Markets report incipient recovery one year after the pandemic

Highlights

A significant decline in infections in developed countries and progress - albeit uneven - in the vaccination rollout means that the outlook for global activity recovery continues to improve.

In the U.S., commodity price hikes and a new fiscal stimulus package keep inflation fears alive. In response, long-term interest rates rise again and the dollar strengthens.

Copper prices reach levels last seen in a decade (US$ 4.3 a pound), boosted by favourable demand projections and a restricted supply. As inventories normalise, its value should fall back in the future.

January's Imacec (-3.1% YoY) surprised on the downside, but activity continued to recover and approached pre-pandemic levels. We will continue to see improvements in the economy during February, but in March, the activity level could contract again due to the new containment measures.

The labour market continues to lag with slow job creation. Converse to the activity level, there is still a relevant gap regarding the pre-pandemic situation, with about 1 million fewer jobs than a year ago.

After surprising on the upside in January, February's CPI (0.2%) was below expectations. Price pressures will remain contained in the future, but the annual change in the CPI will temporarily climb to more than 4% by mid-year due to a low comparison base.

Market rates are betting on this year's start of the MPR rising much earlier than previously expected. Nevertheless, we estimate that the ample slack in the economy and risks to the recovery will lead the Central Bank to keep the MPR at its minimum of 0.5% until at least the middle of next year.

High copper prices open debate on the use given to resources that the Treasury collects from mining activity. An early review of the reference price would help assess how persistently high the current value will be and how much fiscal space there is to finance permanent expenditures responsibly.

CLAUDIO SOTO
Chief Economist
claudio.soto.gamboa@santander.cl

LORENA PALOMEQUE
Economist
lorena.palomeque@santander.cl

CARMEN GLORIA SILVA
Economist
carmengloria.silva@santander.cl

MIGUEL SANTANA
Economist
miguelpatricio.santana@santander.cl

FABIÁN SEPÚLVEDA
Economist
fabian.sepulveda@santander.cl

Recovery outlook raises long-term interest rates and fuels global inflationary expectations

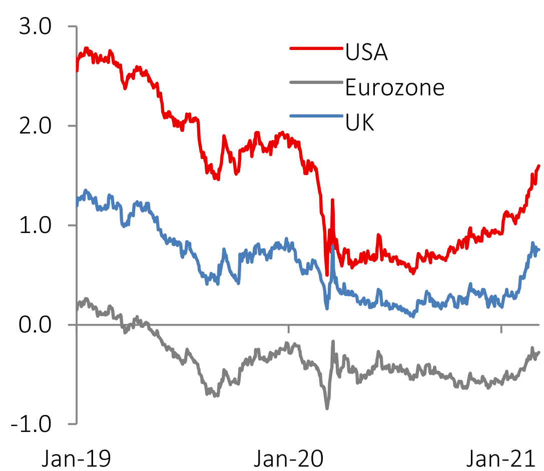
One year into the pandemic, there are still encouraging signs regarding its evolution in important regions of the world. Containment measures implemented in recent months led to further declines in infections globally during February, while the vaccination rollout continued to progress in advanced and some emerging countries. About 4% of the world's population has received at least one dose to date, and there are countries where a significant fraction already has achieved degrees of immunity, including Israel, the U.K., the U.S. and Chile.

In light of this scenario, global markets have remained optimistic despite some turmoil. Improvements in the healthcare situation, coupled with a new fiscal stimulus program in the U.S., have boosted commodity prices and fuelled inflation expectations, causing long-term interest rates to continue rising in major economies and leading to a significant steepening of yield curves. For example, the 10-year U.S. Treasury bond rates rose more than 40 basis points in the month and reached 1.6% at the beginning of March, their highest value in a year. The dollar, meanwhile, appreciated nearly 2% globally.

In this context, Treasury Secretary Janet Yellen dismissed fears of a possible inflationary de-anchoring, while Fed Chairman Jerome Powell ratified on several occasions that the monetary policy would remain expansionary. Nevertheless, the markets paid no heed.

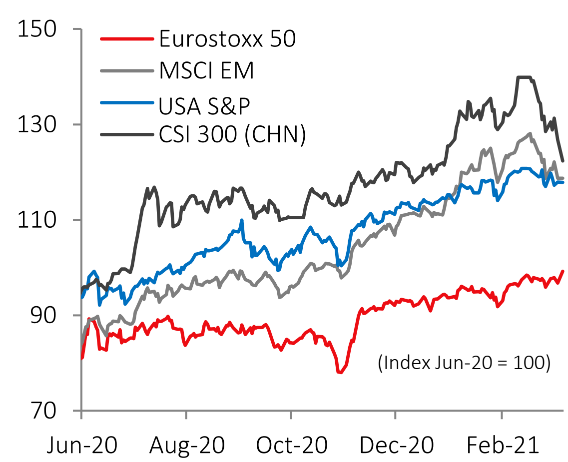
The rate hike has caused stock market indexes to retreat, even though after the approval of the new fiscal package at this report's conclusion, several of them rebounded. The MSCI Global fell nearly 3% during the month, with declines in emerging markets, particularly China. The S&P 500 contracted by 2%, while European stock exchanges performed somewhat better and rose by around 2%.

Long rates continued to rise strongly in the month



Source: Reuters and Santander

Stock markets retreat on prospects of a withdrawal of liquidity



Source: Reuters and Santander

As of the date this report was issued, the U.S. House of Representatives was preparing to ratify the new US$ 1,900 billion stimulus package after tense negotiations in the Senate. This includes a new direct one-off injection to households of up to US$ 1,400, along with raising emergency unemployment benefits from US$ 300 to US$ 400 per week extended to August, and assisting educational institutions and state and local governments.

