Santander

Inflation is relentless

The global slowdown in financial conditions, the lockdowns in China and the ongoing war in Ukraine have depressed markets and threatened global growth.

Highlights

- **Global inflation pressures remain high**. The extension of Ukraine's conflict beyond expectations has kept commodity prices up, while severe lockdowns in China have led to further disruptions in supply chains. This has been compounded by the global strengthening of the dollar, which has raised dollar-denominated prices.
- **Financial conditions are tightening.** The rate-hiking process of the Fed –and that of the central banks of several leading economies– has increased long-term rates, strengthened the dollar and reduced liquidity, which has caused stock markets to fall in general, with risk aversion also on the rise.
- **Local activity rebounded temporarily in March, boosted by consumption and inventory restocking.** Preliminary figures for April show a further decline. The contractionary nature of fiscal and monetary policies, the political uncertainty and the external scenario will cause the GDP to slow down and close 2022 with a 1.5% growth.
- **Job creation has lost momentum in recent months**. Although there has been a significant recovery in employment, there is still a gap between actual and trend data. Demand for labour seems to be moderating, and real wages declined significantly due to the inflationary shock.
- **The high CPI (1.4%) in April was surprising, causing inflation to reach its highest level in almost 30 years.** Beyond the external pressures, second-round effects have become evident in a context where liquidity is still high. As a result, inflation will continue rising in the short term and could reach 12% mid-year before starting to relent.
- **The Central Bank again sharply raised its rate to 8.25%.** While the hiking process is likely to continue, the cycle should be close to ending with a Monetary Policy Rate (MPR) between 9% and 9.5% mid-year. By the end of 2022, as inflation shows signs of easing, the Council could lower the policy rate.
- **There is restricted room for fiscal policy.** In its latest Public Finance Report, the government announced its target of reducing the structural deficit by 0.75% of GDP per year for the next four years. If met, gross debt will continue to rise and stabilise somewhat below 45% of GDP. The target is ambitious and leaves very limited fiscal space for expenditure growth in the coming years.

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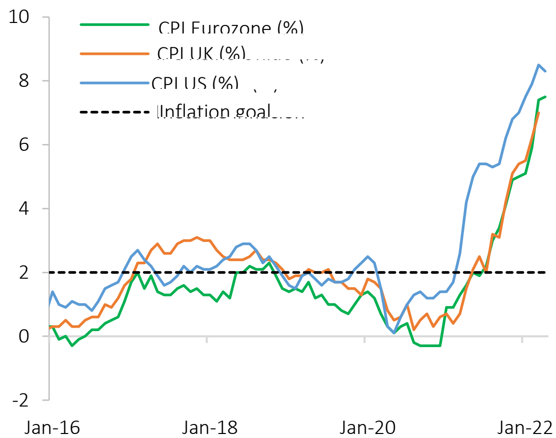
Withdrawal of monetary stimulus leads to tighter global financial conditions

The past few weeks have been marked by high global inflation and tightening global financial conditions, causing substantial rises in long-term interest rates and strengthening the dollar. All this is in a context of high uncertainty and new inflationary risks, both from the prolongation of the war in Ukraine beyond what was expected and from the confinement measures in China, which have once again strained supply chains.

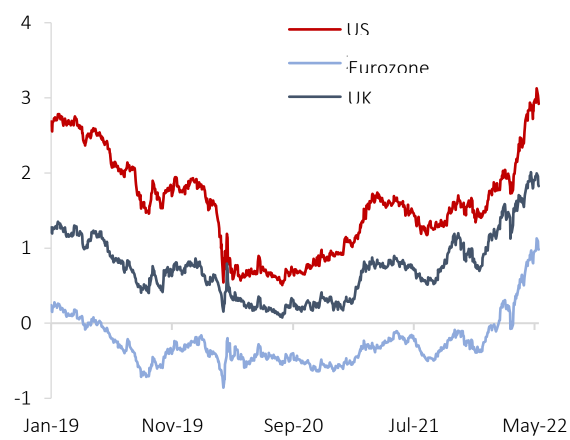
High inflation (US: 8.3% YoY; Eurozone: 7.5%; UK: 7%) and new sources of price pressures have caused the monetary policy stances of leading central banks to change. The Fed raised the benchmark rate by 50 bps after its May meeting and wanted to continue with substantial hikes, beyond 2%, by the end of the year. It also announced the reduction of the balance sheet (holdings of Treasury bonds and mortgage-backed securities) from 1 June, at a combined monthly pace of US$ 47,500 million for three months, before increasing withdrawals to the previously anticipated US$ 95,000 million. This is in a context in which, despite the high prices, the labour market figures remain strong, with a low, stable unemployment rate of 3.6% and impressive job creation at the margin (April non-farm payrolls: 428,000 vs 380,000 expected).

