MONTHLY ECONOMIC OUTLOOK

World torn between optimism and concern

The gradual vaccination process against COVID-19 has encouraged markets, but new containment measures due to outbreaks of the pandemic in several countries are dampening the outlook in the short term.

Highlights

Opposing forces within international markets. The start of inoculation against COVID-19 is bolstering asset prices, but the new wave of contagion in advanced economies adds a note of caution.

China's economy continues to show strength, which has led to further increases in base metal prices. Copper has reached its highest values since 2013, the period of the super cycle of raw materials. In the future, a normalisation of supply and an easing of demand could bring its price closer to long-term values.

Local activity is recovering more slowly than anticipated. In October, the weakness of services was not compensated by the strong rebound in trade and manufacturing that resulted from the liquidity injection received by households. The second withdrawal from the pension funds could give a short-term boost to demand, but more limited than the first occasion. We assess that the year will close with an annual variation of -6% in the GDP, in line with the Central Bank's latest projection.

The exchange rate has reached its lowest level since October 2019. Explaining these movements is the high price of copper, the global dollar's weakness, the Ministry of Finance's foreign exchange sales and the liquidation of external assets of the AFPs. Some of these factors are transitory, so the parity should tend to depreciate and converge towards $750 in the short term.

November inflation is surprisingly low. After the high CPI records in September and October, there was an unexpected drop in November prices, reflecting the low underlying inflationary pressures. In December we would see some acceleration in prices, with inflation closing the year at 2.9%.

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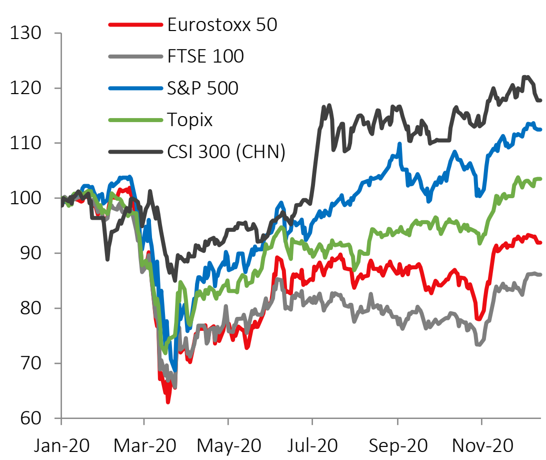
The beginning of the pandemic's end continues to encourage financial markets

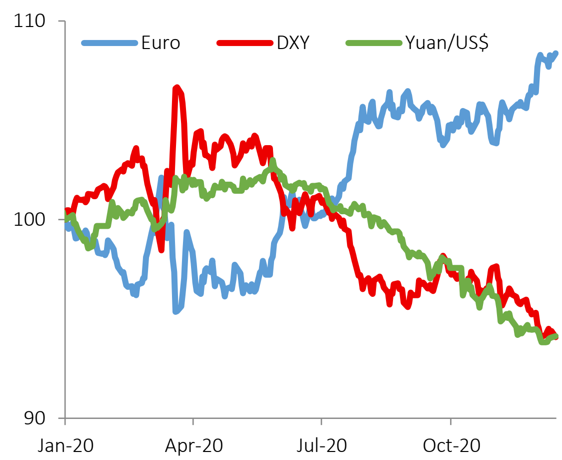
The global economic and financial indicators continue to be marked by opposing forces. On the one hand, the intense outbreaks of the pandemic in the northern hemisphere countries - resulting in record levels of deaths - have led to the adoption of new lockdown measures. This has impacted the performance of the services sectors, particularly in Europe, and has affected employment recovery. On the other hand, governmental entities' approval of different vaccines has initiated the vaccination process, which has boosted financial assets that also continue to be supported by strong liquidity. Thus, the S&P rose by more than 3.5% during the month to around 3,660 points, the Topix (Japan) increased by 3.7%, the FTSE 100 in the UK by 3% and the Eurostoxx 50 by 2.2%. Latin American stock markets rose the most, especially Brazil, with a 12.3% increase. Meanwhile, the dollar remains relatively weak and is at its lowest level compared to the euro the last two years.

