October Preview

**Negative surprises not enough to change base rate direction**

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On Thursday (19), Chile’s central bank (BCCh) will hold its October monetary policy meeting, where the market (including us) expect it to remain on hold, as suggested by recent communications. For the last paragraph of the communiqué, which reflects the monetary policy stance in the short term, we expect no changes to its neutral stance.

Since the last monetary policy meeting (September 14), the main news was the negative inflation surprise in September. However, BCCh could easily downplay the inflation surprise (mostly linked to volatile items), and continue to have a constructive view on economic activity going forward.

Regarding inflation, there was a significant negative surprise of 0.4pp (-0.2% m/m vs. market at +0.2%), which was mainly explained by the non-core CPI, particularly volatile food prices and energy. On its part, core inflation came in broadly in line with the expected pass-through of recent peso appreciation, showing a clear downward trend in the last few months. In recent communications (e.g., minutes) the central bank has stated that it was not the risk of low short-term inflation per se what justified the option of cutting rates, but the impact of these risks on the convergence path to the inflation target in the policy horizon. **It is important to say that for BCCh the low inflation prints are a transitory phenomenon mainly explained by the appreciation of the peso and a low variation of food prices, while the non-core inflation part has moved broadly in line with their forecast.**

Regarding inflation expectations, both the economist and trader survey downgraded the 1yr horizon expectations (2.5% and 2.3%, from 2.7% and 2.6%, respectively) and, in the case of the trader survey, there was a slight downgrade in the 2yrs horizon expectations as well to 2.7% (from 2.8%, the lowest print since the year 2009); in the case of the economist survey, inflation expectations for the 2yrs horizon remained at 3%, although we observed a shift to the left in its distribution (35% of economists expect inflation below 3%, while in September survey it was 30%).

As for economic activity, 2.4% Imacec growth came in slightly below market expectations at 2.7%, but above economists’ expectations before sector data were released at 2%. Non-mining activity came in at 1.8% y/y (vs. July’s 2.6% y/y). The central bank explained that construction sector was a negative contributor, suggesting that its negative effect on the economy has still not faded away. For their part, wholesale & retail commerce and services were highlighted as positive drivers for the economy. In seasonally- and calendar-adjusted terms, the Imacec increased 0.3% m/m (7.5% 3m/3m a.r. s.a.), its fifth consecutive improvement at the margin, with a positive performance from non-mining activity as well (+0.2% m/m and 3.9% 3m/3m a.r. s.a.), suggesting the economy is picking up after 3 quarters of low growth figures. On the manufacturing side, it seems that the sector left behind the negative prints of previous years, but we do not observe a swift recovery, while retail sales prints posted strong growth, mainly in durable goods.

Recent coincident economic activity data show that some relevant components of domestic demand, mainly private consumption and machinery and equipment (imports), are firming up, suggesting higher economic growth for the second half of this year. As for leading indicators, we highlight the significant improvement of Chile’s PMI.
(IMCE), standing at a level of 48.26, only slightly below the neutral threshold (50) and well above the August print of 43.17, with its non-mining index standing at 44.61, above the previous month at 42.93. Notably, capex intentions stood close to neutral levels for both retail sales and manufacturing, while hiring intentions jumped significantly for retail sales (51.2 vs. previous 43.6). We highlight the significant improvement in expectations on Chile’s economic outlook, which moved from a pessimistic level to significantly high optimistic levels (60.9 vs. 43.3 in August).

On the labor side, the unemployment rate stood at 6.6% in June-August (vs. May-July and the same period last year at 6.9%), below market expectations of 6.8% (we had 6.9%) and also below the typical seasonality variation at this time of the year, mainly explained by the positive performance of self-employment (+4.3% y/y, 1pp contribution) and public payrolls (+10.2% y/y, 1.1pp contribution), while private payrolls suffered again (-0.2% y/y, -0.1pp contribution). The labor force increased 2.1% y/y (+0.1% m/m s.a.). These numbers suggest stable labor market conditions, mainly on the back of low quality employment and public services.

On the international front, we continue to observe a positive outlook for the Chilean economy, with a sustained increase in copper prices, a firm growth outlook in the developed world, and a stable outlook in emerging economies, which have been favored by positive financial conditions.

As we see it, despite the negative headline surprises for economic activity and inflation, an improving economic outlook together with a non-core inflation moving broadly in line with expectations, BCCh will not change its view on the direction of the monetary policy rate. However, we still expect BCCh to include cutting rates as a relevant option, especially considering that negative second-round effects are still possible, the decline in medium-term inflation expectations, and the fact that the economy has not yet started to close the output gap, with a construction sector that is still lagging behind.
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