Economics and Strategy
Latin America - Chile

HSBC Global Research

# Chile Economics & Strategy

## Weaker CLP in 2012

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**Clyde Wardle**
EM FX Strategist
HSBC Securities (USA) Inc.
+1 212 525 3345 clyde.wardle@us.hsbc.com

**Marjorie Hernandez**
Latam FX Strategist
HSBC Securities (USA) Inc.
+1 212 525 4109 marjorie.hernandez@us.hsbc.com

**Jorge Morgenstern**
Economist
HSBC Bank Argentina S.A.
+54 11 4130 9229 Jorge.morgenstern@hsbc.com.ar



- **We identify five key drivers for the Chilean peso (CLP) in 2012**
- **We believe most of these will have a net negative influence on the CLP, although many carry a high degree of uncertainty**
- **We have revised our USD-CLP forecasts higher, now expecting the pair to trade at 530.0 at end-2012, up from 470.0**

## Weaker CLP in 2012

In this report, we analyze five factors that we expect to be the main influences on the Chilean peso (CLP) in 2012. These are:

1. **Eurozone, broad risk on/risk off movements**: A high degree of uncertainty, but we lean towards this being a net **negative** influence, especially in 1H 2012.
2. **China GDP growth, commodity prices**: Again, quite uncertain, and no hard landing for China, but nevertheless we expect softening Chinese growth will be a **headwind for the CLP**.
3. **Chile's growth and interest rates**: Declining growth and interest rates are likely to be net **CLP-negative**
4. **Current account balance**: The shift towards a negative current account balance is **CLP-negative**
5. **FX Positioning**: In general, light positioning is broadly **CLP-positive**, but local pension funds (AFPs) shifting funds overseas on any improvement in risk appetite **could pose headwinds for the CLP** in the shorter term.

We summarize our FX forecast revisions in the table below and discuss the factors in more detail in the report:

**Table 1: HSBC USD-CLP FX forecasts**

| | Old forecasts | New forecasts |
|---|---|---|
| 4Q11(f) | 455 | 515 |
| 1Q12(f) | 455 | 525 |
| 2Q12(f) | 460 | 530 |
| 3Q12(f) | 465 | 530 |
| 4Q12(f) | 470 | 530 |

Source: HSBC

# Key drivers for the CLP in 2012

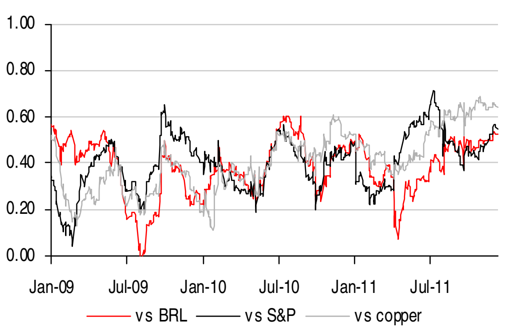
Looking ahead to next year, below we identify the likely key influences for the Chilean peso. In general, we expect most of these to have a more negative impact on the CLP, although many are subject to a high degree of uncertainty given the unpredictable external environment.

We discuss each driver below:

## 1. Eurozone outcome and broader risk on/risk off movements

This factor remains the most important factor for the CLP, we believe. The CLP continues to show a strong correlation to other 'risk on' assets, notably the BRL and the S&P500 Index. For example, the current 3-month rolling correlation of daily differences between the CLP and BRL is 0.52, and between the CLP and the S&P is 0.55 (see Chart 1). Both are currently above their 2-year averages of 0.40 and 0.42, respectively.

**Chart 1: CLP correlation with BRL, S&P and copper**




Source: Bloomberg, HSBC

The recent EU Summit resulted in a plan for tighter fiscal rules for the majority of EU members (although some countries may yet face resistance at home) and an acceleration of the European Stabilisation Mechanism. But the outcome once again underlined that there will be no quick fix (see *EU Council Summit*, 9 December). Our house view remains that we still need to see common Eurobond issuance and a larger role for the ECB's balance sheet before we see market stresses (read European bond yields) begin to recede.

Therefore, with an assumption that eurozone stresses will not dissipate in the short term, we expect the CLP will struggle to recover back to levels seen during the first eight months of 2011. Indeed, we find it increasingly unlikely that USD-CLP can trade back below the psychological 500.0 level without more meaningful positive developments in the external environment.