Global markets react positively to vaccine news



Source: Reuters and Santander

The dollar continues to depreciate in comparison to major currencies

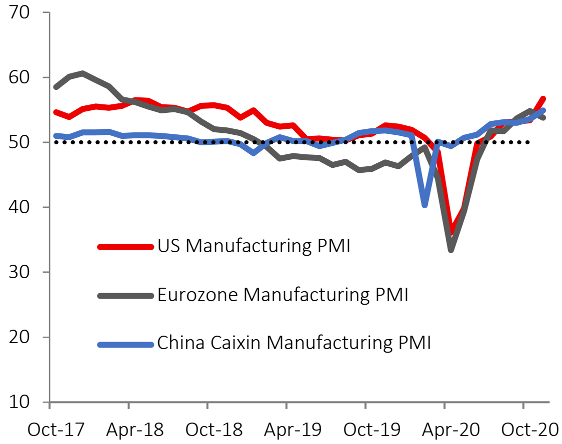


Source: Reuters and Santander

In Europe, the pandemic's resurgence has caused additional falls in service PMIs, which have been under the expansion pivot for several months. This has led the European Central Bank to increase its monetary stimulus, through a EUR 500 billion increase in the asset purchase programme, which now totals EUR 1.85 trillion. Moreover, the European Commission managed to unlock its 2.2 trillion euro budget, consisting of a high expenditure level to revive the block's economies. Meanwhile, difficulties remain to reach an agreement between the UK and the EU on Brexit, creating uncertainty for some sectors such as fisheries. It also raises concerns in the headquarters of large European corporations, which may have to move their operations from London to the mainland.

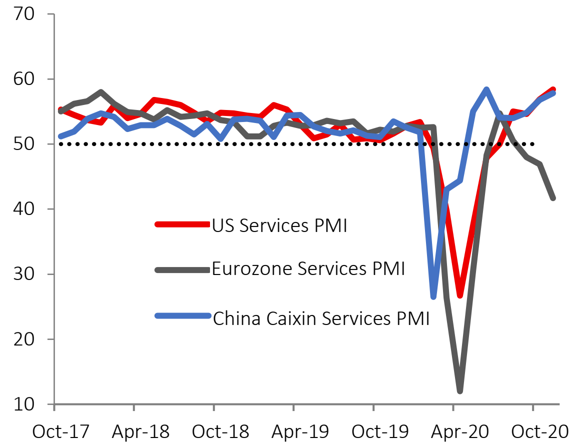
In the US, the labour market has slowed down its recovery, with the creation of fewer than 250,000 jobs in November, while wages remain relatively flat. Against this background, talks between Democrats and Republicans for a new fiscal stimulus package have continued to move forward, and an agreement for just over $900 billion is now practically settled.

Manufacturers continue to regain ground in big markets



Source: Reuters and Santander

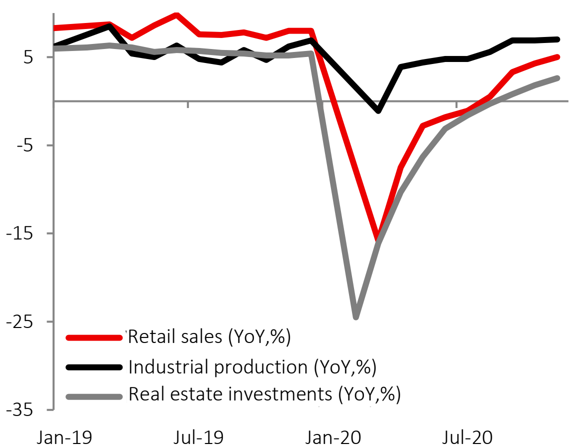
In Europe, the service sector is in decline again