Global inflationary escalation persists



Source: Bloomberg and Santander

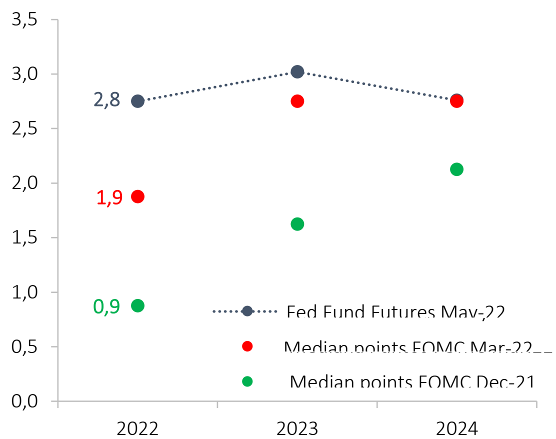
Long-term rates continue to rise



Source: Bloomberg and Santander

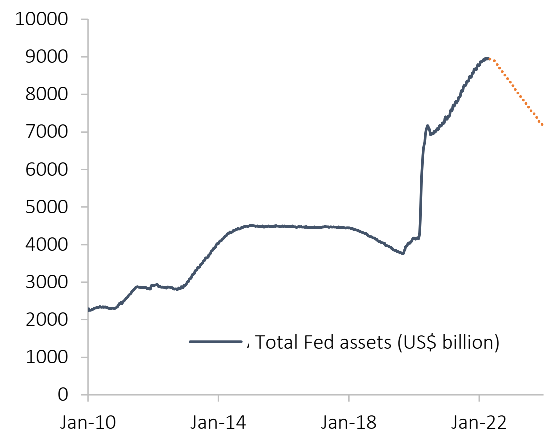
While Fed Chairman Jerome Powell's message after the last meeting was more dovish than expected (some dealers were expecting a 75bps hike), the clear direction of the monetary policy led 10-year rates to rise sharply on the month slightly above the 20 bps, reaching to levels unseen since late 2018.

The Fed will continue to raise its rate aggressively...



Source: Bloomberg and Santander

...and the balance sheet will be reduced from June onwards



Source: US Federal Reserve and Santander

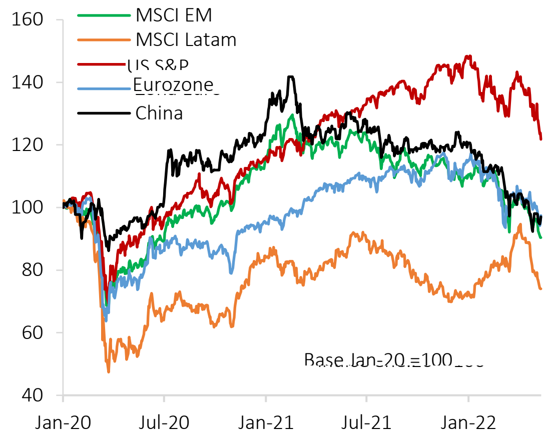
In Europe, first-quarter economic data showed a weak performance, with preliminary GDP growth of 0.2% QoQ (5% YoY) and Germany narrowly avoiding a technical recession (0.2% QoQ vs -0.3% previously). While April PMI indices remained stable (composite PMI: 55.8), both consumer and investor confidence indices dropped (consumer confidence index: -22 vs -16.9 in March; Investor Sentix: -22.6 vs -18 previously).

This has raised uncertainty concerning Europe's recovery and led the European Central Bank (ECB) to maintain a cautious stance on the withdrawal of the monetary stimulus. Nevertheless, when this report was issued, ECB President Christine Lagarde stated that they would probably halt their asset purchase programme in July and start raising their policy rate due to high inflation. Meanwhile, the Bank of England (BoE) raised its MPR by 25 bps to 1%, displaying a markedly hawkish bias for upcoming moves.

Confinements in China, which have increased in severity recently despite a decline in infections, are impacting logistics chains causing severe bottlenecks at major ports and significantly threatening China's growth. April’s activity indicators have shown significant deterioration (manufacturing PMI: 46 vs 48.1 previously; services PMI: 36.2 vs 42 previously; exports: 3.9% YoY vs 14.7% YoY in March). Furthermore, several organisations have cut growth projections to less than 5% this year. This has led to falls in some commodity prices, such as copper (-10%), and has contained the price of oil, which has fluctuated somewhat above US$100 a barrel.

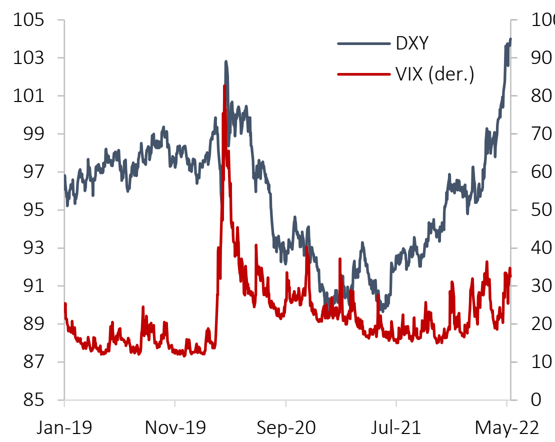
Global stock markets have broadly fallen by more than 10%, with double-digit declines in Latin America (notably Peru: -18% and Brazil: -11%) due to these countries’ greater exposure to China. The US and European stock indices declined by 12% and 5%, respectively in the month. The latter was affected by the tightening financial conditions. Thus, after surpassing historical highs, the S&P 500 dropped below 4,000 points and reached its lowest level in over a year. The dollar strengthened by 4%, bringing the DXY index close to 104 points, its highest level in almost 20 years.