### Funding stresses/repatriation risks

In our report, *European banks' funding: Don't panic, but keep a watchful eye*, 12 December, we reviewed the potential for stresses from the eurozone crisis to affect the Latam region. Note, we would distinguish these from the broader risk on/risk off influences on the CLP discussed above.

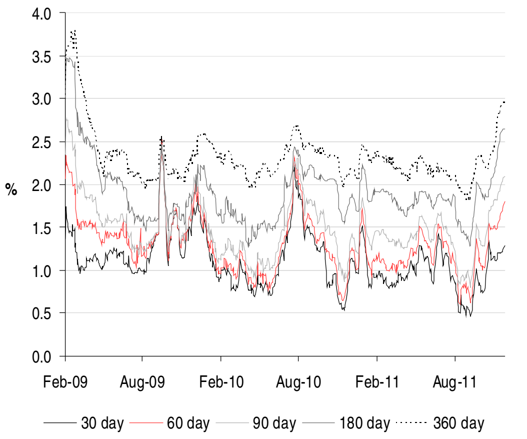
In our report, we identified a number of channels of potential stresses:

- non-renewal of credit lines, generating higher funding costs
- the ability of exporters to absorb higher funding costs
- alternative sources of funding
- repatriation risks for currencies

Notably, we find Chile as being the most exposed to potential funding stresses from a withdrawal of credit from European banks, given its relatively high reliance on funding from European sources.

Indeed, already we are seeing higher USD borrowing costs for onshore financial institutions, especially at the back end of the curve. For example, one year USD rates onshore in Chile have widened out from 2.20% at the beginning of November to 2.96% on 12 December (see dotted line in Chart 2 below).

Chart 2: Onshore USD funding rates are higher

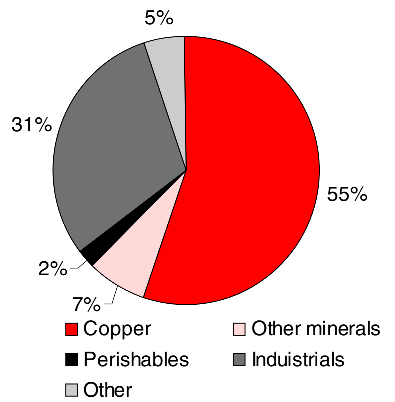



Source: www.abif.cl, HSBC

## 2. China's GDP growth and commodity prices, particularly copper

At 55% of total exports, copper still represents a substantial portion of Chilean trade (see Chart 3), although this figure has fallen from about 65% in 2009. This illustrates the importance of commodity prices to Chile's overall balance of payments.

Chart 3: Chile's exports are dominated by copper and other minerals

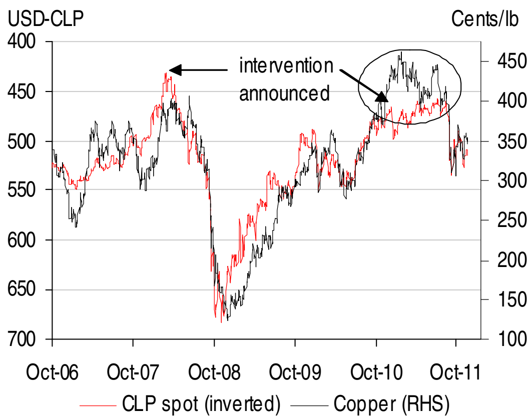



Source: Bloomberg, HSBC

Indeed, as was shown in Chart 1, the correlation between the CLP and copper prices, at 0.64, is even higher than that seen between the CLP and BRL or the S&P500 Index.

Chart 4 shows USD-CLP (inverted) against copper prices, showing the clear relationship that existed between them over the last five years. We also highlight the start of USD buying intervention that the central bank embarked upon in both 2008 and 2011 (arrows). The latest round of intervention (USD12bn bought during 2011) appears to have prevented USD-CLP from tracking the copper rallies seen in 1Q and 3Q 2011, which, based on past history, might have seen USD-CLP fall to around the 420-430 area (see circled area on Chart 4). Instead, USD-CLP only reached a low during the past year of 454.8.

Chart 4: Intervention in 2011 interrupted the normal relationship between copper prices and the CLP




Source: Bloomberg, HSBC

However, since September, we have seen copper and the CLP move much more in tandem with each other and the move in copper back below USD3.50/lb taking USD-CLP back above the 500 mark.