Source: Reuters and Santander

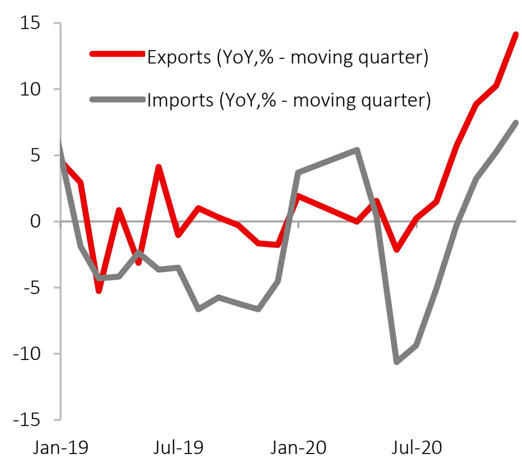
The Chinese economy has continued to show signs of strength, driven by investment and the external sector, where shipments of durable goods and medical supplies stand out. Retail sales (5% YoY vs 4.3% previously) and manufacturing production (7% YoY vs 6.9% previously) in November showed that activity continues to accelerate. Stimulus programmes have favoured infrastructure projects which, in turn, have stimulated the internationalisation of base metals. In this context, copper has reached new highs, trading at around US$3.5 per pound, a figure not seen since 2012 during the period of the super commodity price cycle.

The Chinese economy continues to show a strong recovery



Source: Reuters and Santander

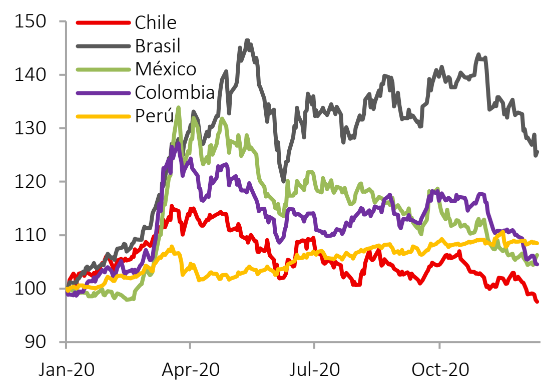
China's foreign trade is growing at high rates



Source: Reuters and Santander

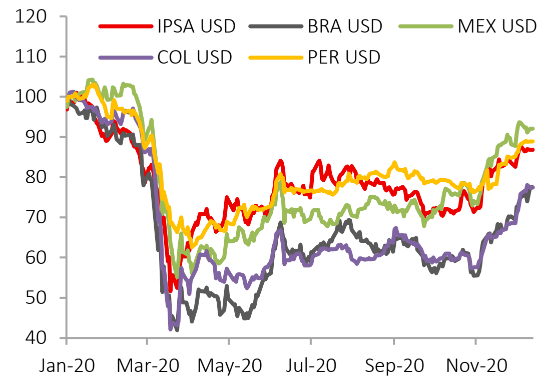
In Latin America, the Mexican economy has been recovering buoyancy, particularly in the industrial sector which has behaved above expectations. Meanwhile, Brazil has also performed well, not only because of the manufacturing sector's progress but also because of other activities linked to domestic demand. Simultaneously, the dollar's global weakness has led to significant appreciations of the region's currencies - led by Brazil - and an increased flow of funds has meant substantial gains in the stock markets. The Bovespa rose 10%, the Mexican stock exchange climbed 7% and Colombia and Peru 12%.

