EM Alpha

Chile: Two new trades based on our higher inflation and policy rate views

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GEM FI & FX Strategy
Emerging Markets Global

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For a complete list of our open and closed trades over the past 12 months, see our latest Global Emerging Markets Weekly.

Trade #1: Buy 5y inflation swap breakevens

We recommend buying 5-year inflation swap breakevens at 2.80% (target 3.5%, stop 2.4%, historical vol 82bp) since we forecast higher inflation than priced and higher than expected by the consensus.

Long-term inflation breakevens well below the inflation target is a significant mispricing in our view. Inflation has averaged considerably more than 3% over the last two decades. And it is likely Chile's inflation will be higher going forward given higher expected inflation globally and weaker fiscal metrics domestically. Wage growth is also running at levels inconsistent with the 3% inflation target. The market is not pricing enough risk premium as a result.

Trade #2: Pay 3y2y forward CLP swap rates

We also recommend paying 3y2y forward swap rates at 4.62% (target 5.8%, stop 4.0%, historical vol 118bp) since we expect the monetary easing cycle to end with rates significantly above than forward prices and consensus expectations.

We forecast Chile's central bank will cut its benchmark rate to 6.5% by end-2024 and to 5.5% by end-2024 from 9% currently. These forecasts are well above market forwards of 5.25% by end-2024 and 4.50% by end-2025. We are also considerably above analysts' consensus of 5.00% by end-2024 and 4.25% by end-2025.

Referendum uncertainty may be a trigger

Chile will hold a constitutional referendum on December 17. Latest polls show about 50% would vote against, 32% in favor and 18% are undecided. While the proposal is not as market unfriendly as the one rejected in the 2022 referendum, we think rejection is the market's baseline. Yet, political analysts in our recent trip to Chile argued the referendum could be tighter than polls show (see Chile trip notes: weaker sentiment, but limited damage). Uncertainty may act as a trigger for a selloff in back end rates.

Lower inflation is the risk to both trades

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.

Chile: Buy 5Y Inflation Breakevens, Pay 3y2y Swap Forwards

We recommend two new trades in Chile's fixed income market. The first trade is buying 5-year inflation swap breakevens at 2.80% (target 3.5%, stop 2.4%, historical vol 82bp) since we forecast higher inflation than priced and higher than expected by the consensus. The second trade is paying 3y2y forward swap rates at 4.62% (target 5.8%, stop 4.0%, historical vol 118bp) since we expect the monetary easing cycle to end with rates significantly above than forward prices and consensus expectations.

Trade #1: Buy 5-year inflation swap breakevens

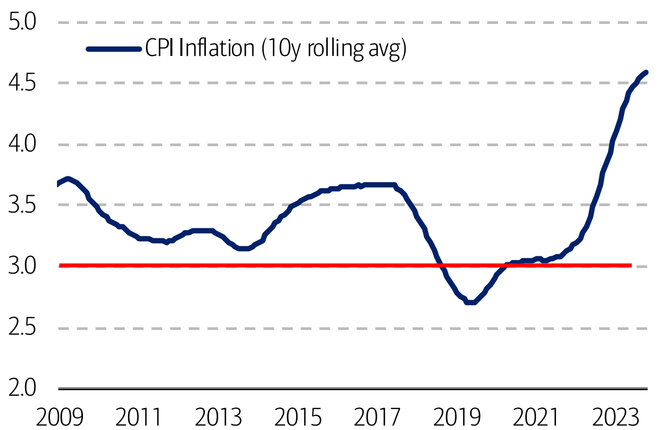
We recommend buying 5-year inflation swap breakevens at 2.80% targeting a level of 3.5%. Long-term inflation breakevens well below the inflation target is a significant mispricing in our view. Inflation has averaged considerably more than 3% over the last two decades. And it is likely Chile's inflation will be higher going forward given higher expected inflation globally and weaker fiscal metrics domestically. The market is not pricing enough risk premium as a result.

