Monetary tightening cycle is coming to an end

Although high inflation continues, the rate hiking process may be over or nearing its end. However, the likelihood of major banks cutting rates this year seems remote despite the market conditions.

Highlights

- **Global activity accelerates, driven by services, but China's economy loses momentum.** International financial markets rebound almost across the board, except for China. Its slowdown has led to a sharp fall in commodity prices.

- **Global financial conditions remain tight.** While the hiking cycle may be over or nearing its end, signals given by the major central banks have been cautious. Despite the debt ceiling debate in the US, geopolitical tensions have strengthened the global dollar, and long-term interest rates rose by around 30 bps on average.

- **Local activity accelerates due to temporary factors, but private consumption falls sharply.** The 1Q23 National Accounts figures showed a significant drop in domestic demand, with a severe contraction in consumption and a moderate decline in investment, offset by a temporary rise in the external sector. In the future, we expect activity to contract again before recovering by the end of the year. Thus, we maintain our projection of a negative GDP change of -0.25% by 2023.

- **Inflation continues to recede.** April CPI fell below double digits for the first time since March 2022 (to 9.9% YoY), driven by a decline in volatile components. In the future, weaker activity, the recent exchange rate appreciation and lower commodity prices will continue to put downward pressure on inflation. By the end of the year, we estimate that the annual change in the CPI will reach 4.5%.

- **The Central Bank maintained the MPR at 11.25% at its May meeting.** At the July meeting, with two additional CPI and Imacec data, the conditions would be in place to initiate rate cuts. Tactical considerations could delay the move until September. Nonetheless, we expect the MPR to end the year between 7.5% and 8%.

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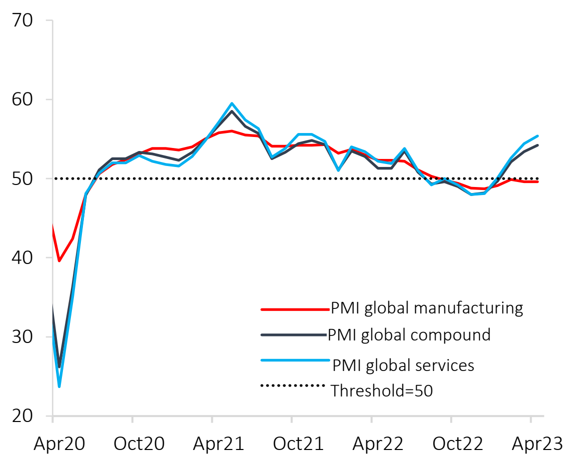
Monetary tightening process in major economies is nearing completion

Although the world economy has tended to accelerate in recent months thanks to the rebound in services (global composite PMI: 54.2 in April vs 53.4 previously), relevant risks to activity remain. The continued tightening of financial conditions for longer than expected has exacerbated recessionary fears. Furthermore, China's recovery has been weaker than expected, affecting commodity prices and the emerging world's growth prospects.

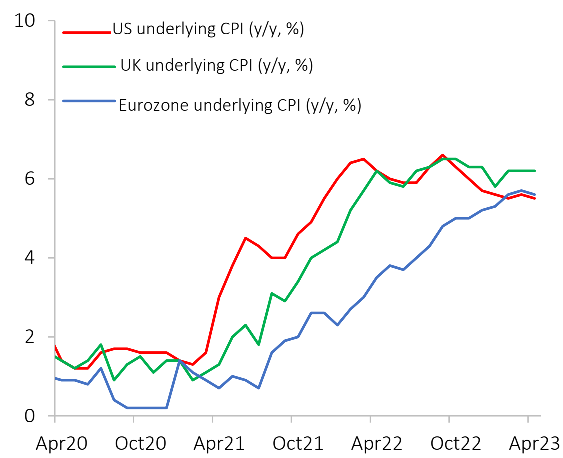
In recent weeks, the US debt ceiling debate has dominated market attention, although an early resolution is expected that does not involve shutting down the federal government's operation. As anticipated, the Federal Reserve (Fed) raised its benchmark rate by 25 bps in May to range between 5% and 5.25%, suggesting that the upward tightening process may have ended. Nevertheless, the Fed stresses the need to maintain a contractionary policy for some time due to the persistence of core inflation (5.5% YoY in April). This led to the global strengthening of the dollar by almost 2% in the last month (DXY rose above 103.2 points, a level not seen since March), while long-term interest rates experienced a new momentum, jumping by 30 bps on average, with the US10Y again around 3.7%. Stock market indices were mixed, with rises in the main markets (MSCI global: +2%) and descents in the emerging stock markets, led by China (-3%). Commodities, meanwhile, recorded substantial declines in the last month (aggregate commodity index: -9%), driven by agricultural and energy products, which declined by more than 10% on average.