Latin American currencies are widely appreciated



Source: Reuters and Santander

Increased risk appetite raises Latin American stock markets

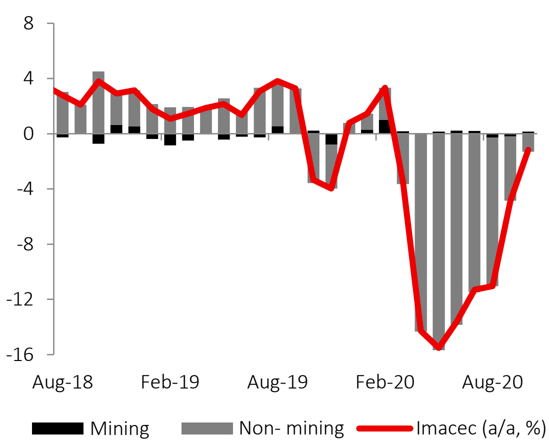


Source: Reuters and Santander

Local activity disappoints in October

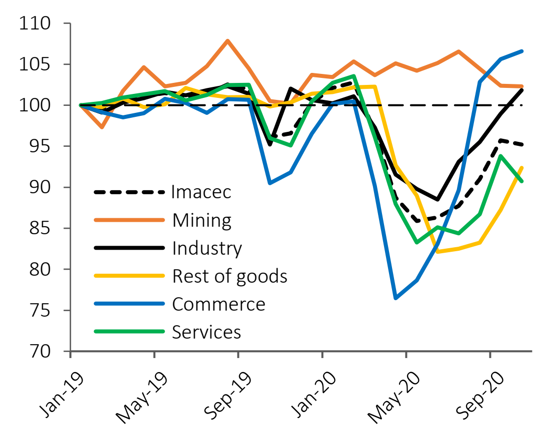
The progressive easing of lockdown measures and the impulse to consumption due to households' liquidity shock added to a low comparison base created expectations for an October showcasing the first positive growth recorded since the pandemic started. The figures were instead surprisingly low (-1.2% vs 0.6% Bloomberg survey) and marked a decline from September (-0.5%) in seasonally adjusted terms. Underlying the poor performance was the monthly fall of more than 3% in the services sector - representing almost 50% of Imacec - which has no clear explanation.

Imacec in October was below expectations



Source: BCCh and Santander

Surprise focused on services



Non-seasonally adjusted series (Jan-19 = 100)
Source: BCCh and Santander

Before this, during the third quarter, figures had shown a strong rebound from the economy's lowest point in May, at the pandemic's initial peak. Mobility recovered, especially starting July with the easing of lockdown measures, which allowed a series of activities to be normalised. Later, the strong liquidity shock received by households with the withdrawal of more than US$ 17 billion from pension funds (7% of GDP) added to the aid packages deployed by the government, in a context of greater openness, implied a substantial increase in consumption that boosted trade and manufacturing. On the other hand, investment lagged behind, affected by health restrictions on the construction sector, which implied an annual contraction of 26% YoY in the third quarter (-17% previously).

During November, the easing of lockdown measures continued to advance, and mobility increased, although slower than in September and October. Therefore, we assess that activity has continued to recover, accompanied by an increase in the pace of services. **Thus, the Imacec should have an annual expansion of between 1% and 1.5%, favoured by the low comparison base of 2019**.

On the one hand, December's activity will be affected by the retreat in the confinement measures, mainly due to the return to Phase 2 within the Metropolitan Region and, on the other, by the second withdrawal of pension funds. In this respect, although the total potential amount is similar to the first - around 7% of GDP - we assess that the withdrawals will be lower this time. On the one hand, a very high fraction of contributors, possibly those most in need of liquidity, will not be able to access retirement as they have no savings in their accounts. On the other hand, people with higher incomes may not feel encouraged to withdraw from their funds, since the flows are not tax-exempt. Data on applications at their fifth day confirm this: if there were 7.8 million applications on the first withdrawal, there have now been only 5.9 million. However, the total amount withdrawn will be lower, and a larger fraction will also go into savings. This accounts for how the people who will access these funds have a lower consumption propensity and how the employment situation is different from how it was in August.

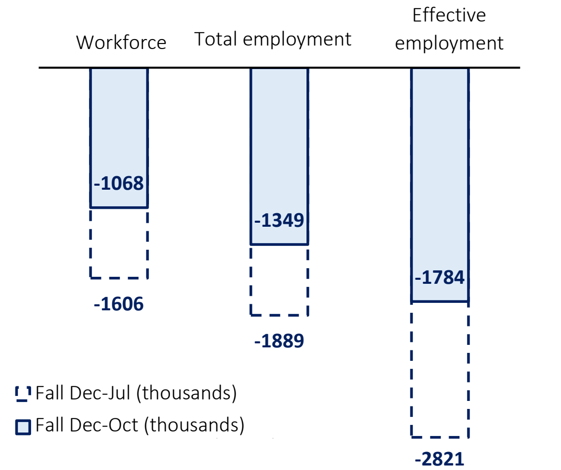
Taking this background into account alongside a more demanding comparison base than in November leads us to project that we will observe an annual contraction of the product of around -2% in December. Thus, the year's GDP will close with a variation of -6% with respect to 2019.

