Short CLP, Long USD

Thesis:

While many people have identified the Chilean Peso as an attractive Post Covid-19 reflation trade, poor post covid-19 recovery, concerns over sovereign debt, and a pricing in of rate hikes means that the currency seems to have appreciated as far as it can in the short term, with many potential downward triggers in the near term. I chose to pair CLP with USD as the rising US treasury yields are one of the major threats to CLP, with investors rotating money out of Chile and other Latin markets as American yields rise.

Short CLP:

New Constitution Creates Uncertainty

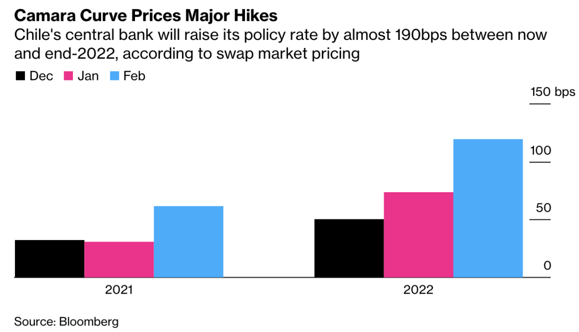
- In October of 2019, protests broke in Santiago over a 4 percent metro-fare hike, a policy that highlights how the government elite has failed to understand the concerns of the average citizen in Chile
    - Nearly ⅓ of Chile's wealth is held by just 1 percent of the population, leaving almost ½ of the nation drowning in debt
    - The increase in the metro tax was a symbolic breaking point of the government failing to represent the working class
- On Oct. 25, 2020, Chilean voters approved a referendum to draft a new constitution
    - The decision was widely popular, with 78 percent of Chileans voting in favor
- In April, Chileans will return to the polls to elect a constitutional convention to write the new charter
- Investors are concerned that the rewrite of the constitution will weaken the pillars of Chile's economy that have made them so stable over the past few decades
    - Higher corporate taxes, increased corporate regulation, privatization of water, and greater environmental restrictions are all changes that could be implemented
- Government programs seem almost certain to be expanded regardless of the result, which could be problematic Chile's gross debt is already projected to rise to 42.9% of GDP in 2024
- The drafting concludes in June 2022, meaning that the constitutional rewriting will cast a shadow over Chile for the foreseeable future
- It is a very delicate situation as too little change could enrage Chileans once more, sending them into the streets, while too much change could strip away the foundation of the Chilean economy

Chile Closes Borders amongst Pandemic Problems

- Chile is currently experiencing another outbreak of Covid-19, hurting their economic recovery as another lockdown is in place
- President Pinera mandated a strict quarantine that applies to 16 of the 19 million people
- The capital of Santiago has been completely frozen
- Chile will close its borders for the month of April in a dramatic escalation of coronavirus
- Health Ministry officials reported a daily record of 7,830 infections, an all-time high for occupied hospital beds and a nationwide positivity rate of 11%

- ➢ Chile also extended a nightly curfew and restricted retail activity to essential goods such as food and medicine
- ➢ Another lockdown will slow Chilean recovery and curb rising inflation, reducing the Peso's attractiveness by killing the possibility of higher yields

Interest Rate Hikes Far too Priced in



- ➢ Investors have priced in a rate hike schedule that does not appear to align with reality
- ➢ Investors are anticipating that rapid economic growth in Chile will cause inflation to skyrocket and push interest rates up
- ➢ The swap market has priced in nearly a 190bps rise in the interest rate under the assumption that inflation and rising treasury yields will force the Chilean government to respond by raising interest rates
- ➢ The market's projections are misguided for three main reasons
    - ○ The Central Bank has indicated that its timeline is far from the one that many investors project, signaling that they will maintain rates at 0.5% for at least the end of 2021
    - ○ The Central Bank is also confident that current inflation is 'transitory', and will fade once short-term demand and the copper boom fade
    - ○ Growth and Inflation numbers from December and January fell short of projections

Credit Downgrades Cast Concern

- ➢ Chile has also undergone a pair of recent credit downgrades
- ➢ S&P downgraded Chile from an A+ to an A, while Fitch downgraded Chile from an A to an A-, with both agencies citing increased fiscal pressures as a major reason why
- ➢ Chile has been forced to increase spending during the pandemic, leading projections of their central government fiscal deficit to rise to 8.5% of GDP in 2020 and 5.1% of GDP in 2021 in comparison to 2.8% of GDP in 2019 and 1.7% in 2018.
- ➢ Whie Chile is still the highest graded nation in Latin America, these downgrades are already depreciating the Peso, as it has slid since the announcement

Copper Rally Fades

- ➢ The Peso has recently traded as a proxy of copper
- ➢ This led to sharp Peso appreciation as the price of copper boomed earlier
- ➢ Copper has started to cool off, however, creating a downward pressure on the Peso which we have already seen
- ➢ Chinese Demand Set to Fade
    - ○ A lot of the copper demand was fueled by Chinese stimulus, which is starting to be pulled back
    - ○ In order for Copper to continue to rise, it depends on demand from the rest of the world
- ➢ Supply Returns Post Covid-19, CRU expecting global production to jump up by 2.9% in 2021
- ➢ At this point, Copper has been priced in and the Peso can only negatively respond to a decline in copper price

Long USD

Rising Treasury Yields

- ➢ Rising US Treasury Yields have created pressure on emerging markets as investors have flocked towards higher returns
- ➢ This rise in treasury yields has increased inflows into the United States and of the dollar, appreciating of late
- ➢ A Strong US Economy will only bolster this sentiment
  - ○ Nonfarm payrolls rose by 916,000 in March, while the unemployment rate declined to 6%. The job growth was well ahead of Dow Jones estimates for 675,000 and the fastest since August 2020.
- ➢ Yields could rise towards 2%, meaning that this appreciation is not done yet

Vaccination Rollout Success

- ➢ Over 50 million people have been fully vaccinated
- ➢ This translates to 17.5% of the population being fully vaccinated
- ➢ More than 30% of the United States population also has at least one dose
- ➢ America has had one of the most successful vaccine rollout programs in the world, with enough vaccines for its entire population by this July
- ➢ The successful vaccine rollout will boost economic growth and increase inflation, which should continue to fuel the increase in treasury yields in the status quo and excite investors seeking higher rates

Risks

Chile’s Central Bank turning more hawkish

- ➢ Last week, there were some signs of a more Hawkish Central Bank
- ➢ The central bank dropped a pledge to hold borrowing costs steady during the two-year policy horizon
- ➢ One economist explains that “There were substantial changes in the language of the expected path of the key rate, which is now linked to the process of economic recovery”
  - ○ “The central bank is no longer talking about a steady key rate during most of the policy horizon” he explained
- ➢ Economist growth also is expected more bullish than prior projections
  - ○ The Bank’s monetary report this week forecasted growth between 6% and 7%, higher than December projections of 5.5% to 6.5%

Conclusion:

Overall, I think that there are a combination of factors that should serve as a bearish force upon CLP. The Peso, similar to many other Latin American currencies, seems to have rapid economic growth and rate hikes far too priced in, with only potential for downward movement on these fronts. In addition, the presence of uncertainty around the constitutional situation of Chile could cause new bearish theses to emerge amongst investors, adding further unique risk. In contrast, the United States looks to have an excellent 2020 as yields rise and its economy reopens. Much of this success will come directly at the expense of emerging markets like Chile, which is a major reason why this is such a logical pair.