Global activity rebounds, driven by services



Source: Bloomberg and Santander

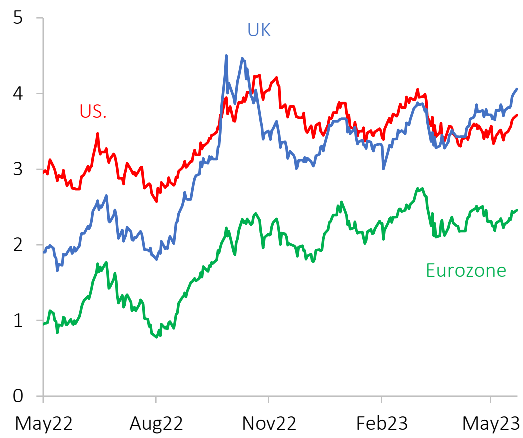
Persistent core inflation continues to be a cause for concern



Source: Bloomberg and Santander

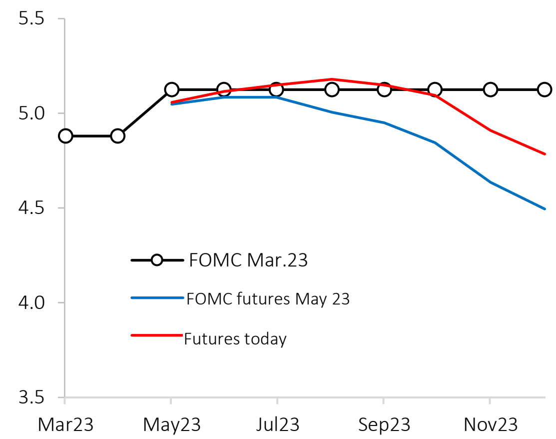
The latest activity figures in the US were mixed (industrial orders in March: 0.9% vs 1.2% expected; durable goods orders: 3.2% vs 2.8% previously). Annualised GDP grew only 1.1% YoY (1.9% expected) during 1Q23, although personal consumption remained buoyant (3.7% vs 1% previously). April figures showed some improvement (industrial production: 0.5% MoM vs 0% expected; retail sales: 0.4% MoM vs -0.7% previous; ISM manufacturing: 47.1 vs 46.8 expected), but they still with lower consumer confidence (Conference Board: 101.3 vs 104 expected). So far in May, economic sentiment continues to show mixed signals (Philly-Fed: -10.4 vs -31.3 previously; U. Michigan index: 57.7 vs 63 expected). For its part, the labour market continues to stand out for its resilience (initial unemployment benefits: 242k vs 251k expected; unemployment rate April: 3.4% vs 3.6% expected; job creation in non-farm payrolls: 253k vs 185k expected and ADP private job creation: 296k vs 150k expected).

10-year benchmark rates rise marginally



Source: Bloomberg and Santander

The market still expects cuts this year

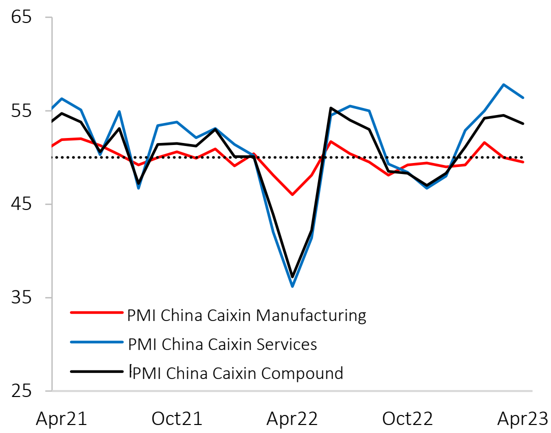


Source: Bloomberg and Santander

In the Eurozone, inflation surprised with a slight downward revision in April (0.6% MoM vs 0.7% expected), keeping the annual measure at around 7%, distancing it from the peak of more than 10% reached in October 2022. Activity figures decelerated (industrial production: -4.1% MoM vs 1.5% previously; retail sales: -1.2% MoM vs -0.2% previously), while 1Q23 GDP did not surprise (0.1% YoY), expanding 1.3% YoY. The ZEW survey of expectations contracted sharply in its preliminary report for May (-9.4 vs 6.4 previously), reflecting recessionary fears and the still persistent cautious outlook for Europe. Nevertheless, the ECB raised the MPR again, in line with expectations, but at a slower pace than in previous meetings (25 bps vs 50 bps). In addition, it maintained a data-dependent bias for the following decisions.

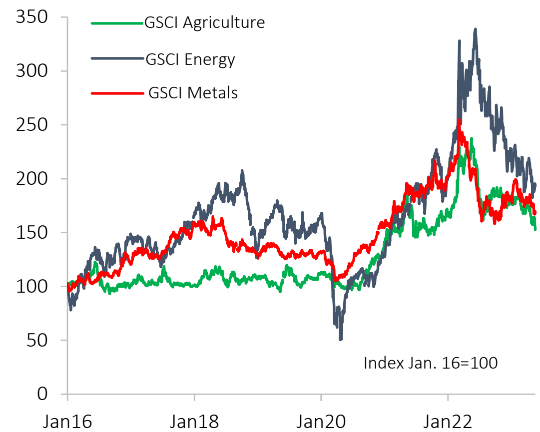
In China, although 1Q23 GDP surprised on the upside (4.5% YoY vs 4% expected), the April sectoral figures disappointed, suggesting a less dynamic recovery than expected (industrial production: 5.6% YoY vs 10.9% expected; retail sales: 18.4% YoY vs 21.9% expected). The external sector, meanwhile, gave mixed signals (exports: 8.5% vs 8% expected; imports: -7.9% vs -0.3% expected). As for Caixin's PMI indicators, both the manufacturing and services components declined in April (49.5% vs 50 previously; 56.4 vs 57.8 previously), with the former falling back into contractionary territory.