Labour market recovers, but gaps remain wide

In October, nearly 300,000 jobs were recovered, and an increase of almost 30% of health crisis related loss has been accumulated since July when employment reached minimum levels. Moreover, effective employment - which fell by 2.8 million up to July - has recovered by approximately 1 million due to the return of workers under the Employment Protection Act (considered absent employees in the National Institute of Statistics (INE) survey). Together with this, there was a significant re-entry of people into the labour market, which increased the labour force, although somewhat less than the employment recovery.

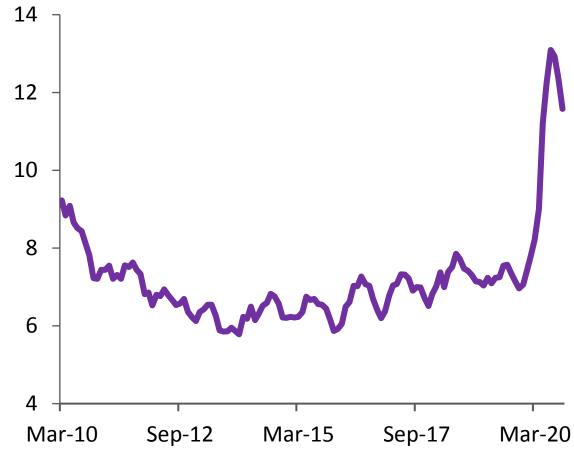
With these figures, the unemployment rate fell back to 11.6% in the three-month period ending in October (12.3% in the previous mobile quarter). Hence, the employment situation is improving, but rather gradually, while there are still wide gaps.

Labour market recovery is still partial



Non-seasonally adjusted workforce and total employment.
Source: INE and Santander

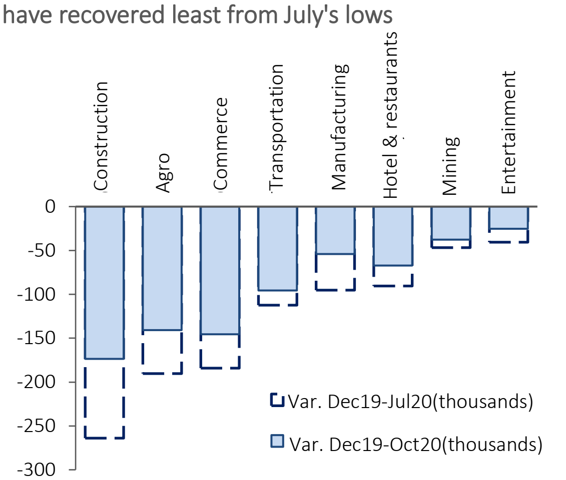
Unemployment is falling again, though still well above pre-pandemic levels



Source: INE and Santander

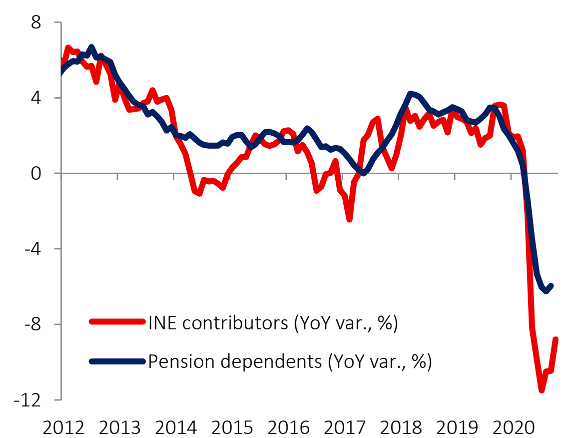
The sectors most affected by the social distancing measures are precisely those that have seen the greatest recovery since mid-year. Some, such as construction and manufacturing, have closed between 35% and 40% of the gap opened up to July. But others have made less progress, such as trade (21%), hotels and restaurants (26%) and transportation (15%). However, these figures are not entirely consistent with the activity values for the same sectors. For example, according to Central Bank data, construction is one of the sectors lagging behind, while trade has even exceeded the previous year's activity levels.