All this leads us to maintain our conviction that the CLP remains at the mercy of copper prices and commodities more generally. To that end, China's economic performance will remain crucial.

We assume China will engineer a soft landing, avoiding a hard crash, but even our base case assumes softening activity data. Indeed recent data prints for November have shown official manufacturing and non-manufacturing PMI's dipping below the 50.0 boom/bust level, driven

mostly by a sharp drop in both output and new orders. This, as well as a fall in China's inflation to 4.2% from 5.5% (consensus was expecting 4.5%), has prompted the PBOC to initiate an easing cycle with a 50bp cut in the reserve requirement ratio (RRR) on 30 November.

Looking ahead, as China's growth rate takes over from inflation as the primary area of concern for Beijing policymakers, our economists expect more aggressive easing into the next quarter. They expect another 150bp of RRR cuts in 1H and a larger new loan quota for 2012. Interest rates, however, will unlikely be lowered until China's CPI slows to below 3%, they believe. They also expect fiscal policies to be used (tax cuts for small and medium sized companies have just been announced), and the result to be that growth should remain above 8.0% in 2012.

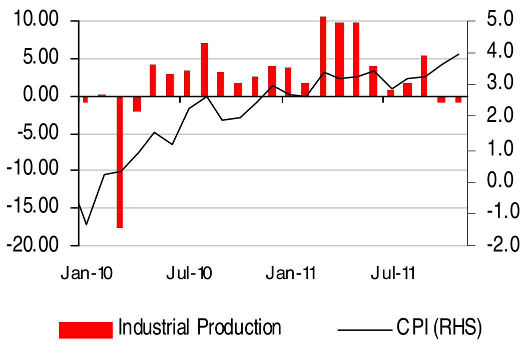
Our own house view on copper envisages weaker demand from Europe and North America being offset by relative strength in China and other developing markets, which will see prices average above USD3.50/lb in 2012. While this is good news overall, there remains a risk that a slowing Chinese economy (and a 'permafrost' in the West) is an environment where commodity prices in general will struggle to rally. If copper prices can manage to average above USD3.50/lb next year, this should offer the CLP some support in the face of other negative pressures, but we are unconvinced that, by itself, it can sustain a strong rally, and worry that the risk to our copper forecasts is to the downside.

## 3. Growth and interest rates

Economic activity decelerated in H2 2011, partly due to a series of supply disruptions affecting first mining and then manufacturing production. Despite that, the economy looks likely to achieve close to potential annualized GDP growth of 4.0-5.0% by the end of the year. We forecasts 4.5% GDP growth for 2012.

Meanwhile, inflation surprised to the upside in recent months, but should be headed back towards the middle of the central bank's target range of 2.0-4.0% (see Chart 5).

**Chart 5: Activity has been negative in the past two months**



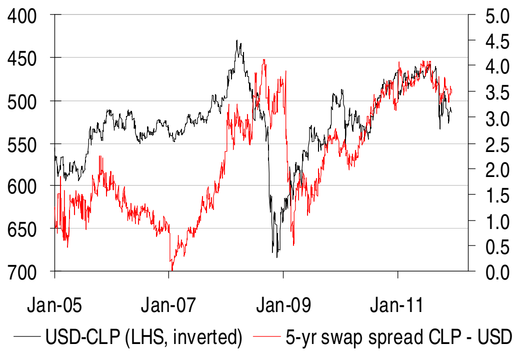

Source: Bloomberg, HSBC

In this environment, and with risks to both GDP growth and inflation tilted to the downside, we expect the Central Bank of Chile to ease monetary conditions, cutting the monetary policy rate by 75bp to 4.50% during the first quarter of 2012.

Given this, and the fact that US interest rates are expected to remain low, we would expect spread differentials between Chile and US rates to narrow. This is a potentially important factor for the CLP.

Chart 6 shows 5-year swap spreads between Chile and the US against USD-CLP. As can be seen, there is a tangible link between the two indices, the implication being that lower spreads will see the CLP weaken against the dollar (the traditional interest rate differential vs currency pair relationship). Indeed, looking across all emerging market currencies and these swap spreads, we find that Chile is the most correlated in this way.

Chart 6: USD-CLP and 5-year swap spreads tend to move in tandem




Source: Bloomberg, HSBC

## 4. Deterioration in current account balance

We have revised down our current account forecasts for 2011 on the back of supply disruptions affecting mining production in Q3 and the decline in copper prices. We now expect a USD1.6bn deficit, where previously we expected a USD0.4bn surplus.

