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Emerging Insight

Chile – Rates views post-Santiago trip

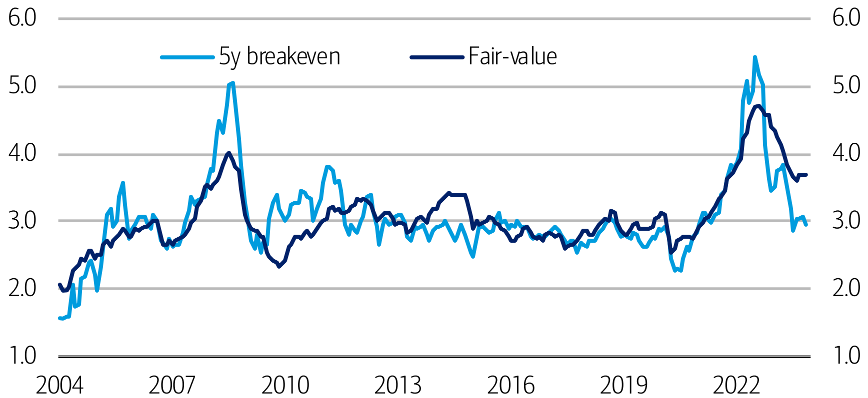
Key takeaways

- The central bank will likely keep cutting rates but in a more gradual manner.
- BCCh is perceived to have concerns of floating amid higher global interest rates.
- We recommend buying 5-year inflation breakevens at 2.94%, which are pricing in too much disinflation, despite fiscal risks.

By Sebastian Rondeau and Ezequiel Aguirre

Chart of the Day: Inflation swap breakevens at below 3% target level

We believe inflation breakevens are not accurately accounting for positive risk premiums



Source: BofA Global Research, Bloomberg

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Chile in Focus

Rates views post-Santiago trip

Global tensions and CLP volatility are putting limits to monetary policy in Chile. BCCh will likely keep the slower pace of rate cuts in coming meetings. The economy is stagnant but not collapsing, which removes pressure from BCCh to cut faster. Still, the disinflation progress and weak economy open room for further substantial cuts, in our view. Structural risks have declined significantly, amid moderation in the constitutional process and tax and pension reforms. But inflation breakevens already price too much disinflation ahead without offering risk premium. We recommend buying 5y inflation swap breakevens at 2.94%.

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GEM Fixed Income Strategy & Economics
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Global risks felt in Santiago; cautious BCCh

We visited Santiago de Chile last week. Local sentiment has worsened this year due to the global situation and domestic political gridlock. Credit risks are seen as limited in the short-term due to prudent policy making and moderation in reforms and constitution process. See the report: Chile trip notes: weaker sentiment, but limited damage.

Higher US rates for longer (despite the recent rally) have weighed on Chile long end yields and CLP, adding constraints to monetary policy. As a result, BCCh moved to a more cautious stance both in terms of the pace of rate cuts and USD purchases. BCCh only cut 50bp in the last meeting to a 9% policy rate, following 75bp and 100bp cuts in the September and July meetings respectively. This makes it unlikely to meet the forward guidance of a rate between 7.75% and 8% in December (stated in September's minutes). See the report: BCCh cuts only 50bp and suspends FX accumulation program.

Stagflation scenario, but not a collapse

Economic activity remains weak (though it surprised on the upside in September, with Imacec flat at 0.0% yoy growth) and unemployment finally started to increase. Economists we met expect GDP decline of up to 0.5% for this year and GDP growth at about 1.5% in 2024 (below 2.5% government's GDP forecast). We expect a 0.3% GDP decline this year and a 2% rebound in 2024 amid lower policy uncertainty and some fiscal policy easing (downside risks given slower monetary easing).

We expect inflation at 0.5% mom in October, coming out this Wednesday (same as Bloomberg, down to 4.3% this year (from 5.1% yoy in September). We see inflation declining to 3.7% next year, still above the 3% target. Volatilie factors have put pressure in recent months despite ex-volatile inflation remained contained. See the report: Headline inflation upside surprise. But....