Trade, restaurants and transport among sectors that have recovered least from July's lows



Source: INE and Santander

Administrative records show a significant but less intense deterioration in employment



Source: SPensiones, INE and Santander

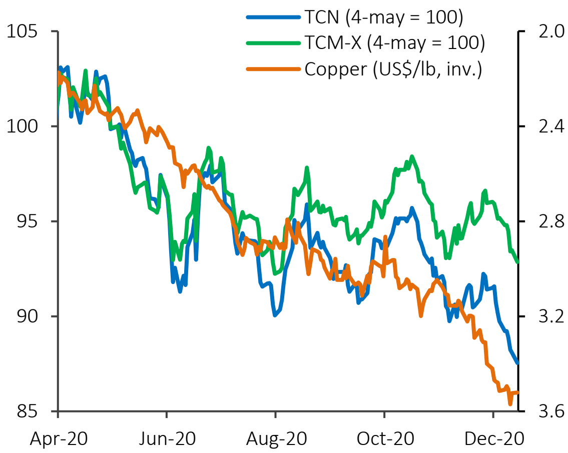
It should also be noted that there are significant discrepancies between the INE's figures and the administrative records for formal employment. According to the INE, there was a 10.5% drop in contributors as of September over the previous year, while this was only 6% according to the Superintendency of Pensions. A possible explanation for this discrepancy is that a fraction of workers under the Employment Protection Law have mistakenly reported that their contributions would not be paid (INE: Employment Survey Technical Note). Nevertheless, even when adjusting the figures to account for this potential reporting error, a significant gap with the administrative data still remains.

Exchange rate reaches minimums of more than one year

The Chilean Peso has had a strong appreciation trend, and at the time this report was issued, it placed around $735, its lowest level since October 2019. Behind the Peso's strength are global factors, such as the dollar's weakness and the high price of copper, and short-term local factors. These include the liquidation of external assets by the AFPs to deal with the second withdrawal of pension funds and the sales of foreign currency by the Ministry of Finance to fund its cash flow.

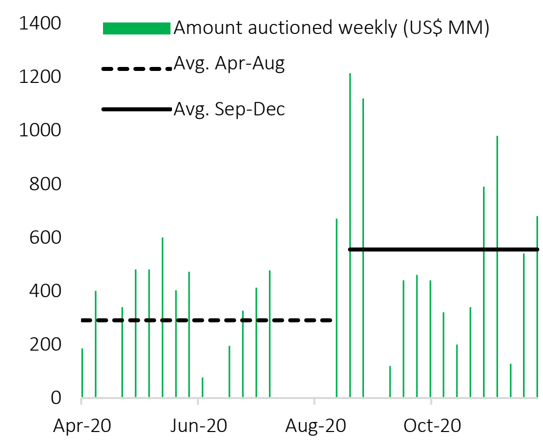
In the coming weeks, pressures on the currency resulting from portfolio adjustments should moderate. On the other hand, as copper supply is restored, the price of copper should move towards levels more consistent with its long-term values. These phenomena could lead to a correction in the exchange rate to around $750.

The weak dollar and high copper prices explain the appreciation of the Peso



Source: BCCh, Bloomberg and Santander

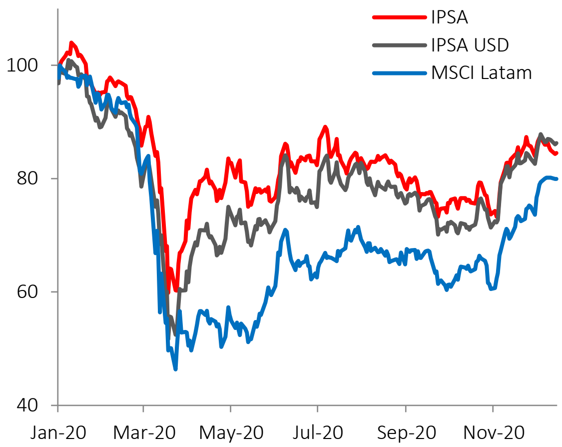
The Ministry of Finance's foreign exchange auctions have also played a role