Global markets retreat in unison...



Source: Bloomberg and Santander

... amid heightened risk aversion



Source: Bloomberg and Santander

In Chile, activity recovers temporarily

The Imacec in March showed a break from previous months, with a significant monthly rebound (1.6%). According to the Bloomberg survey, the annual activity change was well above expectations (7.2% vs 6.2%). The rise was general, but notable increases occurred in mining (6.6% MoM, seasonally adjusted) and manufacturing (3.5% MoM, seasonally adjusted), two sectors underperforming early in the year.

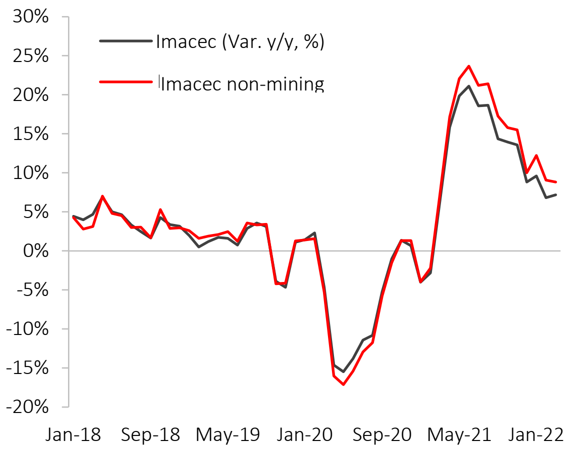
Trade rebounded (0.5% MoM, seasonally adjusted) after four months of decline. With these data, the preliminary estimate of the first-quarter GDP indicates an annual 7.9% growth, but with a fall over 2021's last quarter (-0.4% QoQ, seasonally adjusted), thus reflecting the economy's slowdown.

We consider that the rebound in March activity was rather isolated. In mining, a highly volatile sector, the structural conditions limiting production are still present, so we do not see room for dynamic growth in the future. Instead, there are risks of further setbacks. Regarding demand, the strong local monetary contraction, political uncertainty, and the global scenario's deterioration will cause both consumption and investment to decline significantly in the coming months.

We assess the Imacec in April to be moderately lower than in March, consistent with some preliminary data, which show declines (monthly business confidence index (IMCE) excluding mining: 44.1 vs 47 in March; electricity generation: -5.8% MoM; new car sales: 37,900 vs 41,500 in March). Nevertheless, the low base of comparison (April 2021 was a month of heavy pandemic confinements) will cause the annual change in the index to be high and rise to 8.5%.

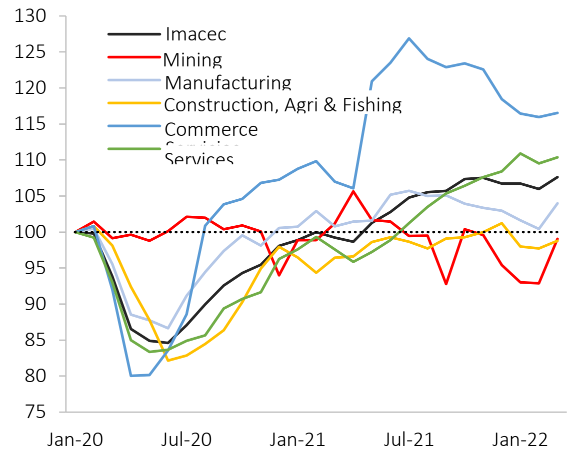
The annual growth rate will slow down by May and become negative from July/August onwards. We thus maintain our growth outlook for the year at around 1.5%, similar to the recent update of the Ministry of Finance's projections.

Imacec surprised on the upside in March



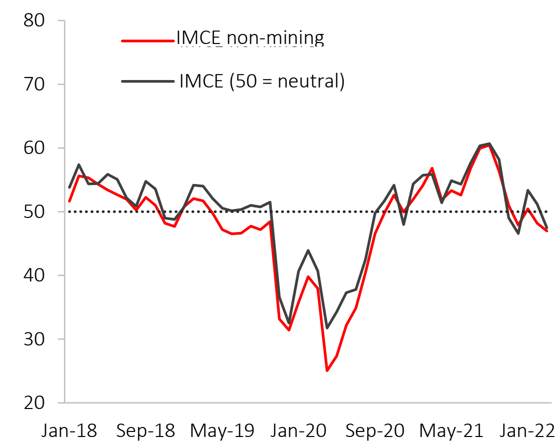
Source: Central Bank of Chile and Santander