BCCh should continue cutting, not too fast, not too slow

Locals we met expect BCCh to keep cutting rates significantly as the domestic macro continues moving as BCCh expected (inflation expectations anchored at 3%, activity slowdown). We think the bar is high to resume 75bp rate cuts amid the current global volatility, but the benign domestic scenario and high interest rate (9%) allows for further cuts. We see the most likely outcome as 50bp-clip cuts in coming meetings. We expect the policy rate at 8.5% in December, 7% in June 2024 and 6.5% by the end of 2024.

BCCh suspension of the FX reserves accumulation program was seen as another signal that reinforced that the BCCh cares about CLP volatility and financial stability. This coincided with ministry of finance selling much less USD than the maximum announced ($2bn per month). They sold $1.1bn in September and only $0.6bn in October.

Keeping an eye on the fiscal

The current economic leadership is seen as limiting the fiscal deterioration, but locals seem to believe medium term balanced fiscal targets are very challenging as 2024 budget already used all the fiscal space (it is hard to raise taxes). Presidential elections are due in 2025. The fiscal deficit for next year (1.9% of GDP budget) is not yet concerning, but is consistent with debt-to-GDP still growing (to 41% of GDP according to the government). We see some risks to the 2024 budget as we forecast less GDP growth than the government's 2.5% (metal prices also a risk). The 2026 deficit target 0f 0.3% of GDP sounds optimistic to us considering spending demands (we think it will be hard to lower the deficit from current levels). Higher real rates for longer have deteriorated debt dynamics in most countries. Some locals were concerned about the magnitude of government bond issuance (over $19bn next year), which could put some pressure on yields.

Structural reforms: taxes, pension and Constitution

Structural risks have moderated considerably. Political analysts we met believe the constitutional referendum on December 17 will be tighter than polls show, but their base case is a rejection. The constitutional draft is seen as moderate in most aspects (like respect for property rights) which can make it palatable. However, the constitution draft is seen as more maximalist than expected. If it fails to pass, the constitutional reform process is seen on hold for at least two years as the population tires of the topic.

The probability of the government passing tax increases or pension reform is seen as very low, according to political analysts we met. This creates tensions as social spending promises that do not meet new revenue to finance them (pensions, health, education and security). The government is expected to send an income tax reform bill to Congress in March (no timeline yet expected for the pension reform). Locals see some room for agreement on pro-growth reform proposals including a bill to accelerate permits to big investment projects this year. Copper production is seen as increasing in coming years amid investment pick-up in the private sector.

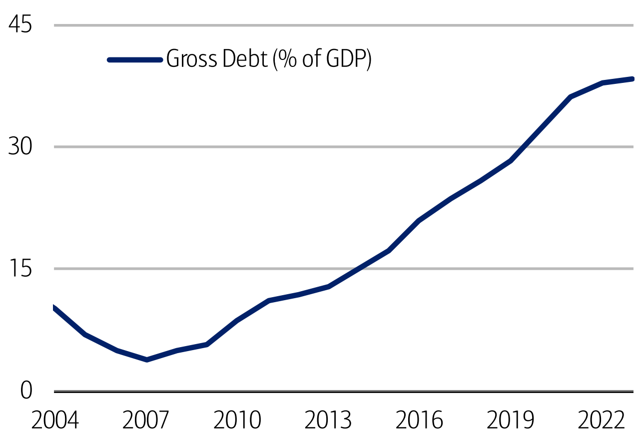
Strategy: Buy 5-year inflation swap breakevens

We recommend buying 5-year inflation swap breakevens at 2.94% targeting a level of 3.5%. Given historical average inflation of more than 3% and the deterioration of budget balances and rising debt levels, inflation breakevens should trade with a positive risk premium, and therefore above 3%. Risk to the trade is lower than expected inflation due to weak activity.

First, headline inflation has averaged 3.9% since 2004 and 4.4% since 2013, significantly above the 3% inflation target level. If history is any guide, investors should then require some positive risk premium. And second, fiscal policy has deteriorated significantly over the years – Chile run an average 0.6% budget surplus during 2004-2019 but we expect it to run a 2%-2.5% budget deficit over 2023-2025. Government debt has increased to almost 40% from just 10% in 2004 (see Exhibit 1). Weaker fiscal metrics increases the probability of higher future inflation.

