)	0.6	-1.0	4.9	-2.5	-1.1	-1.5	1.1	1.2
Imports (% real var. YoY)	1.2	4.5	8.6	-1.7	-12.7	31.3	0.9	-6.9
GDP (US$ billion)	249.5	276.5	296.0	279.0	253.5	316.8	300.5	299.0
GDP per capita (US$ thousand)	13.7	15.0	15.8	14.6	13.0	16.1	15.2	15.0
Population (million)	6.2	6.5	7.1	7.1	10.3	7.2	7.8	8.5

Payment Balance	2016	2017	2018	2019	2020	2021	2022 P	2023 P
Trade balance (US$ billion)	5.0	7.5	4.4	3.0	19.0	10.5	1.0	3.5
Exports (US$ billion)	60.8	68.9	74.8	68.8	74.1	94.7	96.6	88.1
Imports (US$ billion)	55.8	61.4	70.4	65.8	55.1	84.1	95.6	84.6
Current account (US$ billion)	-6.5	-7.6	-13.3	-14.5	-4.3	-20.3	-28.6	-13.5
Current account (% GDP)	-2.6	-2.8	-4.6	-5.2	-1.7	-6.6	-9.5	-4.5
Copper price (year average US$/lb)	2.2	2.8	3.0	2.7	2.8	4.2	3.9	3.6
WTI oil price (year average US$/bbl)	43.2	50.9	64.8	57.0	39.0	68.0	94	75

Money and Exchange Market	2016	2017	2018	2019	2020	2021	2022 P	2023 P
CPI Inflation (% var. YoY up to December)	2.7	2.3	2.6	3.0	3.0	7.2	12.6	4.9
CPI Inflation (% var. YoY average)	3.8	2.2	2.4	2.3	3.0	4.5	11.6	7.7
CPI Inflation excluding food and energy (IPC-SAE) (% var. YoY up to December)	2.8	1.9	2.3	2.5	2.6	6.4	8.6	5.1
CLP/US$ exchange rate (year-end)	667	615	696	745	711	852	875	885
CLP/US$ exchange rate (year average)	677	649	640	703	792	759	873	880
Monetary policy rate (% annual exercise)	3.5	2.5	2.8	1.8	0.5	4.0	11.25	6.25
Monetary policy rate (% year average)	3.5	2.7	2.5	2.5	0.8	1.2	8.6	9.1

Fiscal Policy	2016	2017	2018	2019	2020	2021	2022 P	2023 P
Public expenditure (% real var. YoY)	3.8	4.8	3.5	4.1	11.0	31.6	-24.0	4.2
Central Government balance (% GDP)	-2.7	-2.8	-1.7	-2.9	-7.3	-7.7	1.3	-2.6
Central Gov. gross Debt (US billion)	53.4	68.9	70.2	74.4	91.6	102.0	108.2	114.0

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