The rebound was general



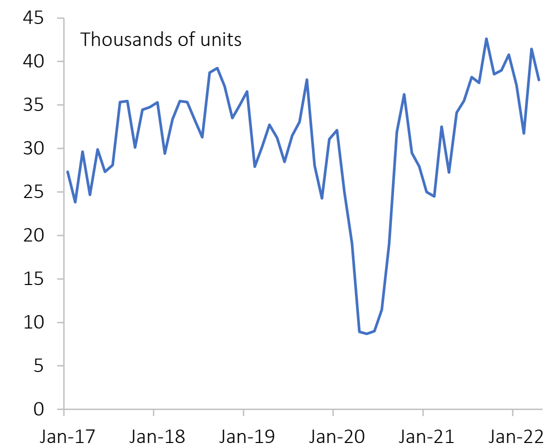
Source: Central Bank of Chile and Santander

Confidence falls in April



Source: ICARE and Santander

New car sales remain high but moderate marginally



Source: ANAC and Santander

Job creation loses momentum

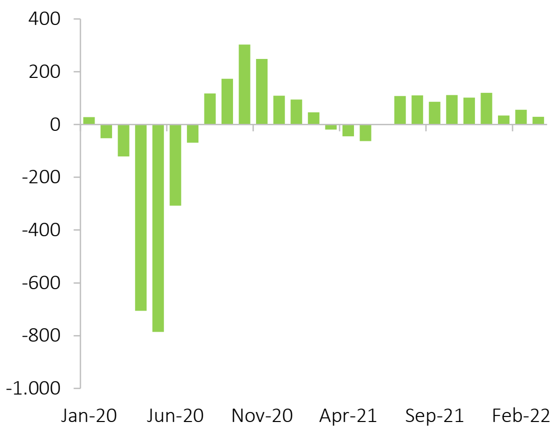
While the number of workers has continued to recover (8% YoY in March), the level of employment (8.8 million employees) is still below its pre-pandemic level and well under what it would have reached without the health crisis. Thus, the employment rate (employment versus working-age population) remains more than 3% below its historical average, with a significant gap in the female population, with about 350,000 fewer jobs than its trend. For men, there is also a significant but smaller difference of around 250,000.

The labour force has not fully recovered, so the unemployment rate has remained subdued (7.8% in April). Nevertheless, the unemployment rate measured by historical labour force participation remains high at around 12.5%.

There was a loss of dynamism in marginal job creation. Even though until a few months ago jobs increased by around 100,000 in the last few quarters, this figure has now fallen to below 50,000. This is consistent with the fall observed in the vacancy rate in recent months, suggesting that the slowdown in new employment is related to weaker demand.

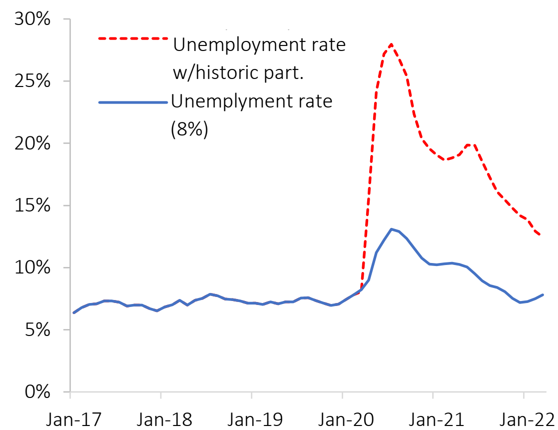
Nominal wages have increased, but less than inflation. Therefore, in real terms, they have contracted by around -1.8% annually, which is the largest decline in the last 10 years. This slowdown is part of the economy's adjustment after the overheating at the end of last year, which is necessary to avoid inflation intensifying its persistence.

Job creation has lost momentum...



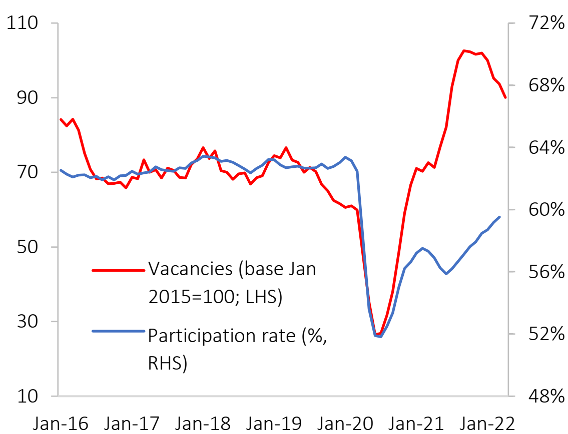
Source: National Institute of Statistics and Santander