Chinese slowdown raises alarm bells



Source: Bloomberg and Santander

Commodity prices fall



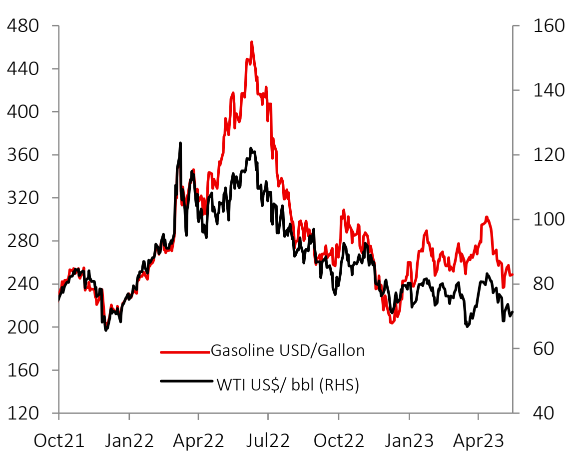
Source: Bloomberg and Santander

Oil and copper prices fall due to fears of weaker Chinese demand

The oil price has sharply adjusted in the last month, falling 15%. This movement has led it to lose all progress made in the first half of April after the unexpected announcement of the extended OPEC production cut. In addition, fears of further weakness in Chinese demand have weighed on the adjustment, as inventories have also fallen significantly since late February.

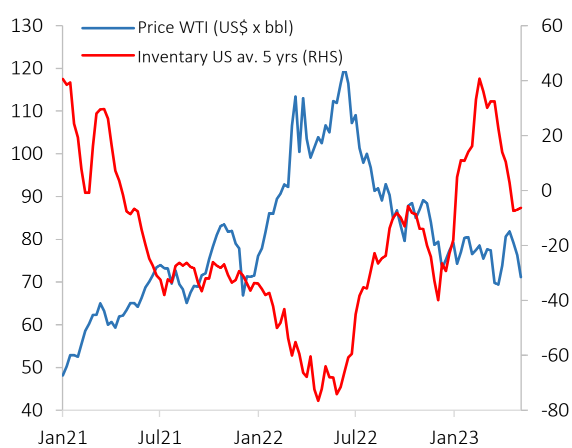
In the future, however, we may see a partial recovery in the price of crude oil. According to the International Energy Agency's latest report, global oil demand is expected to exceed supply in the second half of the year by two million barrels per day, pushing up oil prices. Thus, we maintain our assumption of a year-end WTI oil price of around US$ 80 per barrel.

Gulf Coast oil and gasoline prices fell 15% in the last month



Source: Bloomberg and Santander.

US inventories break the link with WTI price, which is expected to be a temporary phenomenon



Source: EIA and Santander.

The copper price has also been affected by weak figures from China, falling 9% in the last month. China's copper imports fell 12.5% year-on-year in April, while the sharp drop in the producer price index indicates that the manufacturing sector in China, a main copper buyer, has yet to recover from the slowdown in 2022 completely.

Nevertheless, in the future, we could see a rise in the metal price as supply remains tight (declining ore grades in Chile and a significant delay in the development of Codelco's large structural projects will keep production constrained) and demand continues to increase due to the needs imposed by the global energy transition. Currently, the average spot copper price is US$ 4.0 per pound, which compares with a projection of US$ 3.90 from Cochilco and our projection of US$ 4.0, which we maintain.

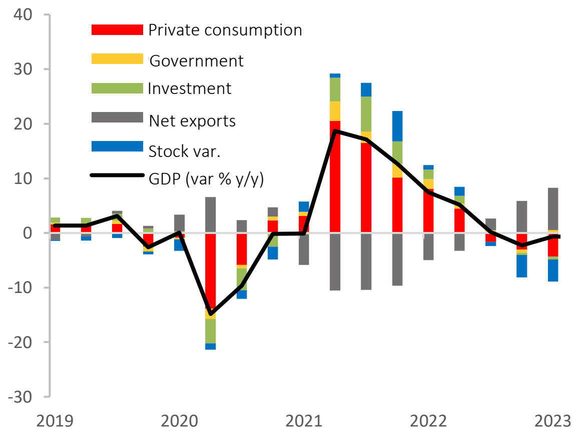
Domestic demand contracts sharply

Activity data for the first quarter showed a sharp contraction in domestic demand (-1.0% QoQ seasonally adjusted), with a significant drop in private consumption (-2.5% QoQ seasonally adjusted), a decline in fixed capital formation (0.9% QoQ seasonally adjusted) and a significant deaccumulation of inventories. On the contrary, GDP rebounded (0.8% QoQ seasonally adjusted) due to the contribution of the external sector, especially the rise in transport activity due to the withdrawal of Latam's Chapter 11.