The "Beige Book" which measures business perception released in February, confirmed greater optimism and suggested the gradual improvement of the labour market despite the slow pace of recovery. Indeed, unemployment insurance claims have shown declines in recent weeks, while job creation during February far exceeded expectations (379,000 vs 200,000 expected). Furthermore, the Manufacturing ISM reached its highest level since 2004, at 60.8, and the PMI reaffirmed its optimistic outlook.

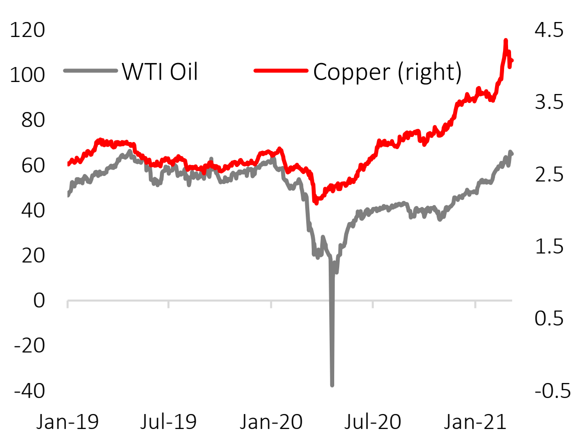
In Europe, zero inflationary surprises and lower unemployment (8.1% vs 8.3% expected) partly offset the retail sector's negative figures, which contracted 6.4% YoY in January. February PMIs came in slightly above expectations, but the services component is still on negative grounds.

In China, the latest PMI figures surprised on the downside, bordering the threshold of pessimism. Purchase orders in the services sector fell for the third consecutive month. Nevertheless, external sector data surprised on the upside, especially exports, which registered an annual increase of around 60%.

Commodity prices rose sharply again in the month. The value of copper increased by 6% and reached US$ 4.3 per pound by the end of February, its highest level since 2011. There have been some setbacks due to worsening data from China and selling by speculative investors recently. Even so, the price has remained above the barrier of US$4 per pound. Behind these substantial increase is the renewed optimism of the global economic recovery and a still contained supply. Abundant market liquidity benefiting metals as a store of value has also played a role. In this context, a discussion has arisen as to whether we are experiencing a new supercycle such as the one observed in the mid-2000s. Nonetheless, several elements point to the fact that prices would not remain at such high levels on this occasion, tending to correct themselves.

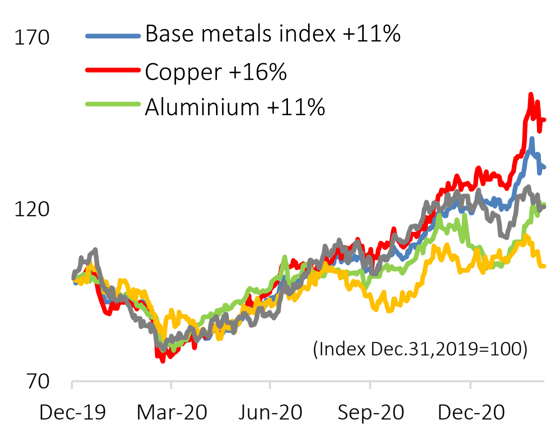
Meanwhile, the oil price rose sharply, particularly in the last week, following the unexpected decision by OPEC - and a group of other producers, including Russia - to not increase April's production, as agreed on early January. Consequently, oil prices climbed to their highest levels since October 2018, accumulating a 34% increase in 2021 so far.

Commodity prices rise sharply



Source: Bloomberg and Santander

Copper value has been driven by specific factors, including a restricted supply

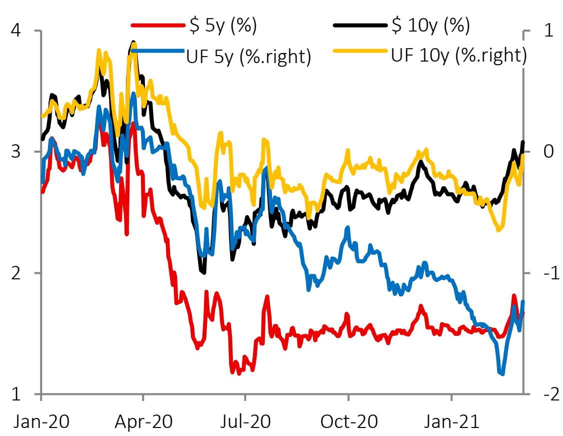


Source: Bloomberg and Santander

Local financial prices tend to reverse

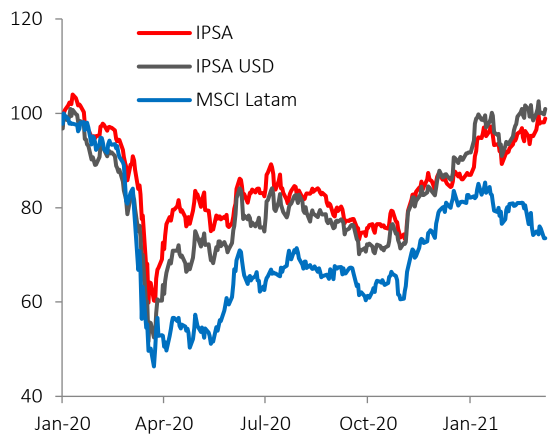
Like the major economies, the local fixed-income market showed a generalised increase in interest rates. The steepest increase was in nominal 10-year rates, which rose above 3%, the highest since April 2020. In turn, real rates reversed last month's declines after January's inflationary surprise, while the stock market continued with favourable returns. The local stock index IPSA rose around 3.3% in the month and has remained at approximately 4,700 points during March, a level not seen since January 2020 prior to the pandemic's most acute phase. These figures reflect the optimism regarding the vaccination rollout's rapid progress and the companies' positive quarterly results by the end of 2020.