...but the unemployment rate remains high



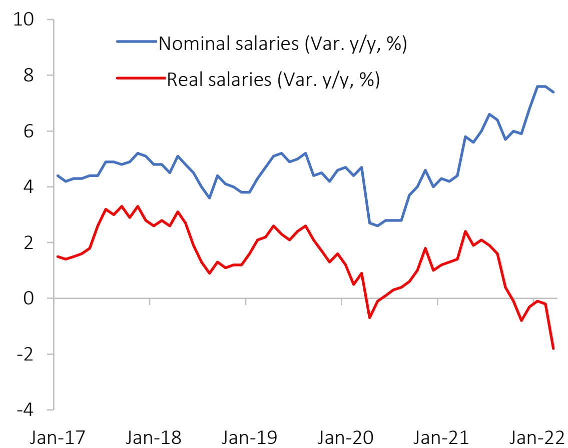
Source: National Institute of Statistics and Santander

Participation rate is still low, and vacancies recede



Source: National Institute of Statistics (INE) and Central Bank

Real wages fall sharply as inflation rises



Source: Central Bank and Santander

Inflation rises to its highest level in almost three decades

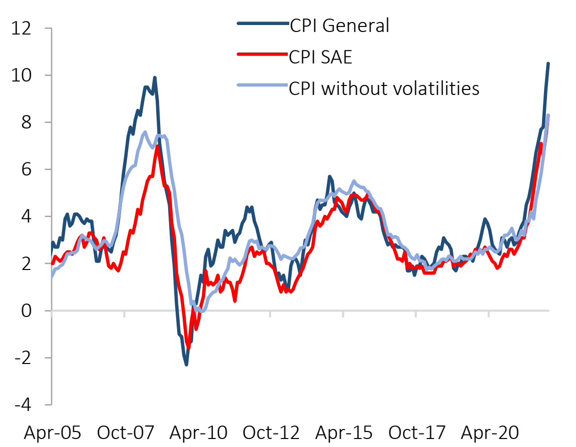
The CPI in April marked a strong increase (1.4%) which was well above market expectations for the second consecutive month (Bloomberg: 1%; Santander: 1.1%). This brought the annual price change to 10. 5%, the highest since mid-1994.

The increase was general, reflecting the impact of global food price hikes (2.3%; incidence 0.47pp) and fuels due to the war in Ukraine. Also, second-round effects were reflected in significant hikes in restaurants and hotels (2%; incidence: 0.13pp), health services (1.3; 0.09pp) and housing and basic services (1%; incidence 0.15pp). As a result, the underlying components of the CPI rose strongly (CPI SAE: 1%; CPI non-volatile: 1.1%) and reached record annual changes (8.3% each).

We would like to highlight the rise of the 'tourist package' item (14.9% MoM), which again had a very relevant impact on the CPI (incidence 0.17pp). This component has introduced high volatility into the CPI for some time now, and substantial reversals in the coming months that will lower the CPI cannot be ruled out.

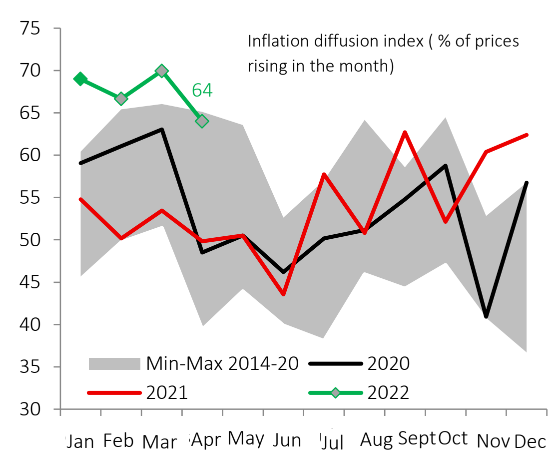
Most recently, inflation pressures arising from Ukraine's conflict, the level of confinements in China, which has remained high, and the global appreciation of the dollar have made dollar-denominated prices rise. As a result, we expect inflation in Chile to remain elevated for some months. For May, we estimate that the CPI will again have a great change, close to 1.3%, causing the annual price change to persist. Subsequently, as the economy moderates and external prices lower in the second part of the year, local inflation may start to relent. Nevertheless, we project that 2022 will close with an annual CPI change close to 9%.

Total CPI and underlying data surpass almost three-decade records



Source: National Institute of Statistics, Central Bank and Santander

Price rises are widespread, reflecting second-round effects



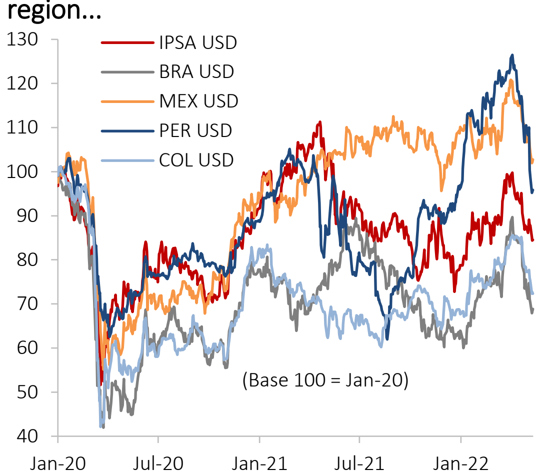
Source: National Institute of Statistics and Santander

Local assets lose value in line with regional movements

The refusal to accept the pension fund withdrawal projects was not enough to prevent local assets from showing negative results in the last month, in line with the weak returns of the region's markets. This, in a context where the constituent process has entered its final phase (the document is due to be ready in early July, to be submitted to a referendum on 4 September) and local political uncertainty remains high.