The contraction in demand shows that the adjustment of the economy has continued. While fiscal policy has been somewhat more expansionary in recent months, with a significant acceleration in public spending (5.9% YoY vs -34.4% YoY in 2022. IV), financial conditions remain very tight. This, coupled with a weakening labour market, has dampened household spending. In the case of investment, the adjustment has been more moderate. Even so, domestic political uncertainty in past quarters and the high cost of financing have weighed on gross capital formation. In fact, the latest CBC (Corporación de Bienes de Capital) report concerning large projects registered in the first quarter of the year shows a very substantial decrease compared to previous records.

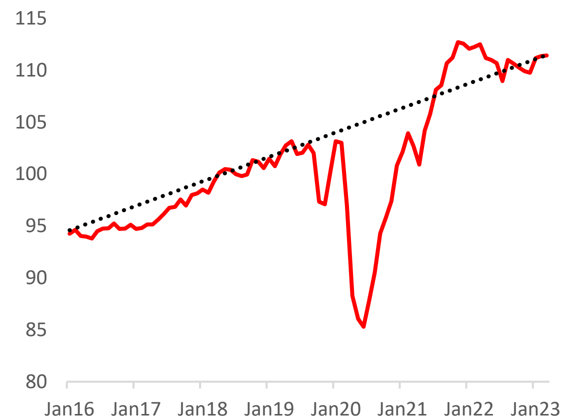
Data for the second quarter show that the economy is contracting again. April retail sales again declined sharply (-14.6% YoY), imports are down nearly 20% YoY, and activity sentiment indicators remain depressed. Therefore, with the available data, we estimate that the Imacec will have a new annual contraction in April (-1% YoY), which will be repeated in May and June. Thus, for the entire year, we maintain our projection of a moderate decline in activity (-0.25% YoY), somewhat stronger than the mid-point of the Central Bank's range (-0.5 to 0.5%) and the latest projection of the Ministry of Finance (0.3%).

Economy continues its adjustment process amidst declining domestic demand



Source: Central Bank of Chile and Santander

Non-mining activity is around trend



Source: Central Bank of Chile and Santander

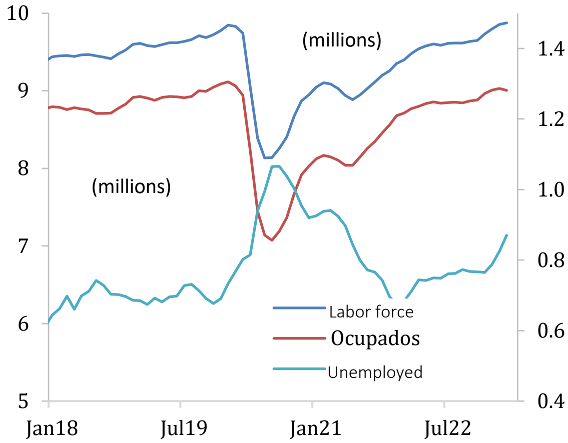
Labour market continues to lose momentum

After moderating its pace of expansion in recent months, employment fell significantly in March (-0.3% compared to February; -24.5 thousand jobs), although part of this was linked to seasonal factors. On the other hand, the labour force continued to grow, approaching its pre-pandemic trend levels. This has meant an increase of 45,000 unemployed persons in the moving quarter ending in March, bringing the unemployment rate to 8.8%.

The labour participation rate reached 61 % (men: 71.4%, 2.4 percentage points below pre-pandemic levels; women: 51.1%, 1.8 percentage points below their historical average), with slightly more than 400,000 people still excluded from the labour force.

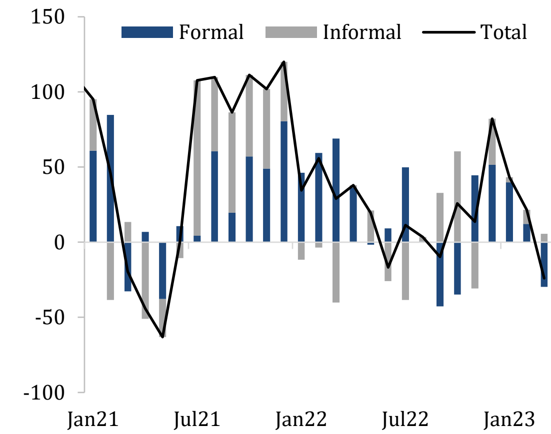
In the future, we expect unemployment to continue to rise, primarily on the grounds that lower economic activity will keep demand for labour and job creation weak. Moreover, there is a sharp increase in the minimum wage, which is being discussed in Congress and could imply real labour cost increases of more than 15%, well above the trend increase in productivity. Meanwhile, the labour force will continue to grow, so the unemployment rate could exceed 9% by mid-year.