First, headline inflation has averaged 3.9% in the last two decades and 4.6% in the last ten year. That's significantly above the 3% inflation target level. Exhibit 1 shows rolling ten-year averages of CPI inflation and other than briefly during 2019 the ten-year smoothed inflation has always been above 3%. Market inflation breakevens should then build-in a positive risk premium on top of the 3% inflation target if based purely on historical data.

Second, Chile's fiscal metrics have worsened over time which adds to inflationary risks in the future. The government run an average 0.6% budget surplus during 2004-2019 but is now expected to run a 2-2.5% budget deficit over 2023-2025. As a result, gross debt has increased to almost 40% from just 10% in 2004 (see Exhibit 2). A weaker fiscal situation increases the probability of high inflation in the future. This is another reason why market inflation breakevens should price a higher risk premium than in the past.

And third, nominal wage growth accelerated to 8.9% in September from 8.0% in August. Even on a monthly basis, wages grew at a 1.2% pace, up from the 0.2% average in the previous two months. These levels of wage growth are obviously inconsistent with inflation rates at 3% (see Exhibit 3).

Exhibit 1: Inflation has averaged more than 3% most of the time
Rolling ten-year average of headline CPI inflation %YoY



Source: Haver Analytics

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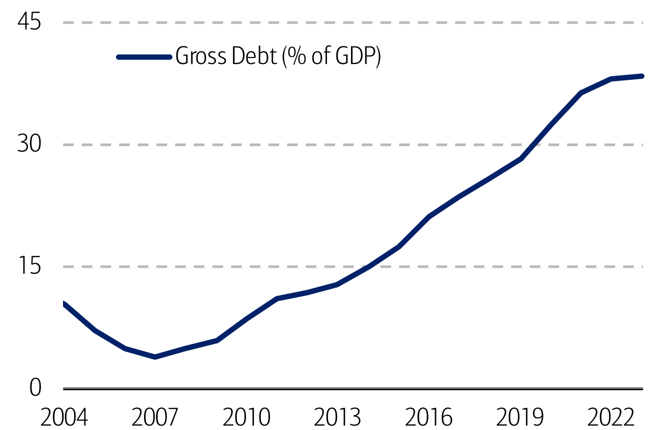
Exhibit 2: Government debt is considerably higher
Higher government debt levels adds to inflationary risks



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A simple regression of 5-year inflation swap breakevens 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 5.0%. 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 4).

A final note on the structure of Chile's inflation (UF-linked) market: The domestic banking sector has a structural position that is long inflation due to most mortgage loans being UF-linked. As a result, domestic banks are usually *sellers* of inflation in the derivatives markets to hedge their *long* inflation positions from mortgages. This structural hedging position implies market breakevens are on average *lower* than they would otherwise be. It also means buying the breakevens tend to have *higher positive* carry as a result.

Exhibit 3: Rapid wage growth inconsistent with inflation target
Wages growing at levels that are too high to be consistent with 3% inflation