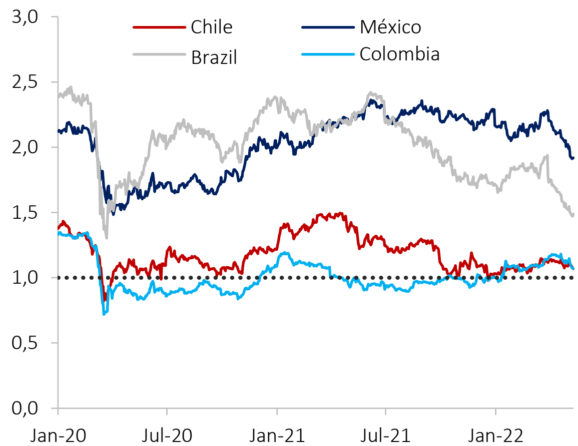
The prolongation of the war, weakness in China and the prospect of more aggressive monetary normalisation by the Fed led global investors to shift their assets into dollars (flight-to-quality), weakening the value of riskier assets such as commodities and emerging currencies and equities. In Chile, the exchange rate rose sharply and surpassed $870, although, when this report was issued, it was trading at $862 (+6% MoM), while the stock market fell by 5% to 4,680 points in line with other stock markets in the region.

The local stock market falls with the rest of the region...



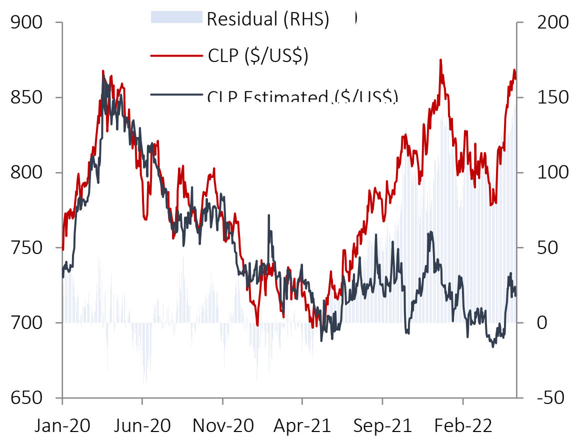
Source: Bloomberg and Santander

...and is once again approaching its book value.



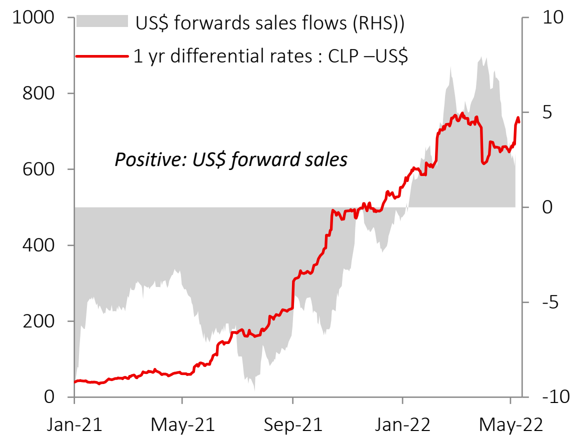
Source: Bloomberg and Santander

The exchange rate depreciates sharply



Source: Bloomberg and Santander

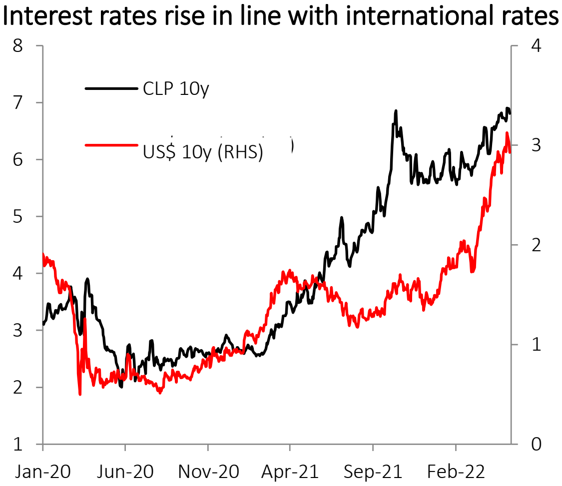
Despite high local rates, non-residents cut their bets on the Chilean peso