Source: Ministry of Finance and Santander

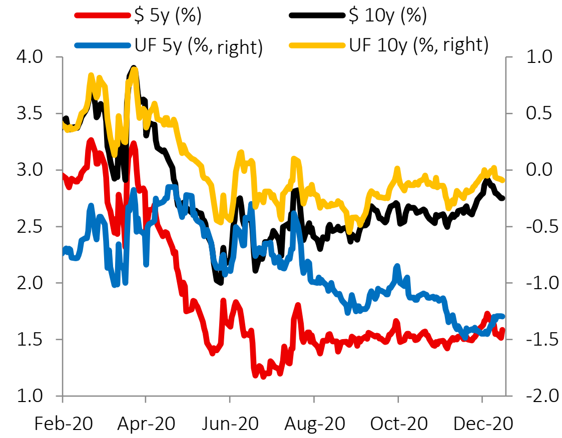
The local stock index IPSA has remained stable over the last few weeks at around 4100 points, following the significant recovery recorded at the beginning of November (+12% in three days), driven by global market optimism in response to the effectiveness of the vaccines. By contrast, local bond yields tended to rise in anticipation to the second pension fund withdrawal. The increase was as high as 30 bps in long rates, although recently it has been partially reversed.

The local stock index IPSA has moved upwards, along with the stock markets in the region



Source: Bloomberg and Santander

Long-term rates are tending to increase, influenced by the second withdrawal of pension funds



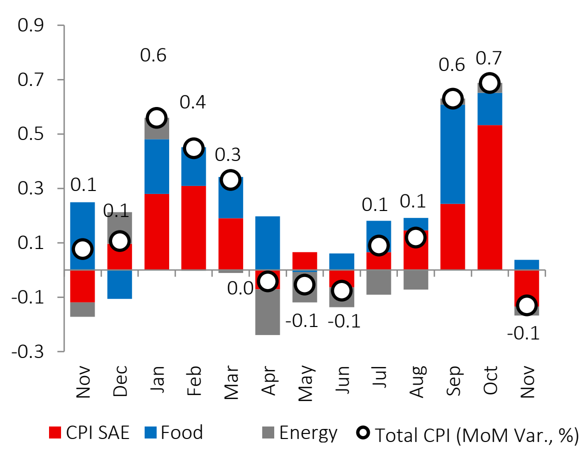
Source: BCCh, RiskAmerica and Santander

Against all odds, November's CPI drops

After two strong hikes in September and October, a further rise in the CPI was anticipated in November. Contrariwise, prices contracted, leading to an annual change of 2.7% (3.0% in October). There were several surprises, but the clothing and footwear sector stood out as it had accumulated a substantial increase in recent months and now had a sharp contraction of 4.9% MoM. In addition, there was a much smaller increase in food than had been observed (0.2% MoM vs 0.6% October).

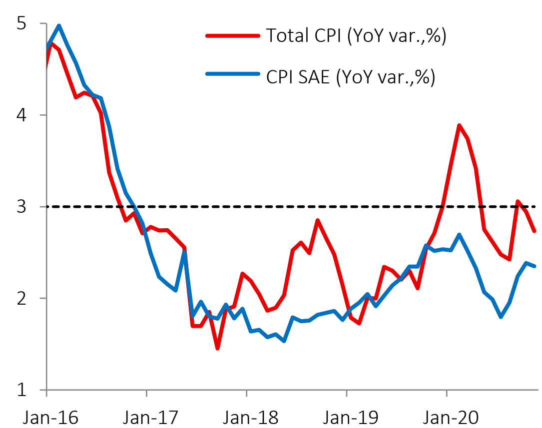
Consequently, core inflation (CPI excluding food and energy) fell by 0.2% MoM, maintaining its annual variation at low levels (2.3% YoY). There were substantial changes in the number of products in the basket that rose in price (inflationary diffusion index) from very high levels to one of the lowest in recent years. Overall, it should be considered that the INE continues to manually charge a large number of prices (24.4% vs 8%-10% in regular times) and, to the extent that this is normalised, there may be further surprises.