Normalisation of the labour force accounts for half of the increase in unemployment



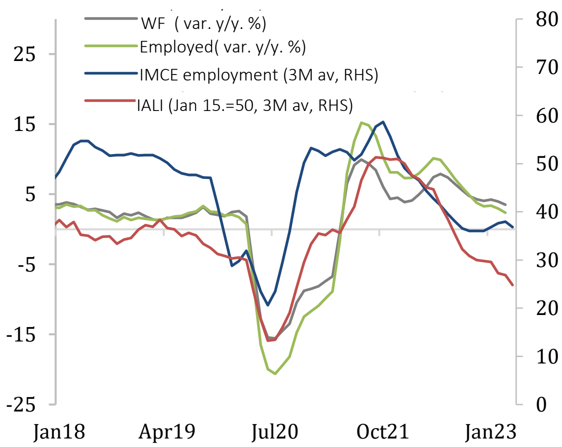
Source: National Institute of Statistics and Santander

Job losses take place in the formal sector



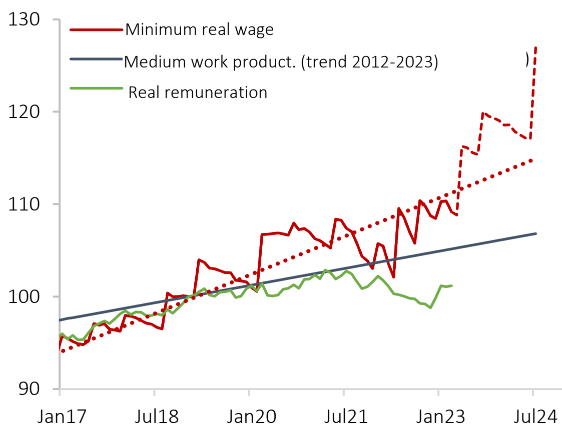
Source: National Institute of Statistics and Santander

Unemployment is set to rise as demand falls and labour force normalises



Source: National Institute of Statistics, ICARE, Central Bank and Santander

Minimum wage to grow more than its historical trend, real wages and average productivity



Source: National Institute of Statistics, Central Bank and Santander

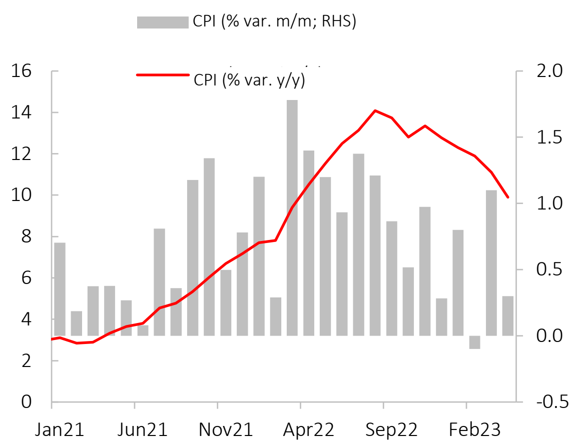
Inflation continues to recede

With a 0.3% change, the April CPI was somewhat lower than expected (Santander: 0.36%; Bloomberg: 0.4%), with the annual change continuing to moderate to below double digits (9.9%) for the first time this year. Meanwhile, the non-volatile CPI - the Central Bank's preferred measure of core inflation - was higher (0.7% MoM) but slowed year-on-year to 10.3% (10.8% in March), its lowest since July 2022.

Furthermore, there was a further decline in the inflation diffusion index (% of items in the basket that increase in price), which stood at 53%, thus reaching the middle of the recent historical range, also evidencing a decrease in inflationary pressures.

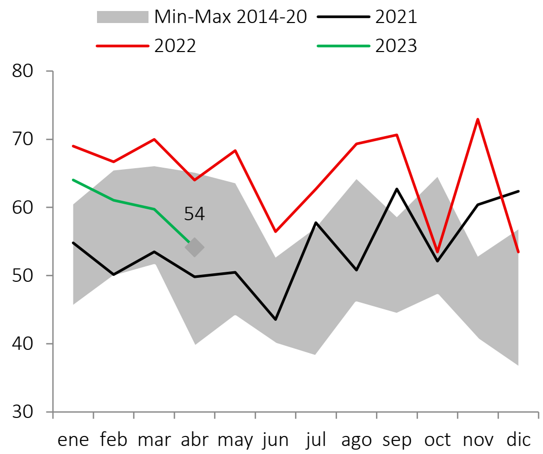
In the future, inflationary figures will continue to ease. International prices have continued to moderate, particularly for food, while the exchange rate has appreciated, and maritime freight rates have fallen to pre-pandemic levels. Furthermore, local economic activity is weak, and unemployment has risen, even if wages show some acceleration marginally. On the other hand, while indexation to past prices in several items of the basket will continue to drive some hikes, the fall in the year-on-year change in the CPI will cause the second-round effects to dissipate. Thus, we maintain our expectations of limited CPI increases in the coming months, which would end the year with a change of around 4.5%.