Source: Central Bank, Bloomberg and Santander

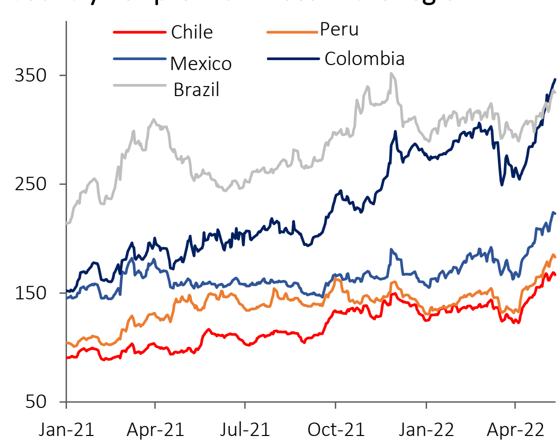
The fixed income market also showed significant losses. The BTP10 rose by 25 bps to 6.8% (a level unseen since October 2021, when the fourth pension withdrawal was being discussed), and the BTU increased 40 bps to 2.3%. This was in line with global rate movements and the sharp increase in the local MPR to 8.25%.

Interest rates rise in line with international rates



Source: Bloomberg and Santander

Country risk premium rises in the region



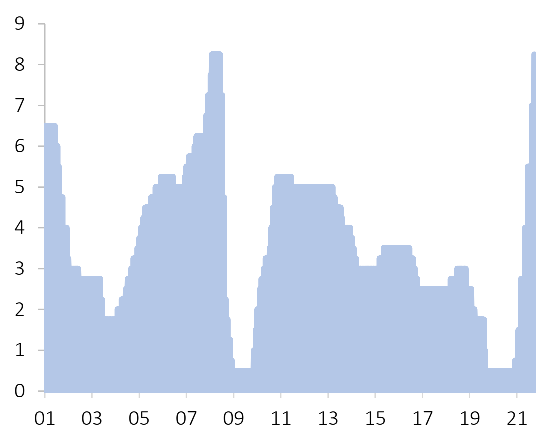
Source: Bloomberg and Santander

After the significant rise in the MPR to 8.25%, the hiking cycle is about to end.

At its third Monetary Policy Meeting, the Central Bank decided to raise the MPR from 7% to 8.25%, placing it at the corridor's ceiling published in March's Monetary Policy Report. The 125 bp increase was at the high end of the range of possibilities considered by the market, where most were aiming for a hike of between 50 and 100 basis points (the Monetary Policy Group had suggested 150 bp). The significant rate hike was consistent with the striking April CPI (1.4% vs 1.1% expected), released the day after the meeting.

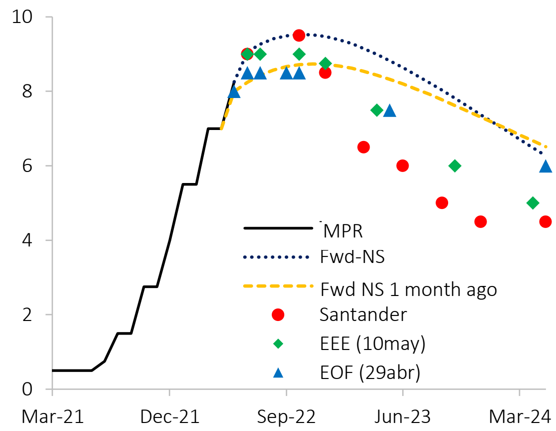
The meeting statement did not give a clear stance regarding the future of the rate and only announced that the Council would reassess its future path in the next Monetary Policy Report, presented in early June. Nevertheless, given the recent surprises in inflation and activity, we expect the next report to contemplate a path for a higher MPR than that of March, with an entry-level rate hike cycle between 9% and 9.5%. The rate would not rise further due to the possibility of a deep slowdown in the economy, which will condition medium-term inflation dynamics. Thus, we estimate that we may see a new rate hike of between 50 and 75 bps at the next meeting, to then increase by no more than 50 basis points in the July meeting. After that, the MPR would remain stable and could fall towards the end of the year, as inflation starts showing signs of moderation.

The MPR reached its highest level since 2008...



Source: Central Bank and Santander

...and would reach a maximum of 9.5% in the following months.



Source: Bloomberg, Central Bank and Santander

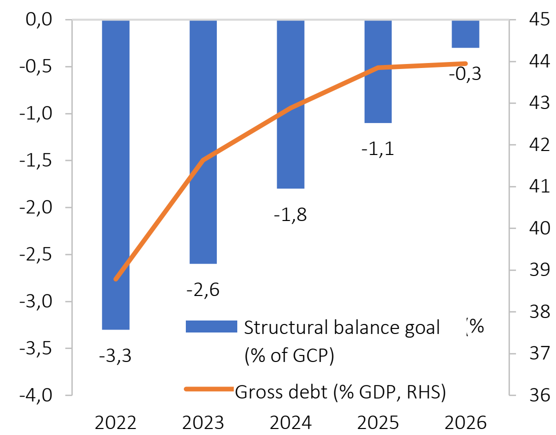
Tight fiscal scenario

In its first annual Public Finance Report (PFR), the Ministry of Finance corrected the growth estimate for 2022 downwards, from 3.5% to 1.5%, in line with the market projection and our estimate. The revenue projection was adjusted, decreasing by 1.5% from the previous report to $57,400 million. This is because of lower tax revenues related to lower domestic demand and the reduced contribution from Codelco due to the use of accelerated depreciation this year.