As in the major economies, local long rates climb



Source: RiskAmerica and Santander

Local stock market decouples from global trends and maintains its dynamism



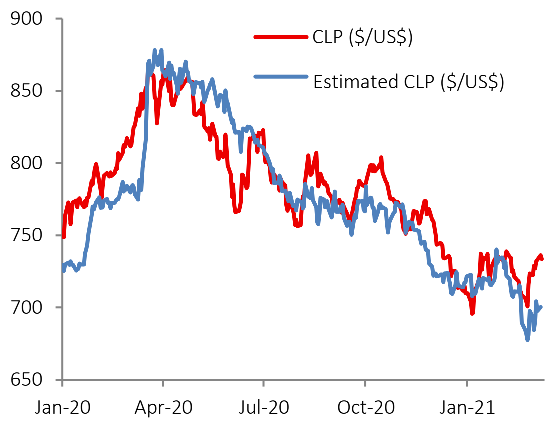
Source: Reuters and Santander

The exchange rate, which had experienced a marked upward trajectory during most of February driven by the copper price rally, almost wholly reversed its gains at the close of this report. Therefore, after reaching a low nearing the $700 barrier, it rebounded sharply - returning to levels more in line with its fundamentals - and in just one week accumulated an increase of $30, in a context of moderation in the copper hike and a rise in international interest rates that has strengthened the U.S. currency at a global level. It should be noted that this depreciation occurs even though the Ministry of Finance has upheld the sale of dollars, estimating to auction a total amount of up to US$ 2 billion by March, with a daily maximum of US$ 200 million.

In the future, we maintain our projection of parity around $760 by the year's end, considering a scenario of continued favourable trade terms, but at slightly lower levels than the current ones. The evolution of the healthcare situation and the constituent process's development could add volatility to the Peso's trajectory.

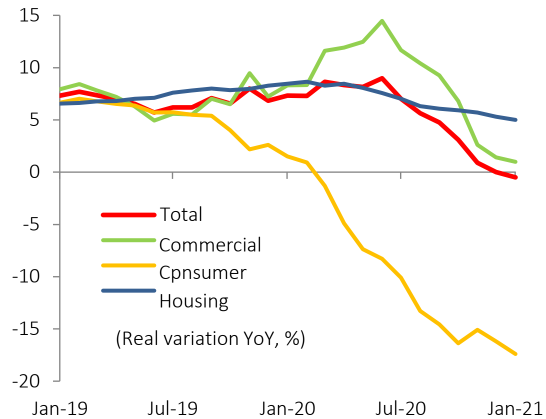
According to preliminary figures, lending activity decreased in January 2021 for the first time since the subprime crisis (-0.5%) and would have maintained similar rates during February. Commercial loans -which represent 60% of lending activity- showed further deceleration, reflecting companies' slow investment. In the future, these could receive a new boost once the state-guaranteed financing program FOGAPE Reactiva is implemented, which extends both the term of the loans -until 2028- and the use of these operations in financing investments, working capital and refinancing of other debts. The above was coupled to the initialisation of the Central Bank's FCIC3 program in March, which will allow banks to access a line of funding of up to US$10 billion over the next six months, conditional on credit behaviour, thus helping to alleviate the credit needs of small and medium-sized companies specifically.

The exchange rate depreciates despite continued high copper prices



Source: Reuters and Santander

Banking loans slow down growth rate due to slowdown in commercial loans



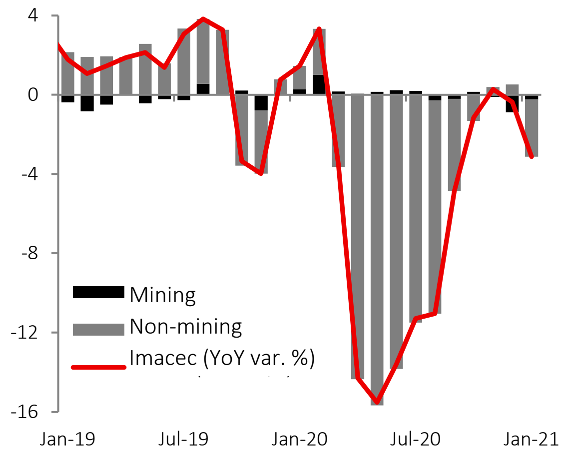
Source: CMF and Santander

January Imacec surprised downwards, but activity continues on a recovery path

The annual variation of the year's first Imacec (-3.1%) was below the market consensus (Bloomberg: -1.3%; Santander: -2.5%), affected by the weakness still persisting in services (-6.3% YoY) and the "other goods" component (-3.4% YoY) where construction is relevant. On the other hand, trade maintained a high dynamism (+8.8% YoY), driven by the impact of the second withdrawal of pension funds. In non-seasonally adjusted terms, activity expanded significantly over December (1.3% m/m) with a strong recovery in services and mining. In the latter case, despite the significant recovery after the weak December record (+7.1% m/m), activity still remains below its historical highs. Therefore, there is room - albeit restricted - for a recovery in response to the high copper price.

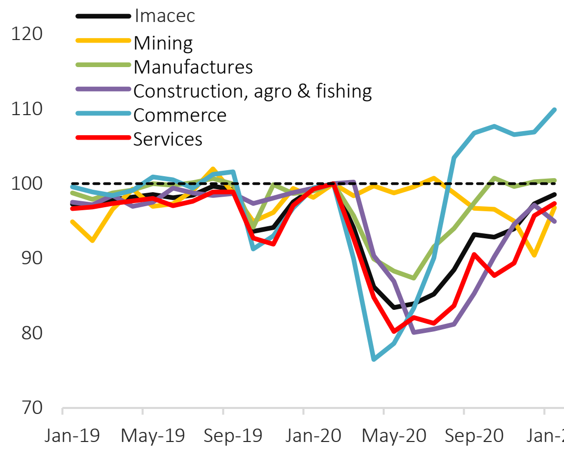
The seasonal effect was particularly relevant in the month, even considering two fewer working days compared to the previous year. Thus, although the annual change was lower than expected, the monthly increase was high and points to a significant recovery in the activity level that leaves us very close to the pre-pandemic peak of February 2020 (only 1.3% difference). Overall, the seasonal factor is a statistical construct subject to volatility and subsequent revisions. For this reason, a revision of the activity's profile cannot be ruled out in the following National Accounts review, to be published on March 18th.

