

# A look at the new government in Chile: Market implications in 2022

*Following Chile's polarized electoral contest, president-elect Boric appointed a balanced Cabinet seen positively by markets, led by the well-respected former Central Bank head Mario Marcel as Finance Minister, along with other moderates from different parties. This announcement, along with a positive momentum in commodities, provided a 3% boost to the CLP and 30bps improvement in rates during that week, while Latam showed mixed movements.*

In the following pages, we seek to answer whether the newly formed Cabinet and Congress will be sufficient to balance uncertainty around the Constitutional Convention, where citizens will be called to approve or reject a new Constitution (most likely in September). At the same time, we will explore other factors that could take center stage in 2022. Finally, we conclude that we see opportunity in the CLP, with 2-2.5% appreciation in 2022, and a rate relief of 40bps on average, within a context dominated by the referendum, commodity prices (e.g. growth in China) and economic dynamism (or lack thereof).

## **Another year of widespread political risk in several Latam economies**

We would argue that political noise began in Santiago de Chile in October 2019 and that the pandemic provided a respite (2020), which came to an end in January 2021 as countries began to ease health restrictions.

A general dissatisfaction with traditional politics and with the scope of the economic model, culminated in Chile with the election of Gabriel Boric, the youngest-ever President (36 years old) in the history of the Country. However, momentum from the left that manifested itself in the Constitutional Convention (May 2021), lost strength and the Chilean people elected a center-right Congress, delivering a clear message of moderation to the new President. Boric seems to have fully understood this message and appointed a Cabinet that departs from initial concerns of extremes. This was reflected in the nomination of Mario Marcel, at that time the President of the Central Bank, as Finance Minister, indicating a moderation in fiscal spending more in line with revenue collection.

However, as long as the constitutional process is still underway, volatility in financial markets will likely continue. We believe that the three following aspects will play a fundamental role in asset transactions over the coming months: i) political dynamics; ii) economic slowdown; and iii) commodity prices.

## 1. Despite a good takeoff, there are still clouds on the horizon

Without backing away from a leftist mandate, President Boric has broadened his political base by appointing a balanced and inclusive cabinet. The appointment of the prominent Finance Minister, Mario Marcel is joined by Antonia Urrejola in Foreign Affairs, who has been an advisor to past governments, Juan Carlos Muñoz in Transportation, an advisor to former President Ricardo Lagos, Carlos Montes in Housing, who has an extensive political career, among others. Now comes the challenging part: governing. This is made even more difficult since it has to be done with a team that was not part of the campaign and has not worked together in the past and that individually each surpass the President in terms of experience and knowledge.

Another factor that will soon affect the government, are campaign promises made to allies, that were a fundamental part of the election; such as the change in the pension system, free public transport, an emergency

housing plan, tax reform, labor reform and environmental initiatives affecting the mining industry. These demands will be confronted by a moderate left-wing Cabinet, with a finance minister ensuring fiscal sustainability of the proposed model and a Senate avoiding any reforms that significantly damage the current system. How will the Constitutional Convention react to this scenario? Therein lies the source of uncertainty.

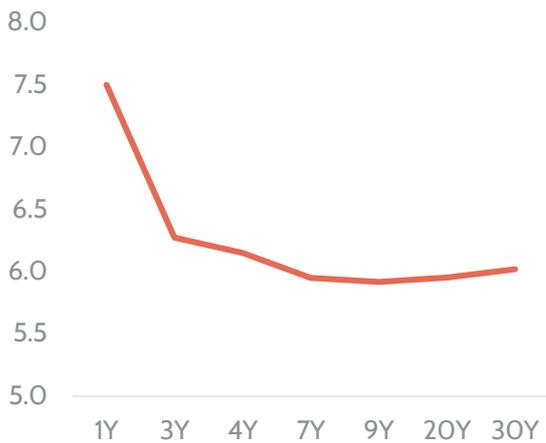
The Constitutional Convention has mentioned initiatives, such as the elimination of certain liberties for private investment, as well as the possibility of limiting the power of the Senate to approve reforms. However, there is an obligatory referendum in September 2022, and we believe it would be difficult to conceive the approval of a document that diverges greatly from the current government line: less radicalization and driving the economy forward in order to finance their plan. However, there is space for political noise in the interim.