Expenditure is increased by 1.5% over the previously planned level due to extending the workers' IFE (emergency family income) and the Universal Guaranteed Pension. Thus, spending would amount to $61,800 million, implying a real contraction of 25.2% vs the 2021 expenditure.

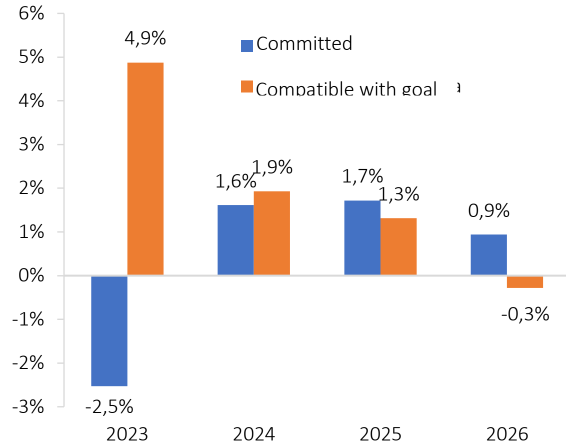
Thus, this year would close with a deficit of 1.7% of GDP (Structural Deficit: 3.3% of GDP) and gross debt of almost 39% of GDP. In the future, the government committed to reducing the Structural Deficit by 0.75 GDP points per year, ending 2026 at 0.3% of GDP. According to the Ministry of Finance's estimates, this provides little room for spending growth: 4.9% in 2023 and 1% on average between 2024 and 2026.

Government announces its fiscal commitment…



Source: Ministry of Finance and Santander

…but it leaves little room for spending expansion.



Source: Ministry of Finance and Santander

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	1.5	0.5
Domestic demand (real var. % YoY)	1.9	2.9	5.0	1.0	-9.3	21.6	-0.6	-0.1
Total consumption (real var. % YoY)	4.1	3.8	3.6	0.7	-7.2	18.2	-0.5	-0.7
Private consumption (real var. % YoY)	3.3	3.6	3.8	0.7	-8.0	20.3	-0.5	-1.1
Public consumption (real var. % YoY)	7.6	4.7	3.1	0.5	-4.0	10.3	-0.2	0.7
Gross fixed capital formation (real var. % YoY)	-2.4	-3.3	6.5	4.7	-9.3	17.6	0.7	-0.9
Exports (real var. % YoY)	0.6	-1.0	4.9	-2.5	-1.1	-1.5	1.7	2.1
Imports (real var. % YoY)	1.2	4.5	8.6	-1.7	-12.7	31.3	-4.7	-1.4
GDP (US$ billion)	249.5	276.5	296.0	279.0	253.5	316.8	320.7	330.5
GDP per capita (US$ thousand)	13.7	15.0	15.8	14.6	13.0	16.1	16.2	16.5
Population (million)	18.2	18.4	18.8	19.1	19.5	19.7	19.8	20

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	10.6	11.9	15.2
Exports (US$ billion)	60.8	68.9	74.8	68.8	73.1	94.7	97.5	95.4
Imports (US$ billion)	55.8	61.4	70.4	65.8	55.1	84.1	85.6	80.2
Current account (US$ billion)	-6.5	-7.6	-13.3	-14.5	-4.3	-20.3	-11.1	-7.8
Current account (GDP%)	-2.6	-2.8	-4.6	-5.2	-1.7	-6.6	-3.5	-2.4
Copper price (annual average US$/lb)	2.2	2.8	3.0	2.7	2.8	4.2	4.4	4.2
WTI oil price (annual average US$/bbl.)	43.2	50.9	64.8	57.0	39.0	68.0	100.0	91.0

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	9.0	4.6
CPI Inflation (var. YoY % average)	3.8	2.2	2.4	2.3	3.0	4.5	10.0	5.6
CPI sans food and fuel inflation (IPC-SAE) (var. YoY % up to December)	2.8	1.9	2.3	2.5	2.6	6.4	6.0	4.2
CLP/US$ exchange rate (annual exercise)	667	615	696	745	711	852	850	860
CLP/US$ exchange rate (year average)	677	649	640	703	792	759	835	855
Monetary policy rate (%, year average)	3.5	2.5	2.8	1.8	0.5	4.0	8.5	4.5
Monetary policy rate (%, year average)	3.5	2.7	2.5	2.5	0.8	1.2	8.2	5.9

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	-25.7	2.1
Central Government balance (% GDP)	-2.7	-2.8	-1.7	-2.9	-7.3	-7.3	-2.0	-3.0
Central Gov. gross Debt (US$ billion)	53.4	68.9	70.2	74.4	91.6	102.0	125.1	135.5

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