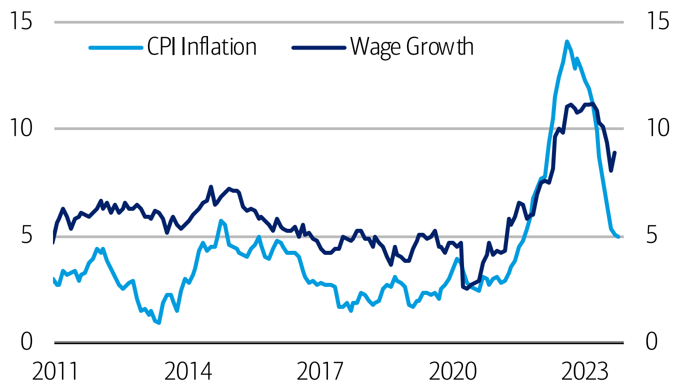

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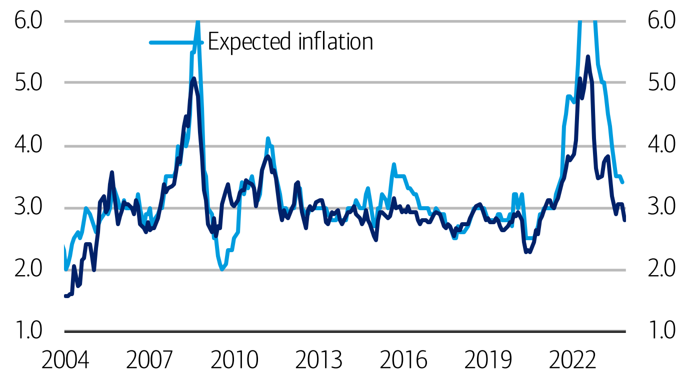
Exhibit 4: Five-year inflation breakevens are too low
Fair values based on OLS regression on CPI inflation and oil prices



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Trade #2: Pay 3y2y forward CLP swap rates

We also recommend paying 3y2y forward CLP swap rates at 4.62% targeting a level of 5.8%. We forecast Chile's central bank will cut its benchmark rate to 6.50% by end-2024 and to 5.50% by end-2024 from 9% currently. These forecasts are well above market forwards of 5.25% by end-2024 and 4.50% by end-2025. We are also considerably above analysts' consensus of 5.00% by end-2024 and 4.25% by end-2025 (see Exhibit 5).

Our less dovish view is due to higher inflation forecasts. We expect inflation to decelerate to 3.7% in 2024 and 3.3% in 2025 from 5.0% currently. If we are right, then Chile's central bank will have missed its 3% inflation target for five consecutive years. Consensus inflation forecasts are 3.2% for 2024 and 3.0% for 2025.

Exhibit 6 shows a regression of 3y2y CLP forward rates on 3y2y USD forward rates and 1y CLP interest rates, a proxy of policy rate expectations. These two factors explain almost 80% of the variability in CLP forward rates. Each 100bp increase in 3y2y USD forward rates leads to a 33bp increase in 3y2y CLP forward rates, and each 100bp increase in 1y CLP interest rates leads to a 50bp increase in 3y2y CLP forward rates. The fitted value of the 3y2y CLP forward rate is 5.75%, or 113bp above its current level.

Exhibit 5: Chile's benchmark rate forecasts
We expect significantly less rate cuts than consensus and forward pricing

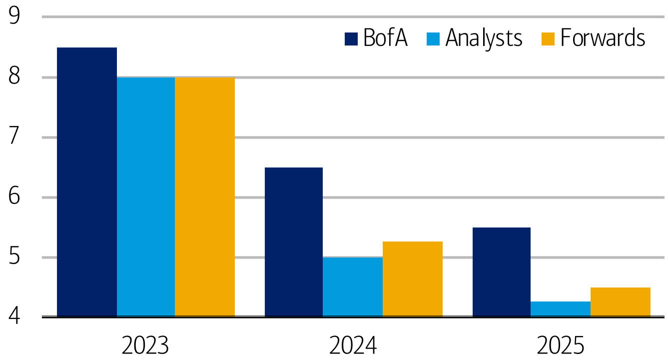

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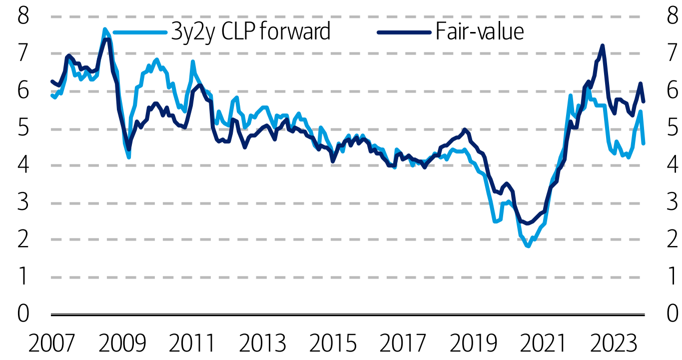
Exhibit 6: Forward CLP rates are too low given our policy rate path
Fair values based on OLS regression on 1y CLP and 3y2y USD forwards



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