January's Imacec showed an annual contraction, somewhat larger than our estimate ...



Source: BCCh and Santander

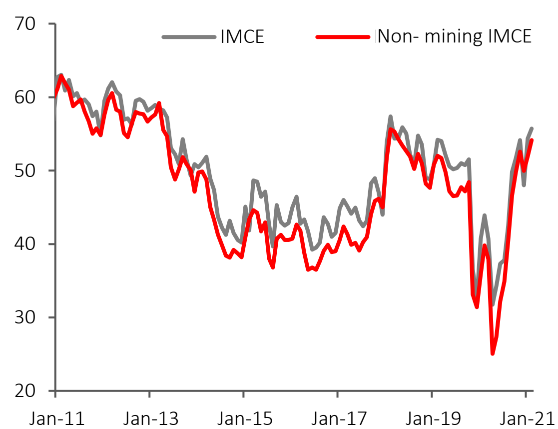
...nevertheless, the level of activity is close to pre-pandemic levels, with a very dynamic trade.



Note: Non- seasonally adjusted series (Feb-20 = 100)
Source: BCCh and Santander

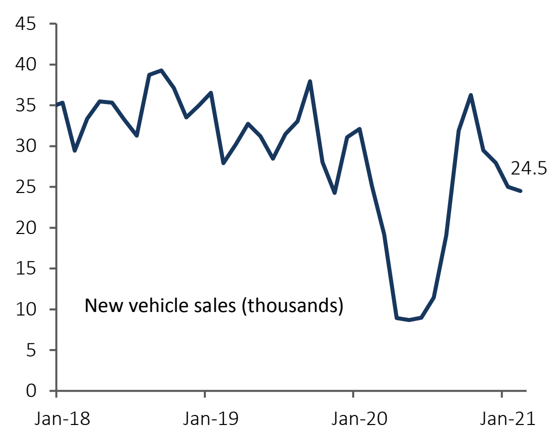
In February, there was a temporary confinement easing, with confidence indicators showing improvements. In particular, the Monthly Indicator of Business Confidence (IMCE) excluding mining reached its highest level since April 2018, even though the perception of demand retreated marginally at the sector level. On the other hand, trade may start to moderate as the impact of the pension withdrawal dissipates. Considering the high bases of comparison - February 2020 is the month in which national activity reached its last peak - we estimate that the Imacec will see an annual contraction ranging 1% and 2%.

Non-mining IMCE reached its highest level in almost three years



Source: BCCh and Santander

Car sales in February were similar to the previous year's level

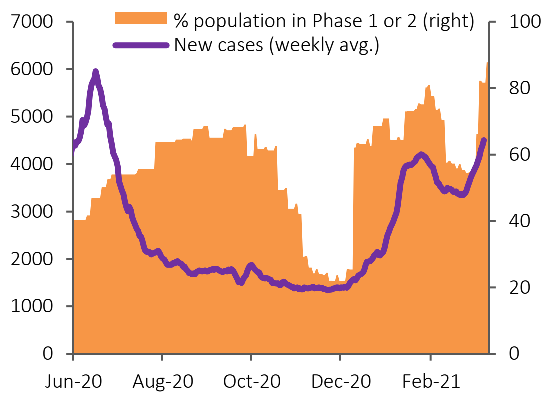


Source: BCCh and Santander

Covid cases nationwide have increased to over 5,000 per day, a level not seen since June. Consequently, social distancing measures have intensified in the Paso a Paso Plan, and 20% of the population was in quarantine and 68% in Phase 2 as of the date this report was issued. This will involve a setback in the activity's recovery process, especially in services and construction, with March's Imacec also having a negative annual variation.

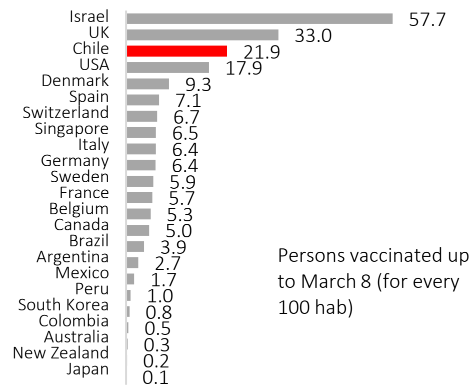
Meanwhile, the vaccination rollout has made steady progress in the country, with more than 4.2 million people vaccinated, 860,000 of whom have received two doses. This makes Chile one of the countries with the highest vaccination rates, with further supply commitments the government has made with various laboratories suggesting this situation will continue.