## 2. Rates dynamic in 2022: will a potential deceleration generate a pause?

Since the beginning of 1H21, monetary policy rate (MPR) for Latin American countries maintain a hawkish bias given persistent inflation. Chile was no exception, raising its rate by 500bps since last July, only surpassed by Brazil (+875bps) in Latin America. As of the publication of this article, the implied forward MPR for June 2022 is 8.50%, which implies 200bps in March, 75bps in May and 25bps in June (see Figure 1).

We believe the market is downplaying an economic slowdown starting in 1Q22. The Chilean economy closed 2021 with 12% growth, widely exceeding pre-pandemic levels (see Figure 2), driven by private consumption (~12.5pp of the increase), on the back of liquidity from pension fund withdrawals and tax transfers. However, both factors will be left behind and we expect to see a deceleration by 1Q22, which would lead to a 1.5% QoQ contraction and a technical recession throughout 1H22 due to a steep decline on domestic demand.

**Figure 1: Nominal Bonds Curve (YTM)**



Source: BSR CCAM, Bloomberg

**Figure 2: GDP (S.A. and Y/Y%)**

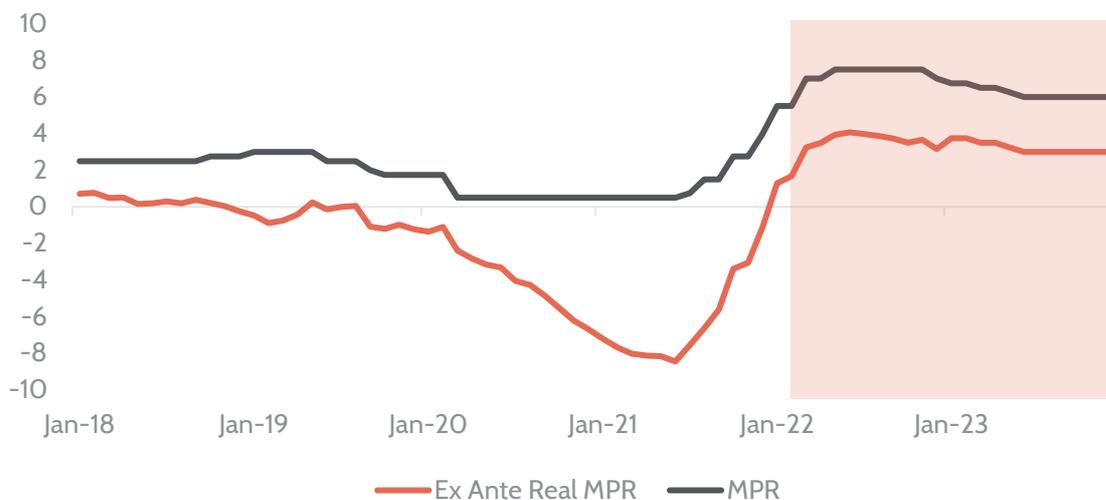


Source: Banco Central de Chile, BSR CCAM

The latter, would go hand in hand with lower inflation. We do not believe monthly figures above 0.5% will be recorded again as of May this year, given demand will not deliver support, thus the price of goods and services should begin to gradually converge.

In this context, what do we see in terms of monetary policy? We do not expect persistent MPR hikes until June, as per market forecasts. We project a 150-175bps hike during the next monetary policy meeting and only if an additional adjustment is needed in May. In any scenario, we expect a maximum MPR below 8% (see Figure 3). What does this imply? This would lead to a significant correction in nominal rates, of around 60bps in a 3-6 month period and 40bps in 1-2 years. Over longer periods and guided by fundamentals, we expect a 25bps reversal by the 5Y node onwards.