For 2012, we expect to see the current account deficit widening to USD2.7bn (USD1.3bn previously), mainly due to lower average copper prices (see Chart 7). However, the deterioration should be contained by several factors, we believe:

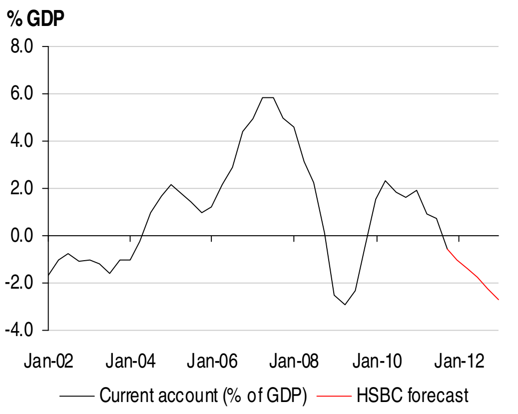
1 Mining production is expected to improve next year, assuming less strike activity in 2012 and the impact of new operations coming on line.

2 Dividend payments from FDI should also come down following the weaker performance of exports in the latter part of 2011.

3 Imports should decelerate markedly due to the deceleration of economic activity and the weakening of the currency (see our revised forecasts below) making external goods more expensive.

The overall balance of payments has showed a marked deterioration in the current account balance to a USD2.9bn deficit in Q3, following a USD0.2bn surplus in Q2 and a USD0.1bn surplus a year ago. The deterioration was explained by the surge in imports and the slowdown in mining exports. Current transfers moderated from previous quarters, while the deficit on services and dividend payments remained stable.

Chart 7: Chile's current account balance has deteriorated




Source: Bloomberg, HSBC

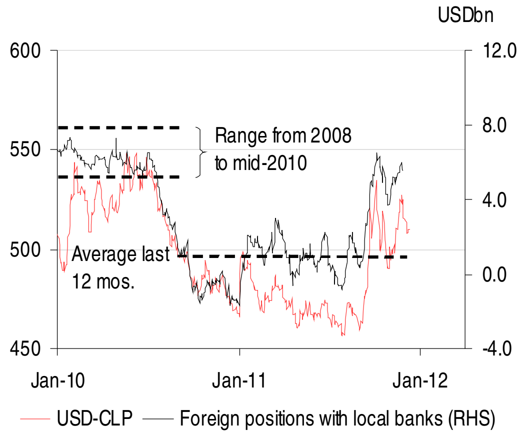
The move from surplus to deficit will be a negative drag on the CLP, and will likely only be curtailed by a significant increase in copper prices, which we do not foresee.

## 5. FX positioning

Looking at FX positioning in USD-CLP, the best metric we have to use is foreign positions with local financial institutions as reported by the central bank. Since 3Q 2010, we have seen two developments in the relationship between these FX positions and movements in USD-CLP.

First, from July 2010 onwards, we saw a structural shift away from the long USD6.0-8.0bn range that had been seen over the previous few years. At that time, positions moved sharply in favour of the CLP and by 4Q 2010 had actually moved to being short USDs. Around the same time (July 2010), we began to see a greater correlation between these positions and USD-CLP (see Chart 8).

Chart 8: FX positioning is light CLP (long USDs)




Source: BCCH, Bloomberg, HSBC

We believe the two factors are related and that since July 2010, we have seen more 'speculative' trading in the CLP through this channel, most of which during 2H 2010 was directed towards long CLP positions.

Since September 2011, however, we have seen a sharp move back in favour of the USD, and this has coincided with USD-CLP's move back above 500. The positions reached a recent peak of long USD6.3bn and at the end of November (most recent data) stood at long USD5.6bn. We can therefore say that current positions strongly favour the USD compared to the average over the past 12 months (long USD1.6bn), although compared to the two year period to mid-2010, positions are perhaps just back to 'normal' levels.

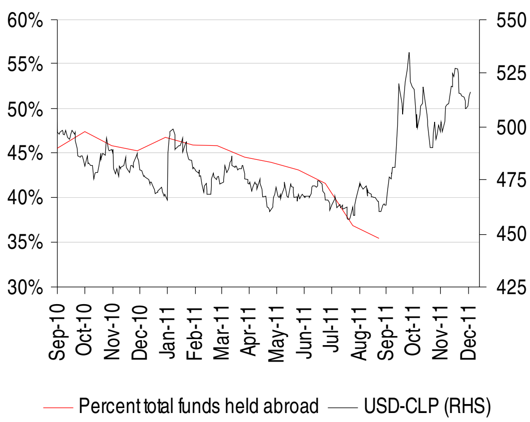
Indeed, if we consider that at present less 'speculators' are engaged in the market, perhaps current positions are reflective of underlying hedge positions, and might therefore be deemed more 'normal'.