Most recently, the number of cases has increased again, leading to further confinement measures



Source: Ministry of Health and Santander

Chile ranks among the countries with the highest vaccination rates



Source: Our World in Data and Santander

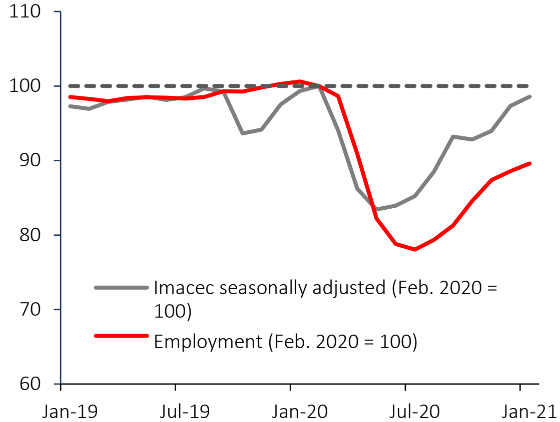
Considering this background, the negative figures for February and March do not change our baseline scenario for the year, as we already anticipated a possible deterioration of the healthcare situation. Thus, we maintain our growth projection for the year in the range of 5.5%-6.5%. We will review these figures once the official 2020 National Accounts revision is known. Beyond this, the economy remains subject to significant risks, and the recovery is fragile.

Labour market recovery continues but at a slow pace

The growth of job creation continued at a slow pace during January, with only 69,000 additional jobs, primarily informal. Thus, employment has remained well below pre-pandemic levels, with about 1 million fewer employed people than twelve months ago. This contrasts with the activity levels, which has practically recovered what was lost during 2020 according to the latest Imacec. This phenomenon has occurred in other parts of the world and points to pandemic-driven structural changes in the market that will persistently impact its dynamics.

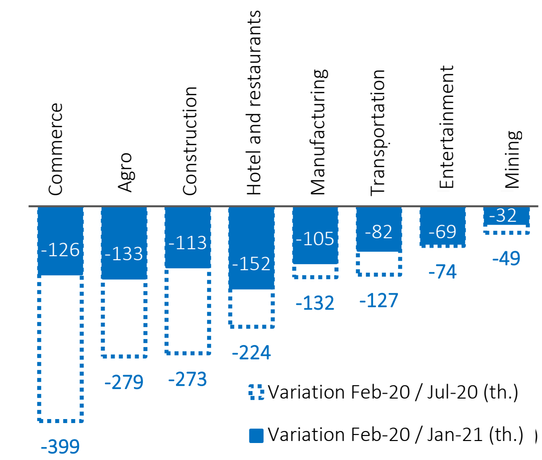
Employment absorption in recent months has been driven by trade, agriculture and construction, which have regained much of what was lost at the pandemic's peak. In contrast, the sectors hardest hit by social distancing measures (hotels and restaurants, transport and entertainment) have only recovered a fraction. Other sectors, such as mining, have not suffered significant impacts on employment.

Employment has recovered slower than activity



Source: INE and Santander

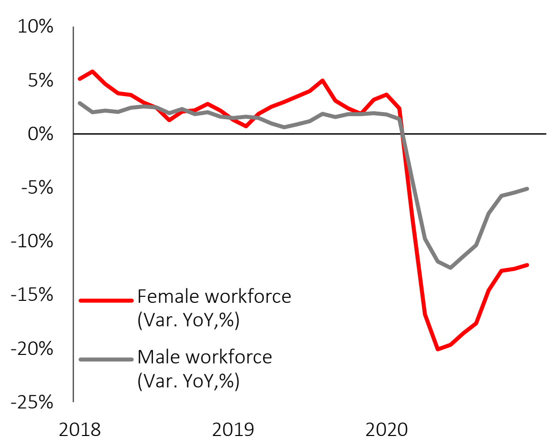
Several sectors are still lagging behind



Source: INE and Santander

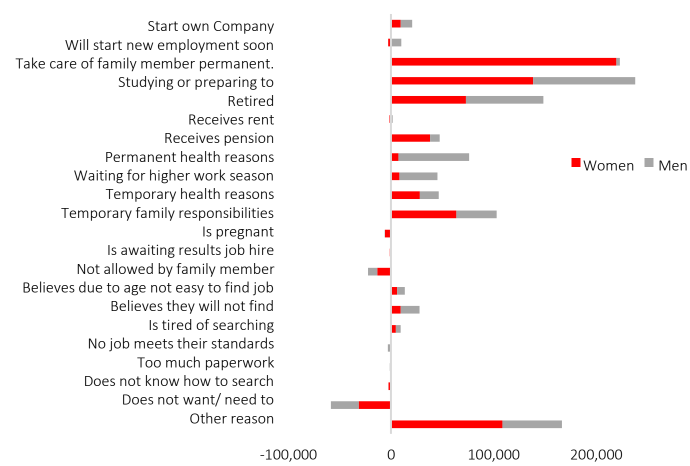
The labour force has also been restoring at a slow pace. Most affected by the pandemic have been women, whose participation rate fell from 53% to 41% in the mid-2020s, only partially recovering recently (46%). The recovery has been somewhat faster for men but has lost momentum in recent records. According to National Institute of Statistics (INE) data, the main reasons for the participation decline were family responsibilities and health reasons. The number of people who report deferring job-searching to study has also risen.

Women's labour force participation has declined significantly.



Source: INE and Santander

Family responsibilities among the main reasons for not looking for a job

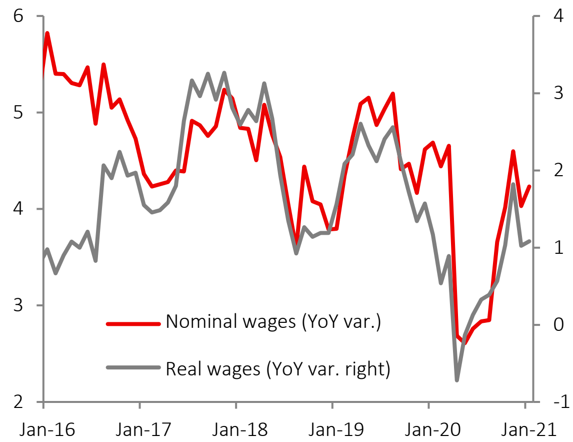


Source: INE and Santander

The unemployment rate has fallen but remains high

Wages have rebounded due to composition effects

Source: INE and Santander



Source: INE and Santander

Despite the slow job creation, the low labour participation has meant that the unemployment rate continues to fall, although it remains high (10.2%). On the other hand, wages have regained momentum after the pandemic's initial impact (+1.1% nominal in January; 1.1% YoY real). This could be explained by a contained labour supply in some specific sectors, where demand for jobs has accelerated. Nevertheless, it is important to note that the pay figures reflect the average situation of companies in the formal sector. Changes in the composition of the type of jobs within companies or in the hours worked may be affecting household averages and final incomes. In fact, the same pay survey shows that total hours per worker have fallen by 2.4% in the last twelve months, affected by a 21% drop in overtime.