Inflation continues to decline



Source: National Institute of Statistics and Santander

Diffusion index of inflation shows a reduction in price pressures



Source: National Institute of Statistics and Santander

Risk premiums decline in a less uncertain environment

Local markets showed strong returns and reduced volatility for most of the month. This is due to a context of reduced economic and political uncertainty following the election of the Constitutional Council on May 7 and to figures such as inflation and activity that have continued their expected path of adjustment.

The local stock index IPSA is above 5,600 points, a level not seen since September 2022, accumulating a return of over 6% since the previous Monthly Economic Outlook (8.4% in dollar terms). While other markets in the region also showed gains, the IPSA is leading due, in part, to the recovery of some stocks with exposure to metals such as lithium.

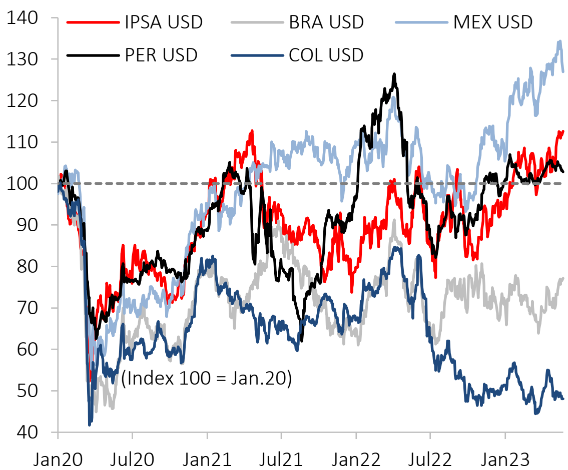
The exchange rate, meanwhile, maintained an appreciating trend, trading below Ch$785, mainly due to lower risk perceptions. This effect seems to have outweighed the depreciatory force suggested by the evolution of its fundamentals: on the one hand, a sharp fall in the price of copper (US$ 3.7 per pound) and, on the other, the strengthening of the global dollar (DXY: 103 points). More recently, this path has tended to reverse and has again approached the Ch$800 barrier but continues to exhibit a significant gap concerning its theoretical values.

In the future, we expect the exchange rate to continue to approach its equilibrium value, the copper price to halt its decline and return to its fundamentals, and the global dollar to weaken due to the fragile US economy. Thus, the parity would reach around Ch$810 - Ch$820 by the end of 2023. This level is somewhat lower than we expected in the previous Monthly Economic Outlook, reflecting the uncertainty improvement.

Nonetheless, a stronger slowdown in China accentuating declines in copper or evidence of greater activity resilience in the US, keeping financial conditions tight or local liquidity injection measures thriving, would set up a risk scenario that could further depreciate the currency.

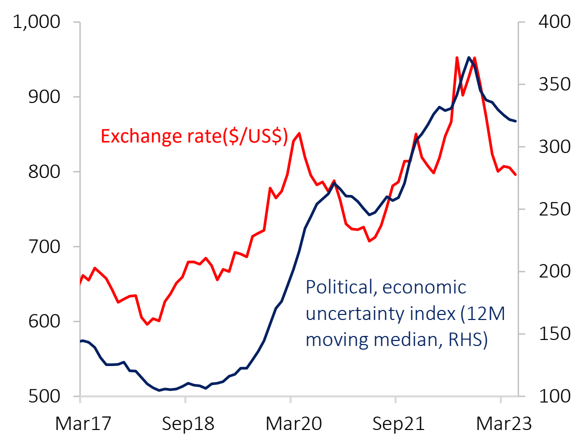
Finally, the bond market showed mixed movements. After rising for much of the month, nominal interest rates have recently reversed. The BTU 10-year reached 5.5%, rising 2 bps since the close of the previous report, in line with international rates and despite the significant reduction in the country risk premium (CDS 5y: 87 bps; -17 bps). On the other hand, real rates rose by over 30 bps (BTU10y: 2.1%), consistent with lower inflation levels.

Local stock market leads the region's earnings



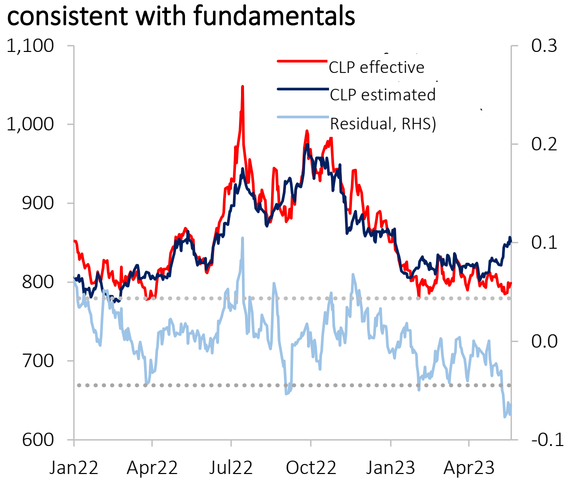
Source: Bloomberg and Santander.

