

## Emerging Insight

## Chile – Inflation and rates convergence risks

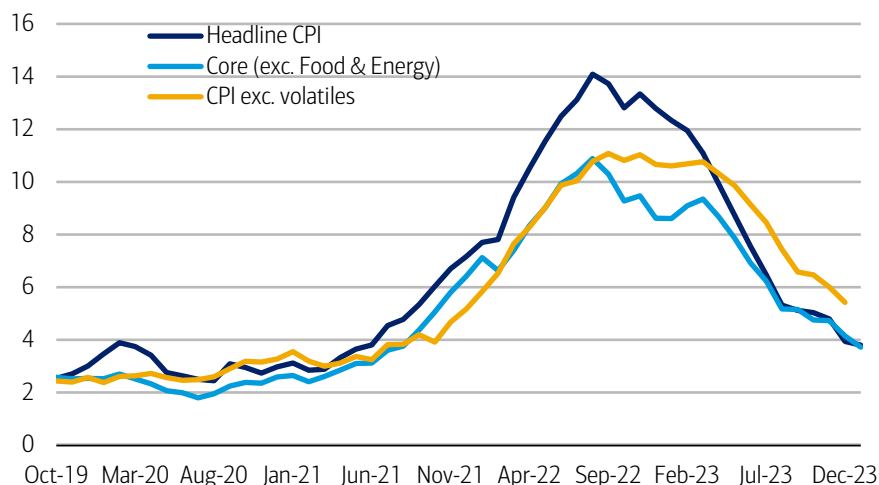
## Key takeaways

- Inflation was 0.7% mom in January, above the 0.4% mom Bloomberg consensus. USDCLP at a new peak.
- Very volatile inflation prints and risks ahead could lead to a more cautious BCCh on rates cuts in the future.
- Local strategy: We like long 5-year inflation breakevens and 3y2y forward rates payer.

By S. Rondeau, E. Aguirre and C. Gonzalez Rojas

## Headline, ex-volatiles and core inflation (yoy, in%)

Inflation back inside the target band, but very noise prints recently



Source: INE, BofA Global Research

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## Chile: inflation and rate convergence risks

Inflation in Chile declined substantially last year. However, some recent upside inflation surprise and highly volatile prints should lead to a more cautious BCCh regarding rate cuts, amid FX pressure (USD/CLP is at recent peaks). Economic activity is stagnant but is not collapsing and expansionary policies should lead to a rebound this year. We like long 5-year inflation breakevens and 3y2y forward rates payer.

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Timestamp: 12 February 2024 05:00PM EST

12 February 2024

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## January inflation upside surprise

Inflation in Chile declined substantially last year. However, highly volatile monthly inflation with some recent upside surprises should lead to a more cautious BCCh regarding coming rate cuts, amid currency pressure. USD/CLP has depreciated 9% year-to-date and trades at a recent peak of 970.

Headline inflation was 0.7% mom in January, above the 0.4% mom Bloomberg consensus, up from 0.5% deflation in December (it was also +0.7% in November), averaging 0.3% in the last three months. Core inflation was also high at 0.7% mom, up from -0.4% in December.

## New CPI methodology base year=2023

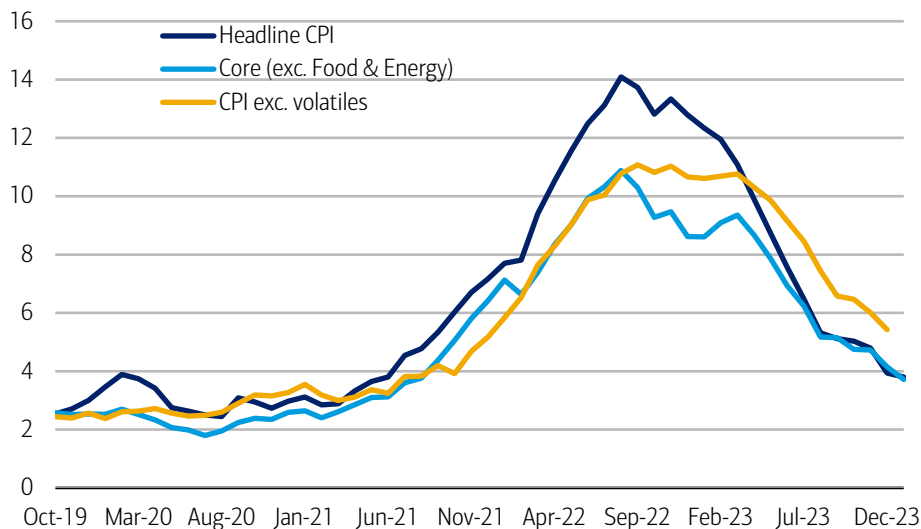
The INE statistics agency published the new CPI monthly data with base year in 2023. In the last 12 months, inflation was down slightly to 3.8% yoy (from 3.9% in December) according to INE, overlapping January print of the new methodology with the previous 11 months under the old one. Using only the new data base 2023, inflation would have been 3.2% in the last 12 months, which showed less inflationary pressure in the past year. We expect BCCh to provide a new ex-volatile index in March.