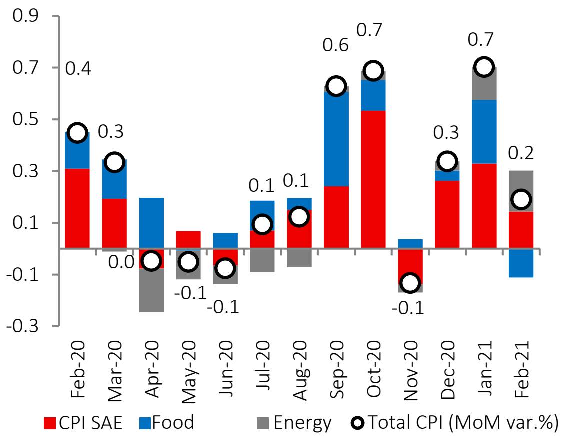
January's inflation surprise partially reverses in February

February's CPI (0.2%) was below expectations (Santander 0.4%, Bloomberg 0.4%, inflation insurance 0.5%), negatively impacted by the food division (-0.5%) and recording the first fall since May, with declines in dairy, fruit and vegetable prices. Additionally, the clothing component expanded by 1.3% monthly, below its usual seasonal patterns reflecting seasonal changes. Inflation thus fell back to 2.8% (vs 3.1% in January), again below target.

The Core CPI, which excludes food and energy, also rose 0.2%, in line with recent monthly records, and its annual variation retreated to 2.4%. Meanwhile, the inflation diffusion index (percentage of products that increased in price) was 50.2, at the bottom of February's historical range. Therefore, underlying inflationary pressures remain contained despite the volatile components, reflecting the slack in the economy.

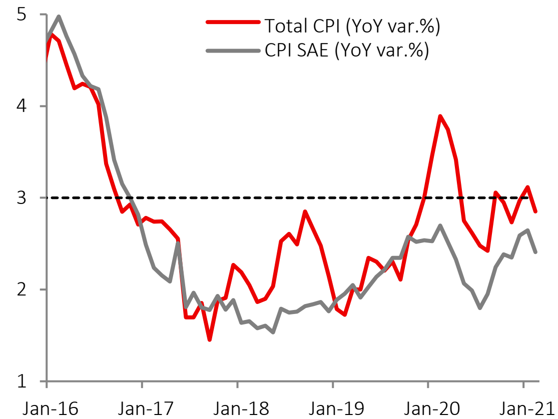
In coming months, if the impulse to consumption and prices from the second pension withdrawal - which was particularly important for January's high inflation- dissipates and the exchange rate remains relatively appreciated, we expect monthly changes in the core CPI to remain restricted, reflecting the gaps in the economy and a still weak labour market. On the other hand, recent oil price hikes will pressure local gasoline prices, which will rise systematically for at least a couple of months. Nonetheless, by mid-year, due to the low bases of comparison, inflation will rise above target and could temporarily approach 4%, concluding the year somewhat above target.

In contrast to previous months, food prices fell sharply.



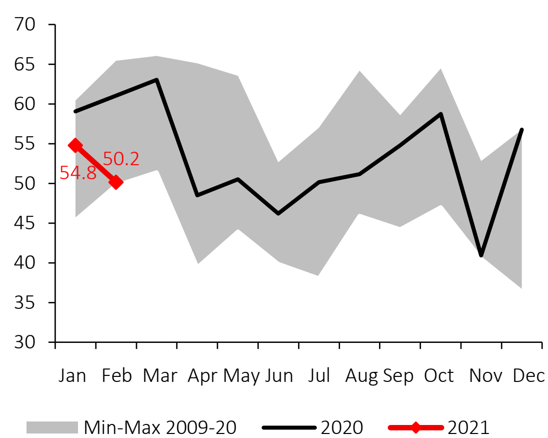
Source: INE and Santander
Note: CPI SAE = CPI sans food and energy

Annual CPI returns to figures below 3%.



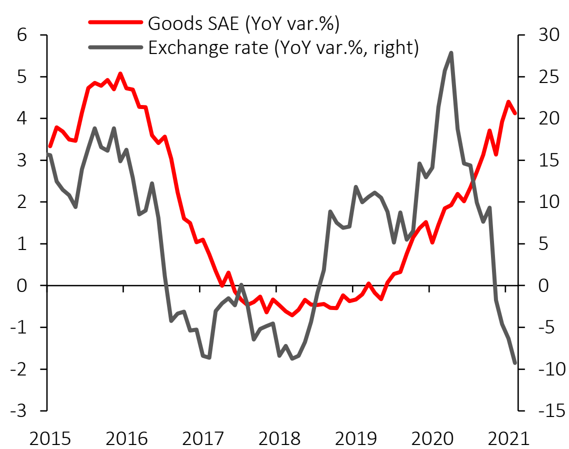
Source: INE and Santander

Inflationary diffusion is at the bottom of the historical range



Source: INE and Santander

Exchange rate appreciation is not yet reflected in the price dynamics of goods.