Either way, it is clear to us that the 'speculative' community is no longer holding large long CLP (short USD) positions. This is potentially good news for the CLP should we see a sustained recovery in risk appetite at some point, and could result in a bigger rally for the CLP should this occur. That said, we would stress that this is not something that we are expecting given what we know now.

## Watch pension funds' overseas assets also

It is also worth watching domestic pension funds' (AFPs') overseas assets. The amount of their funds held abroad has been trending lower in recent months, down from 45% of total funds in September 2010 to just 35% in September 2011 (see Chart 9). This move away from overseas assets has presumably come as a result of the weakening external environment during the past year, leaving pension funds less comfortable with large holdings of overseas assets.

Chart 9: AFPs currently have relatively low holdings of overseas assets




Source: www.spensiones.cl

However, the effect that this movement of funds may have on the CLP is difficult to ascertain. On the one hand, moving funds back into Chile from overseas would be expected to see the CLP strengthen – and Chart 9 implies this might be the case – but at the same time many AFPs hedge their overseas positions back into CLP from a foreign exchange risk perspective. This means that while they may hold overseas assets, they may not have full FX exposure to those assets. Conversely, as AFPs bring assets back into Chile, any accompanying FX hedges will be unwound,

meaning that the overall impact on USD-CLP spot is much reduced.

Nevertheless, if a number of AFPs all chose to increase (or decrease) their overseas allocations around the same time, we can see these fund flows have a short term impact on spot movements.

The bottom line is that current levels of overseas assets held by AFPs are relatively low. This may mean that even should we see an improvement in the external environment – that in theory might be CLP-positive – should the AFPs decide in that scenario to move more funds back overseas, this could act as a headwind against CLP gains.

## Conclusion: CLP weaker in 2012

Of the five factors discussed above, many are potentially negative for the CLP, although we recognize that many carry a high degree of uncertainty. Perhaps most uncertain is the outlook for Europe – both the performance of the economies and their debt markets – and the CLP's movements vs the USD will be highly dependent on these. Below, we summarize each factor and whether its influence will likely be positive or negative on the CLP.

1. **Eurozone, broad risk on/risk off movements**: A high degree of uncertainty, but we lean towards this being a net **negative** influence, especially in 1H 2012.
2. **China GDP growth, commodity prices**: Again, quite uncertain, and no hard landing for China, but nevertheless we expect softening Chinese growth will be a **headwind for the CLP**.
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### New FX forecasts

As a result of most factors leaning towards negative influences on the CLP, we are shifting our 2012 forecasts towards a stronger USD-CLP rate, expecting to see the currency pair end 2012 at 530.0. We summarize these forecast changes in Table 2 below.

**Table 2: HSBC USD-CLP FX Forecasts**

| | Old forecasts | New forecasts |
|---|---|---|
| 4Q11(f) | 455 | 515 |
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| 2Q12(f) | 460 | 530 |
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Source: HSBC

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**Issuer of report**
**HSBC Securities (USA) Inc.**
452 Fifth Avenue
HSBC Tower
New York, NY 10018, USA
Telephone: +1 212 525 5000
Fax: +1 212 525 0356
Website: www.research.hsbc.com