Exchange rate appreciates on lower levels of uncertainty



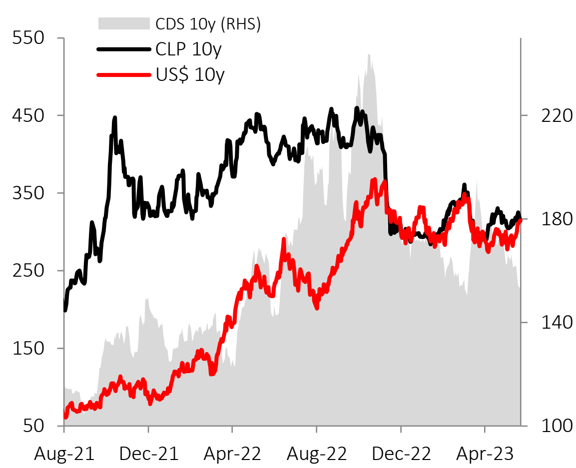
Source: Bloomberg and Santander.

Exchange rate appreciation falls out of value consistent with fundamentals



Source: Bloomberg, Central Bank and Santander

Interest rates remain relatively stable



Source: Bloomberg, Central Bank and Santander

Central Bank sticks with the latest Monetary Policy Report (IPoM) guide

At its May Monetary Policy Meeting (MPM), the Central Bank's Board decided to keep the reference rate unchanged at 11.25%, in line with market expectations. In their statement, they implied that both activity and inflation data have evolved in line with what was projected in the last IPoM. The Central Bank Board acknowledges that consumption has continued to adjust downwards, and that investment and the labour market are weak. Regarding inflation, it is noted that it has declined in line with expectations, while core inflation has also declined but less than the total inflation.

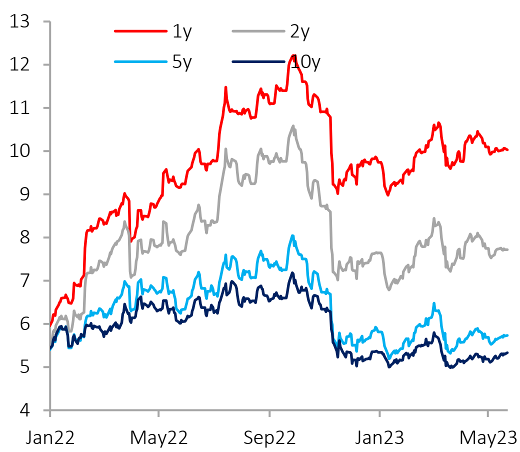
In this context, they reiterate their previous statement, noting that they will keep the MPR at 11.25% until the state of the macroeconomy indicates that the process of inflation convergence to the 3% target has been consolidated.

The next MPM, in mid-June, will have only one additional inflation and activity data (April Imacec) and will coincide with a new IPoM. By then, we do not expect major modifications to the Central Bank's main assessment.

One more CPI and Imacec data report will be released by the time of the July MPM. We believe that, by then, sufficient information will be available to conclude that the process of inflation convergence to the target has been consolidated. We estimate that the underlying component of the next two inflationary records will be below the figure estimated in the last IPoM, which should be acknowledged in the Council's assessment. Furthermore, economic activity is likely to continue to contract, while the unemployment rate is likely to rise beyond 9%. Thus, we maintain our assessment that we could see a first MPR cut of 50 bps as early as July and then a rise in cuts to end the year at around 7.5% and 8%. Local surveys suggest similar trends (Survey of Economic Expectations and Financial Opinion Survey).

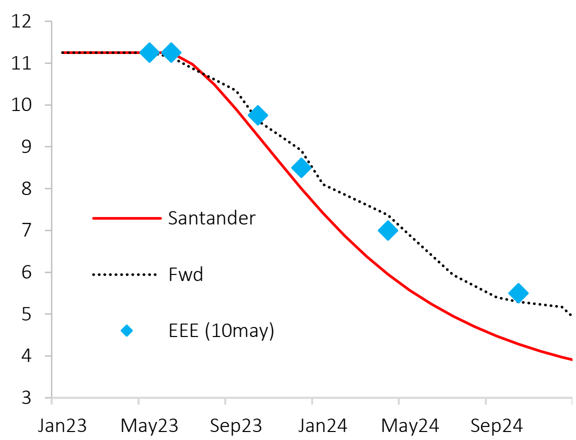
Nevertheless, the Central Bank has tended to be very cautious about monetary easing, so it is not unlikely that they will wait until September before they feel confident about making a policy shift, leading to a higher final rate. Moreover, this scenario seems to be implicit in market prices.

Swap rates rise, anticipating higher MPR by year-end



Source: Bloomberg and Santander.

Our baseline scenario assumes a first-rate cut in July



Source: Bloomberg and Santander.

Tax revenues suffer from the economic slowdown, and spending accelerates

Tax revenues fell by 5.8% in real terms in the first quarter of the year due to lower VAT revenues (-16.3%), which were fully offset by higher lithium revenues, resulting in a -0.7% year-on-year change in total revenues. On the other hand, spending increased by 5.5% in real terms in the same period, almost entirely explained by social security benefits (30% YoY) associated with higher spending for the PGU (Universal Guaranteed Pension). Overall, the quarter's surplus is 0.2% of GDP.