Source: INE and Santander

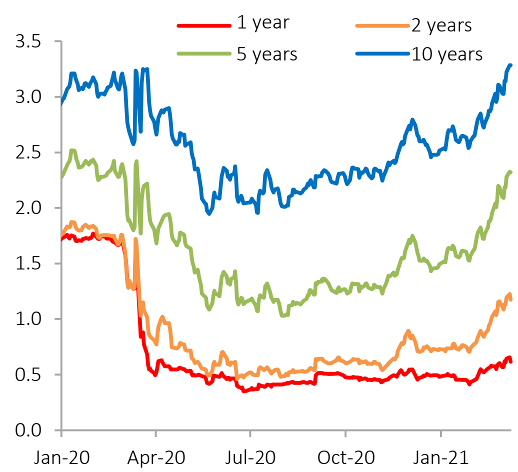
Monetary policy to remain expansionary in order to close capacity gaps

Medium-term swap rates have risen significantly since our last report, by up to 50 basis points in the case of the five and 10-year rates, and implicitly point to the start of monetary policy normalisation in the fourth quarter of this year, much earlier than what was previously expected and what the Central Bank itself indicated in its latest Monetary Policy Report (IPoM).

This follows after a significant surprise in January's CPI, which was partly reversed in February, upward revisions in medium-term inflation expectations, and an improved outlook for both the domestic and global economy. Indeed, local rate movements have replicated the generalised increases in long-term international rates.

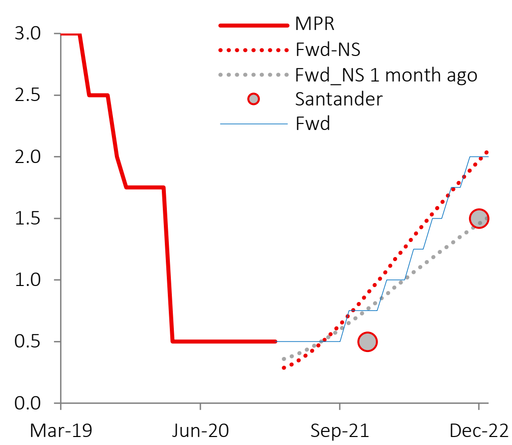
Notwithstanding the above, we maintain our view that increases to the Monetary Policy Rate (MPR) will not occur this year, but only in the second half of 2022. On the one hand, we expect inflation pressures to moderate in the coming months due to large gaps in the economy and a still weak labour market. On the other hand, risks to the recovery remain high, as discussed above. Finally, given the increased leverage of firms - which was necessary to weather the pandemic's toughest period - the normalisation process will have to be particularly careful not to generate financial disruption. Our view is similar to that of the latest Survey of Economic Expectations, which forecasts the MPR to be at 0.5% for the next 11 months and then start a trajectory of gradual increases.

Swap rates continue to trend upwards, driven by domestic and external factors



Source: Reuters and Santander

Policy rate to remain at its technical minimum through 2021



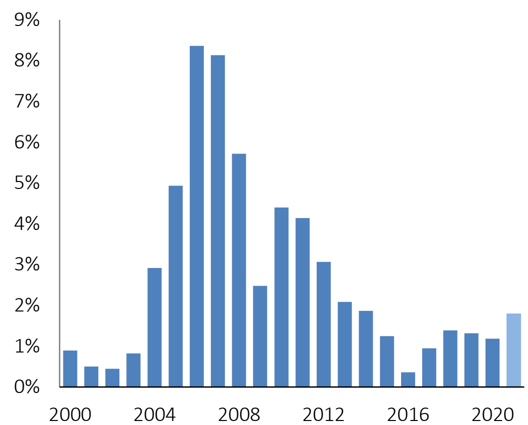
Source: RiskAmerica and Santander

High copper price opens debate on mining's contribution to the Treasury

High copper prices during the year have raised intense debate regarding mining's contributions to the Treasury. The discussion has revolved around three aspects. First, there is the impact quantification of higher copper prices on fiscal revenues. According to the latest estimates of the Budget Directorate, each additional cent in its value would deliver US$20 million to the fiscal coffers (Box 2, IFP 2019Q2). Nevertheless, our estimates and those of other market participants point to higher figures, ranging from just over US$30 million in the first year to US$50 million in the second year if prices are maintained (Technical note: Copper price and tax revenues). Recently, the Dipres updated its revenue projections for 2021, considering an average copper value of US$ 3.35 per pound (US$ 2.88 in the Budget Law), which would bring revenues to US$ 4.4 billion. On the other hand, according to our estimates and with upholding the assumption for the copper price, the revenue could reach around US$ 5 billion. If we also consider that the average price could probably be higher, the fiscal deficit this year would be below 3% of GDP.

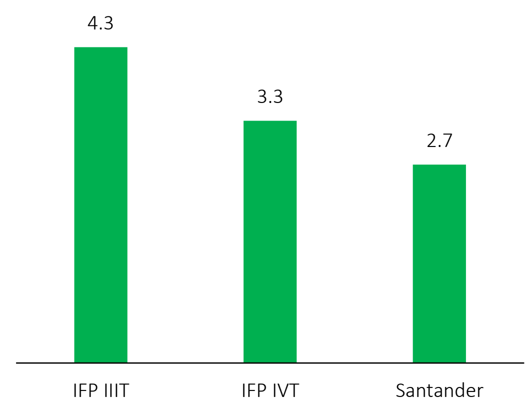
A second dimension of the debate is whether the tax burden on mining is appropriate. E.Y.'s recent report suggests that this sector's tax rate is around 43%, but analysts and tax experts have argued that the number could be lower due to adjustments in the tax base. Overall, mining's contribution to fiscal revenues has been in the order of 1% to 1.5% of GDP in recent years, with a relatively low copper price. This figure is not very different from other mining countries where the share of metal mining is similar, such as Australia. Beyond this, a discussion on this sector's taxation must consider several elements and consider long-term prospects.