**Figure 3: Nominal and Ex Ante Real MPR**



Source: Banco Central de Chile, BSR CCAM

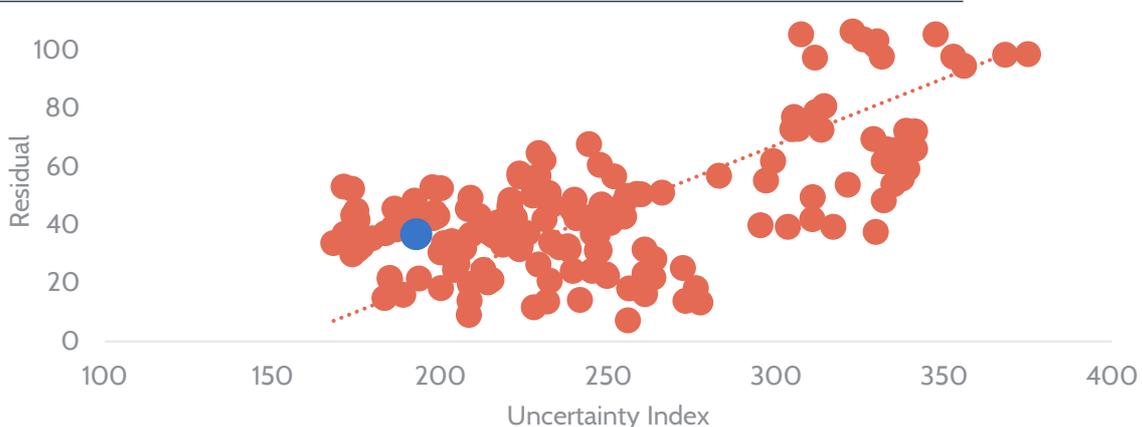
### 3. CLP: copper and greater political certainty would provide support

In the short term, we believe CLP levels would remain steady, with a certain degree of volatility as we approach the constitutional referendum period, to subsequently begin a process of moderate appreciation, approaching CLP780 by year-end, due to favorable commodity prices and lower uncertainty. This level would still be above its fair value, which we estimate at \$760, mainly due to the premium for political uncertainty on the CLP.

Recently, the CLP has detached itself from its fundamentals (PCu, CDS, rate differentials), nonetheless, we believe these variables will continue to sustain an appreciated fair value, with Chile being the world's largest exporter of copper, benefitting from Chinese demand given its energy matrix change, and recent rate hike cycle which we expect to continue during 1H22. In this line, movements attributed to these factors would range between -0.5% and 1%; not very significant, but relevant in terms of containing further CLP deterioration.

This spread in CLP over its fair value, given the current situation, is mostly explained by other qualitative variables, such as the daily uncertainty index based on data from Twitter (BCCh). As we see in Figure 4, the residual from the fundamental model has a direct relation to the uncertainty index, where the blue circle shows that recent appreciation went hand in hand with lower uncertainty. From this perspective, we expect that by the end of the year, the government will have set in motion its model and the Constitutional Convention will deliver new constitutional guidelines providing a clear framework, translating into a reduction in CLP spread attributed to this factor.

**Figure 4: Scatter Residual (Fundamental Model) v.s Uncertainty Index**



Source: Banco Central de Chile, BSR CCAM

In conclusion, we expect CLP appreciation to USD/CLP 780 over the next six months, driven by a positive global context with high copper prices. During 2H22, we expect that greater clarity on a regulatory framework will moderate the uncertainty that has been dragging on since October 2019 at the local level.

## Takeaways

- Our analysis indicates that the main factors affecting market volatility and prices in 2022 will respond to the local political scenario (having observed a “mini rally” when Boric appointed his Cabinet). Furthermore, we believe that one of the factors that would have the most impact on asset valuation would be the certainty and institutional framework provided by the new Constitution.
- Nonetheless, we must not ignore a global context of high commodity prices, and in particular Copper, which would not fall below USD 4.3/pound, supporting a CLP at a contained level compared to previous weeks. This view is also supported by an upward MPR cycle which could maintain an attractive carry trade spread.
- We expect CLP appreciation of 2-2.5% by year-end 2022, mainly affected by a lower currency premium due to uncertainty. In terms of monetary policy rate, we believe the market overreacted to the latest inflation data, leaving aside expectations of an imminent economic slowdown due to lower domestic demand, thus we estimate minor increases resulting in a policy rate of 7.75-8% (market estimates 8.5%). This would lead to a correction in nominal rates close to 60bps in a period between 3-6M, 40bps between 1-2Y and 25bps for longer periods.



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