On the other hand, the Ministry of Finance released the Public Finances Report for the first quarter, where the projected growth for the year is corrected upwards to 0.3%, decreasing the estimated deficit (1.6% of GDP) and gross debt (38% of GDP). Furthermore, the report discloses the mechanism for the prudential adjustment of lithium revenues to calculate the cyclically adjusted balance, which consists of saving revenues above the average of the last four years as a percentage of GDP. This brings the estimated cyclically adjusted balance from -1.9% of GDP to -2.1% of GDP.

Finally, regarding the discussion on the minimum wage, the support that the government is committing to (SME subsidy, guaranteed minimum income adjustment and expansion of the family allowance) would be contained in the expenditure budgeted for this year but would imply higher spending for the coming years, which will have to be discussed in the respective budget laws. In addition, within the subsidies, the extension of the reduction of the first category tax for SMEs is proposed for income in 2023, which they estimate would imply a drop in tax revenues of 0.21% of GDP.

National Accounts	2017	2018	2019	2020	2021	2022	2023 P	2024 P
GDP (% real var. YoY)	1.4	4.0	0.8	-6.1	11.7	2.4	-0.25	2.5
Domestic demand (% real var. YoY)	2.9	5.0	1.0	-9.4	21.7	2.3	-5.3	3.2
Total consumption (% real var. YoY)	3.8	3.6	0.7	-6.6	19.3	3.1	-3.4	0.8
Private consumption (% real var. YoY)	3.6	3.8	0.7	-7.4	20.8	2.9	-5.1	0.9
Public consumption (% real var. YoY)	4.7	3.1	0.5	-3.5	13.8	4.1	4.0	0.4
Gross fixed capital formation (% real var. YoY))	-3.3	6.5	4.7	-10.8	15.7	2.8	-3.9	-0.9
Exports (% real var. YoY)	-1.0	4.9	-2.5	-0.9	-1.4	1.4	1.4	1.4
Imports (% real var. YoY)	4.5	8.6	-1.7	-12.3	31.8	0.9	-12.1	3.4
GDP (US$ billion)	276.5	296.0	278.9	254.9	316.5	304.5	335.7	352.7
GDP per capita (US$ thousand)	15.0	15.8	14.6	13.0	16.1	15.2	16.8	16.8
Unemployment (% as of December)	6.5	7.1	7.1	10.3	7.2	7.9	8.0	7.3
Population (million)	18.4	18.8	19.1	19.5	19.7	19.8	20.0	21.0

Payment Balance	2017	2018	2019	2020	2021	2022	2023 P	2023 P
Trade balance (US$ billion)	7.5	4.4	3.0	18.9	10.5	3.8	12.1	8.8
Exports (US$ billion)	68.9	74.8	68.8	74.0	94.8	98.5	96.9	97.3
Imports (US$ billion)	61.4	70.4	65.8	55.1	84.3	94.7	84.8	88.5
Current account (US$ billion)	-7.6	-13.3	-14.5	-5.0	-23.2	-27.1	-11.6	-10.5
Current account (% GDP)	-2.8	-4.6	-5.3	-1.9	-7.5	-9.0	-3.5	-3.0
Copper price (year average US$/lb)	2.8	3.0	2.7	2.8	4.2	3.9	3.9	4.0
WTI oil price (year average US$/bbl)	50.9	64.8	57.0	39.0	68.0	94.0	76	81

Money and Exchange Market	2017	2018	2019	2020	2021	2022	2023 P	2023 P
CPI Inflation (% var. YoY up to December)	2.3	2.6	3.0	3.0	7.2	12.6	4.5	3.0
CPI Inflation (% var. YoY average)	2.2	2.4	2.3	3.0	4.5	11.6	7.8	3.6
CPI Inflation excluding food and energy (IPC-SAE) (% var. YoY up to December)	1.9	2.3	2.5	2.6	6.4	8.6	5.7	2.8
CLP/US$ exchange rate (annual exercise)	615	696	745	711	852	875	820	830
CLP/US$ exchange rate (year average)	649	640	703	792	759	873	808	825
Monetary policy rate (% annual exercise)	2.50	2.75	1.75	0.50	4.00	11.25	7.75	4.25
Monetary policy rate (% year average)	2.7	2.5	2.5	0.8	1.2	8.6	10.5	5.5

Fiscal Policy	2017	2018	2019	2020	2021	2022	2023 P	2024 P
Public expenditure (% real var. YoY)	4.8	3.5	4.1	11.0	31.6	-24.0	0.6	2.7
Central Government balance (% GDP)	-2.8	-1.7	-2.9	-7.3	-7.7	1.3	-2.1	-2.5
Central Gov. gross Debt (US$ billion)	68.9	70.2	74.4	91.6	102.0	117.3	134.3	144.6

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