Mining revenues have been just over 1% of GDP in recent years.



Source: Dipres, Banco Central and Santander

We assess that the fiscal deficit will close below 3% in 2021.



IFP: Public Finance Report third and fourth quarter
Source: Dipres and Santander

The third element has been the debate on whether and how to spend the higher revenues generated by a higher copper price this year. On the one hand, it has been proposed that these resources could be used to support families, in a context where the labour market is lagging. On the other hand, the government has just announced modifications to the project that reforms the Pension System, where the contributions to the 'solidarity pillar' are increased. These modifications will imply an additional cost of US$ 1.3 billion this year and US$ 4.5 billion in the scheme (including measures already taken since the end of 2019). This year's funding will include the use of increased resources from mining.

Regarding this last point, it should be recalled that since 2001, Chile's fiscal policy has been guided by the structural balance rule, where the Treasury's long-term revenues define the expenditure framework. This rule, which has been widely praised, is based on the principle that permanent revenues must finance permanent expenditures. In the case of copper, rather than the resources generated by one-off changes, the important ones are those associated with persistent changes. Given the above, it will be necessary to determine whether we are facing transitory or permanent changes in the price of the metal to make progress in the discussion, for which the contribution of the Consultative Committee on the Reference Price of Copper - scheduled to meet on July 26th - is particularly relevant.

Macroeconomic projections

National Accounts	2014	2015	2016	2017	2018	2019	2020 E	2021 P	2022 P
GDP (real var. % YoY)	1.8	2.3	1.7	1.2	3.9	1.1	-6.0	5.5/6.5	3.0/4.0
Internal demand (real var. % YoY)	-0.5	2.5	1.8	2.9	4.7	1.0	-9.1	8.0	5.0
Total consumption (real var. % YoY)	2.9	2.6	3.5	3.6	3.8	2.9	-7.3	7.3	4.0
Private consumption (real var. % YoY)	2.7	2.1	2.7	3.4	3.7	1.1	-8.4	7.5	4.2
Public consumption (real var. % YoY)	3.8	4.8	7.2	4.6	4.3	-0.3	-2.3	6.5	3.0
Gross fixed capital formation. (real var. % YoY)	-4.8	-0.3	-1.3	-3.1	4.8	4.2	-13.0	10.0	7.0
Exports (real var. % YoY)	0.3	-1.7	0.5	-1.5	5.0	-2.3	-2.0	2.0	2.8
Imports (real var. % YoY)	-6.5	-1.1	0.9	4.6	7.9	-2.3	-13.0	8.0	8.6
GDP (US$ billions)	260.6	244.3	250.6	277.1	298.9	282.7	255	300	307
GDP per capita (US$ thousands)	14.6	13.6	13.8	15.0	15.9	14.8	13.0	15.3	15.5
Population (millions)	17.8	18.0	18.2	18.4	18.8	19.1	19.5	19.7	19.7

Note: The closing of the 2020 National Accounts will be published on March 18th by the Central Bank.

Balance of Payments	2014	2015	2016	2017	2018	2019	2020 E	2021 P	2022 P
Trade balance (US$ billions)	6.5	3.4	4.9	7.4	4.6	4.2	16.8	17.5	10.0
Exports (US$ billions)	75.1	62.0	60.7	68.8	75.2	69.9	71.7	80.0	78.5
Imports (US$ billions)	68.6	58.6	55.9	61.4	70.6	65.7	54.9	63.5	68.5
Current account (US$ billions)	-5.2	-5.7	-5.0	-6.4	-10.6	-10.9	2.5	-1.7	-6.5
Current account (GDP%)	-2.0	-2.4	-2.0	-2.3	-3.6	-3.9	1.0	-0.6	-2.1
Price of copper (annual average, US$/lbs.)	3.11	2.50	2.21	2.80	2.96	2.72	2.80	3.4	3.1
WTI oil price (annual average US$/bbl.)	93.1	48.7	43.2	50.9	64.8	57.0	39.0	50	55

Money and Exchange Market	2014	2015	2016	2017	2018	2019	2020	2021 P	2022 P
CPI Inflation (var. YoY, % by December)	4.6	4.4	2.7	2.3	2.6	3.0	3.0	3.3	3.0
CPI Inflation (var. YoY, average %)	4.7	4.3	3.8	2.2	2.4	2.3	3.0	3.6	2.8
CPI sans food and fuel inflation (IPC-SAE) (var. YoY, % by December)	4.3	4.7	2.8	1.9	2.3	2.5	2.6	2.2	2.6
CLP/US$ exchange rate (year's exercise)	607	707	667	615	696	745	711	760	770
CLP/US$ exchange rate (year average)	570	654	677	649	640	703	792	735	765
Monetary policy rate (year's exercise, %)	3.00	3.50	3.50	2.50	2.75	1.75	0.5	0.5	1.5
Monetary policy rate (%, year average)	3.75	3.06	3.5	2.7	2.52	2.48	0.8	0.5	0.8

Fiscal Policy	2014	2015	2016	2017	2018	2019	2020	2021 P	2022 P
Public expenditure (real var. % YoY)	6.4	7.4	3.8	4.8	3.5	4.1	11.0	0.5	2.5
Central Government balance (% GDP)	-1.6	-2.2	-2.7	-2.8	-1.6	-2.8	-7.4	-2.7	-3.5
Central Gov. gross debt (US$ billions)	36.6	39.0	53.4	68.9	70.2	74.4	91.6	95.0	105.0

Source: BCCh, INE and Santander

CONTACT

(56 2) 2320 1021
Access to our Reports at:

https://banco.santander.cl/estudios