## Hot items: food and housing

Food prices were strong, increasing 1% mom (0.21 pp incidence) while housing and basic services was +1.2% (0.20pp), amid maintenance costs. Electricity prices (regulated) have been unfrozen recently, with hikes around 8-12% for most consumers (stronger for high-income households). On the downside, volatile air transportation dropped 27% (-0.19pp), which suggests the ex-volatile measure was similar or higher than the core in the month. Fuel prices were down 2.5% (-0.09pp).

### Exhibit 1: Headline, ex-volatiles and core inflation (yoy, in%)

Headline inflation inside the 2-4% target band



Source: INE, BofA Global Research

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## Hawkish print, but very volatile data. Caution needed

inflation surprised on the upside, but amid very volatile month-to-month prints, including core measures, which makes it hard to infer a clear trend forward. Overall, inflation has been declining and remains closer to the 3% target (note also that the new CPI 2023 base showed less inflation in 2023). Thus, more cuts are justified. However, this upside inflation surprise and the extreme volatility demand more gradual cuts going forward, in our view. USD/CLP is at 970, a new high, and the increase of US rates recently plays in the same direction.

We forecast a slowdown in cuts to 75bp in April from 100bp last meeting. Also, the fact that there are three meetings in just three months (April-June), should slow cuts per meeting. We see upside risks for the BCCh scenario of convergence of the policy rate to 4% in 2H (we expect the rate at 5% in December). We forecast inflation at 3.4% this year (from 3.3% before). We also believe the global developments put upside pressure on the neutral interest rate (estimated at 1% by BCCh).

## Other risks: Fed, CLP, fiscal, activity

Overall, the Chilean economy is stagnant, showing a drop in December but marginal growth overall in 4Q (non-mining +0.5% qoqsa) as October-November posted favorable results. Recent weakness was led by mining, which beyond the dovish impact on activity has a hawkish implication for the USD supply (less exports) and CLP pressure.

Business sentiment recovered in January after a very weak December. This removes urgency for more aggressive cuts, in our view. Recent rate cuts (175bp in two months) should support activity with a lag. Expansionary fiscal (+4% real spending growth in the budget) also supports growth. We expect a 2.2% GDP rebound this year.

A more hawkish Fed and weaker CLP (amid fast BCCh cuts) are also risks for inflation and rates.

On the flipside, declining job openings and growing labor supply are supportive of deceleration in wages (which were still growing 7.7% yoy in November) supporting lower inflation in services. The recent wildfires will have a significant impact on the fiscal, with costs already estimated at more than \$1bn. The impact on monetary policy is unclear, as it could affect GDP but is to a certain extent a negative supply side shock.

## Economists survey: convergence on inflation and rates in 1 year

Economists surveyed by BCCh forecast the policy rate down to 6.25% (from 7.25%) or 100bp cut in the next BCCh meeting (faster 6.75% seen previously). They see the rate at 5.50% in two meetings and at 4.25% by year-end (vs 4.75% previously). The rate is forecasted at 4.00% in 12 months and at the same level in 24 months.

Economists forecast inflation at 0.2% this month and at 0.4% next month. They expect annual inflation at 3.0% this year (from 3.0% before) and at 3.0% next year (same as in the previous survey). On GDP growth they expect 1.7% this year, below the government forecast (2.5%) and BofAe (2.2%). The fast rate convergence is partly attributable to growth pessimism.

## Strategy: Long 5y breakevens and pay 3y2y forward rates

The higher-than-expected inflation print sent 5y inflation swaps breakevens 7bp higher to 2.87% and 3y2y forward rates 10bp higher to 4.72%. We maintain our trades, as we see more upside (see [EM Alpha: Chile: Two new trades based on our higher inflation and policy rate views](#)).

Inflation swap breakevens are still below the 3% inflation target but we expect loose monetary policy and some positive fiscal impulse to drive inflation to 3.4% in 2024. We also believe the central bank is too optimistic in estimating the neutral real rate at 1%. If the neutral real rate is closer to 1.5-2%, as we argue, then forward rates have room to rise to around 5%.

The risk to both trades is a softer-than-expected inflation outlook, which may put downward pressure on 5y inflation breakevens and lower the 3y2y forward. Downward surprises to inflation, in our view, could materialize in the event of a global economic downturn. In such a scenario, weaker domestic demand may support services disinflation and lower global commodity prices may sustain goods disinflation. Yet, such a scenario is not our baseline.

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