After two high records, the CPI surprises with a setback in November



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

Inflation will close near the 3% target



Source: INE and Santander

We anticipate the strong appreciation of the Peso in recent days with its respective downward impact on the prices of imported goods will be counterbalanced by the inflationary effect of the renewed withdrawal of pension funds. Nonetheless, this is a transitory event; in the medium term, capacity gaps in the economy that still remain large, and low external price pressures will keep inflation within limits.

Despite some optimism, the Central Bank is cautious about the recovery

The negative surprises of the Imacec - especially in October - and the new quarantine measures imposed by the authority led the Central Bank to lower its growth estimate for the year from an average of -5% to -6% in its December Monetary Policy Report (IPoM). However, it expects a growth of around 6% next year, well above market projections. Nevertheless, the report is cautious about recovery and emphasises the downside risks due to the pandemic's possible resurgence, the uncertainty generated by a prolonged process of partial activity in several sectors and the domestic political climate.

In this context, the Central Bank confirmed its intention to maintain the monetary policy rate at its technical minimum for at least two years. From that moment onwards, if the process of economic recovery were to advance, markedly gradual increases in the rate could be expected. On the other hand, should a further deterioration in activity materialise, additional unconventional monetary stimulus measures would be required.

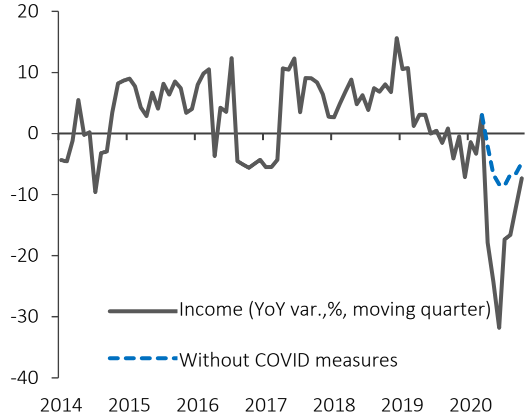
Fiscal budget for 2021 aims at maintaining the level of expenditure

Towards the end of November, the 2021 Budget Law was dispatched after an intense debate hampered by the turbulent political situation. Although the final figures are not yet published, the total amount approved is in line with the government's original proposal, which considered 0% real expenditure growth, maintaining this year's significant fiscal impulse. The points that finally allayed the discussion were the reinstatement of some Education and Science items, which had been cut in the initial proposal, as well as certain restrictions and accountability in the use of the "Covid Fund" being demanded.

The latest performance figures show a strong recovery in tax revenues during October, following the completion of some of the measures implemented since April (suspension of the Monthly Provisional Payments (PPM) and deferment of VAT). Overall, revenues have accumulated a drop of 11.7% as of October compared to the same period in 2019. Additionally, spending has moderated from the record levels reached in the third quarter, when disbursements were made for the Emergency Family Income and the subsidy to the middle class. Even so, total expenditure in the month was 13% higher than in the previous year.

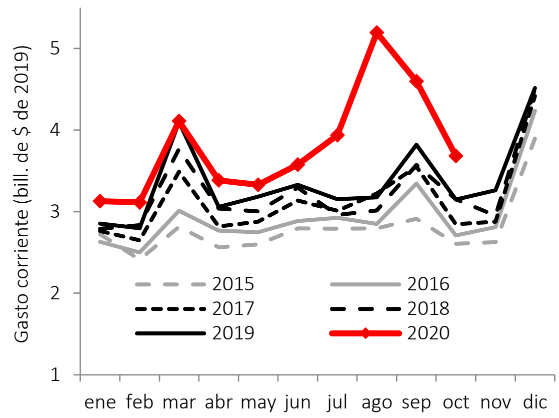
High copper prices and a somewhat more dynamic domestic demand will see revenues close the year slightly higher than previously projected. With this, we anticipate that the government deficit will close the year at around 8%. In the coming year, the Treasury's performance will be conditioned by the speed the economy's recovery, but it is expected that revenues will increase compared to this year and thus the deficit will fall to at least 5% of GDP.

Tax revenues recover after some of the Covid tax relief measures ended in September



Source: Dipres and Santander

Although current spending moderated in October, it maintains an expansion of 17% YoY.



Source: Dipres and Santander

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