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# GEMs Research Team

**Pablo Goldberg**
***Head of Global Emerging Markets Research***
+1 212 525 8729 pablo.a.goldberg@us.hsbc.com

**Bertrand Delgado**
*EM Strategist*
+1 212 525 0745 bertrand.j.delgado@us.hsbc.com

## EM Fixed Income Research

### Americas

**Gordian Kemen**
***Chief Strategist, Latin America***
+1 212 525 2593 gordian.x.kemen@us.hsbc.com

**Victor Fu**
***EM Quantitative Strategist***
+1 212 525 4219 victor.w.fu@us.hsbc.com

**Alejandro Mártinez-Cruz**
+52 55 5721 2380 alejandro.martinezcr@hsbc.com.mx

**Hernan M Yellati**
+1 212 525 3084 hernan.m.yellati@us.hsbc.com

### Asia

**André de Silva, *CFA***
***Head of Rates Research, Asia-Pacific***
+852 2822 2217 andre.de.silva@hsbcib.com

**Pin-ru Tan**
+852 2822 4665 pinrutan@hsbc.com.hk

### EMEA

**Di Luo**
+44 20 7991 6753 di.luo@hsbcib.com

## EM Currency Strategy

### Asia

**Daniel Hui**
+852 2822 4340 danielpyhui@hsbc.com.hk

**Perry Kojodjojo**
+852 2996 6568 perrykojodjojo@hsbc.com.hk

**Paul Mackel**
***Head of Asia FX Strategy***
+852 2996 6565 paulmackel@hsbc.com.hk

**Dominic Bunning**
+852 2822 1672 dominic.bunning@hsbc.com

### Americas

**Clyde Wardle**
+1 212 525 3345 clyde.wardle@us.hsbc.com

**Marjorie Hernandez**
+1 212 525 4109 marjorie.hernandez@us.hsbc.com

### CEEMEA

**Murat Toprak**
+44 20 7991 5415 murat.toprak@hsbcib.com

## EM Equity Strategy

**Alexandre Gartner**
***Head of Equity Research, Brazil***
+55 11 3371 8181 alexandre.gartner@hsbc.com.br

**Herald Van Der Linde**
***Deputy Head of Eq Strategy, Asia-Pacific***
+852 2996 6575 heraldvanderlinde@hsbc.com.hk

**John Lomax**
+44 20 7992 3712 john.lomax@hsbcib.com

**Wietse Nijenhuis**
+44 20 7992 3680 wietse.nijenhuis@hsbcib.com

## Economics

### Latin America

**Andre Loes**
***Chief Economist, Latin America***
+55 11 3371 8184 andre.a.loes@hsbc.com.br

**Javier Finkman**
***Chief Economist, South America ex-Brazil***
+54 11 4344 8144 javier.finkman@hsbc.com.ar

**Sergio Martin**
***Chief Economist, Mexico***
+52 55 5721 2164 sergio.martinm@hsbc.com.mx

**Ramiro D Blazquez**
+54 11 4348 5759 ramiro.blazquez@hsbc.com.ar

**Lorena Dominguez**
+52 55 5721 2172 lorena.dominguez@hsbc.com.mx

**Constantin Jancso**
+55 11 3371-8183 constantin.c.jancso@hsbc.com.br

**Jorge Morgenstern**
+54 11 4130 9229 jorge.morgenstern@hsbc.com.ar

**Marcos Fernandes**
+55 11 6847 9787 marcos.r.fernandes@hsbc.com.br

**Claudia Navarrete**
+52 55 5721 2422 claudia.navarrete@hsbc.com.mx

### Emerging Europe, Middle East and Africa

**Murat Ulgen**
***Chief Economist, Central & Eastern Europe, and sub-Saharan Africa***
+ 44 20 7991 6782 muratulgen@hsbc.com

**Simon Williams**
***Chief Economist, Middle East and North Africa***
+971 4 507 7614 simon.williams@hsbc.com

**Liz Martins**
+971 4 423 6928 liz.martins@hsbc.com

**Alexander Morozov**
+7 495 783 8855 alexander.morozov@hsbc.com

**Melis Metiner**
+90 212 376 4618 melismetiner@hsbc.com.tr

**Agata Urbanska**
+44 20 7992 2774 agata.urbanska@hsbcib.com

### Asia Pacific

**Qu Hongbin**
***Managing Director, Co-head Asian Economics Research and Chief Economist Greater China***
+852 2822 2025 hongbinqu@hsbc.com.hk

**Frederic Neumann**
***Managing Director, Co-head Asian Economics Research***
+852 2822 4556 fredericneumann@hsbc.com.hk

**Leif Eskesen**
***Chief Economist, India & ASEAN***
+65 6239 0840 leifeskesen@hsbc.com.sg

**Paul Bloxham**
***Chief Economist, Australia and New Zealand***
+61 2925 52635 paulbloxham@hsbc.com.au

**Donna Kwok**
+852 2996 6621 donnahjkwok@hsbc.com.hk

**Trinh Nguyen**
+852 2822 6975 trinhdnguyen@hsbc.com.hk

**Ronald Man**
+852 2996 6743 ronaldman@hsbc.com.hk