A simple model of 5-year inflation swap breakevens based on realized inflation and the local currency price of crude oil suggests the fair-value is around 3.7% given the current inflation rate of 5.1%. Every additional 1pp of realized inflation contributes 11bp to 5y breakeven fair-values, so even assuming inflation will decline to 4% would still imply a fair-value breakeven of around 3.5% (see Exhibit 2).

Exhibit 1: Government debt rose to 40% from 10% in 2004.
Higher debt levels and budget deficits imply higher inflationary risks



Source: Haver Analytics

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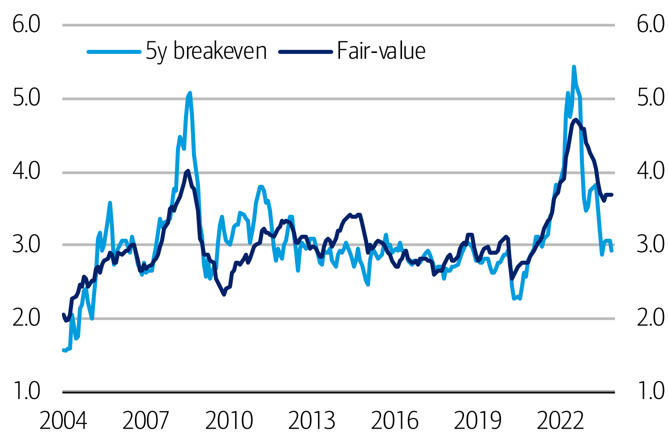
Exhibit 2: 5-year breakevens well below fair-value
We estimate 5-year breakevens are around 50bp below fair-value



Source: Bloomberg

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News and Views

Brazil: Copom Minutes kept the tone for further 50bps cuts ahead

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The Central Bank of Brazil (BCB) released the minutes of the last meeting of the Copom (Monetary Policy Committee), after cutting the Selic rate to 12.25% (from 12.75%). The minutes continued to highlight the decision to cut rates by 50bp in the last week, while maintaining the easing pace in next meetings. Compared to the statement, the board reinforced greater caution in the monetary policy, as the pace of 50bp clips per meeting remains the base case for the board. Both the decision of a 50 bp cut, and the forward guidance was unanimous. The importance of anchoring long-term inflation expectations was also an unanimity, as BCB members still only see a partial re-anchoring. Besides, the board stated higher risks regarding the compliance of the fiscal target, as well as the importance of strengthening the fiscal framework credibility in order to re-anchor inflation expectations.

- **To follow:** Inflation expectations above the target and continuity of disinflation were pointed as the main supporters of the 50bp cut. Therefore, we maintain our forecast of 50bps clips per meeting, with Selic reaching 11.75% by 2023YE, and 9.50% by 2024YE.

Brazil: Outstanding credit continues decelerating in yearly terms

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Total outstanding credit decelerated to 8.0% yoy in September (from 9.0% yoy in August) according to the Brazilian Central Bank (BCB). Since the begging in of the year, the bulk of deceleration came from non-earmarked loans (now at 6.0% yoy, from 15.0% yoy in January), particularly due to non-financial corporates (NFC). Overall earmarked loans have been decelerating as well, reaching 11.0% yoy (from 12.5% yoy in August). Regarding marginal data, originations increased 2.3% momsa, supported by non-earmarked performance, as growth in consumer loans was focused on collateralized products, such as payroll and auto loans, while credit cards and overdraft loans continued to decelerate. Also, broad credit growth, which includes debt securities, sovereign bonds and external debt, decelerated to 7.1% yoy, from 9.0% in the previous month, with all of these breaks decelerating. Weak loan growth reflects sticky indebtedness, which remains well above pre-pandemic levels. Household debt increased to 48.0% (from 47.8% in August), while the debt service ratio was to 27.5% in seasonally adjusted terms (stability compared to August). Individuals book NPL improved 10bp to 4.0% , while Corporate NPL remained flat at 2.7%.

- **To follow:** We remain concerned with credit conditions in Brazil, amid the high indebtedness of households, default rates and high interest rates. The picture should get less tight as lagged effects of monetary policy begin to be felt.

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