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CAPITAL MARKET DYNAMICS

Foreign Exchange ► The Chilean peso (CLP) received a positive impulse from improving terms of trade and persistently benign external financial market conditions. A sharp reduction in global risk aversion in the context of recovering copper prices and slight US dollar (USD) depreciation, contributed to stabilize exchange rate market conditions in Chile. Looking ahead, the direction of copper prices, monetary policy shifts to be adopted by the US Federal Reserve, financial market conditions in China and the degree of global risk appetite will remain the core factors shaping the value of the CLP. We project USDCLP at 658 by year end.

Sovereign Debt & Credit Ratings ► The global perception of Chile's sovereign credit risk remains strong. Financial market conditions, as reflected in the country's credit default swaps (CDS), support a positive investor view on Chile's creditworthiness. In relative terms, Chile continues to be seen as the best sovereign credit in the Latin American region. However, at the beginning of the year, Standard and Poor's was the first credit agency to place the country's "AA -"rating on review with a "negative" outlook on the grounds of persistently low economic growth. Resuming a sustainable growth trajectory will become the primary task of the new government. For now, Chile has been resilient to financial market volatility fuelled by policy uncertainties in the USA.

ECONOMIC OUTLOOK

Growth ► The Chilean economy will experience a modest and gradual recovery over the next 18 months. Although the negative impact of the end of the mining cycle will tend to dissipate, a prolonged strike in the world's largest copper mine earlier in the year, together with persistent weakness in the construction sector, will have a mitigating effect on recovery dynamics. The central bank estimates that following a 1.6% expansion in 2016, real GDP will expand between 1% and 2% this year before accelerating to a 2.25-3.25% range in 2018. Improved external market conditions and persistent domestic consumption growth will play a supporting role in the 2017-18 period. For the first time after three consecutive years of contraction, gross fixed investment will show positive growth rates in 2017.

Inflation & Monetary Context ► The inflation outlook has materially improved. The stabilization of the nominal exchange rate in the context of relatively subdued economic activity remains a primary driver of such disinflation dynamics. Indeed, consumer price inflation reclined from 4.8% y/y (Jan-2016) to 2.7% y/y (March-2017) in line with the inflation target of 2% ± 1%. Looking ahead the headline inflation rate is projected to remain in the 2.8-3.2% y/y range over the next 18 months. Monetary policy conditions remain in expansionary territory; indeed, the central bank opted to reduce its administered interest rate by 25 bps to 2.75% in mid-April, a third decline since Jan-2017. We do not rule out the likelihood of a further rate cut before the end of the year.

Fiscal & Current Account Balance ► The fiscal situation has become an issue of relevance to investors and rating agencies alike. The general government budget will likely post a deficit in the 2.5-3.0% of GDP range in 2017-18. Effective January 1st, 2017, the income tax rate was increased for both corporate and small businesses. The corporate income tax rate moved from 24% (2016) to 25.5% (2017) and 27% (from 2018 onwards). On a positive note, China-led trade links between Chile and the Asia Pacific region remain strong. In this regard, steady economic growth and renewed currency stability in China support a more favourable external outlook for Chile. The current account deficit remains below the 2% of GDP mark.

INSTITUTIONAL FRAMEWORK & POLITICAL ENVIRONMENT

Governance ► Chile remains in active campaign mode ahead of the presidential elections later in the year. The first round is scheduled for November 19th,2017. The trade-intensive Chilean economy is, however, strongly affected by sharp swings in global trade activity in general and by China's economic developments in particular. On a positive note, improved business climate in Brazil and Argentina may open opportunities for further economic integration in the Southern cone.

Financial Sector ► Domestic credit activity remains aligned to a weakened business cycle. Despite a moderation in lending activity, the asset quality of local deposit-taking institutions has not deteriorated as portrayed in stable non-performing loan metrics. Lending to the construction sector has suffered the most in relative terms. Chile counts on a well-developed private pension fund system; indeed, assets under management by local pension funds (AFPs) total US$187 billion, equivalent to 80% of GDP. A pension reform bill will be drafted over the next three months. There is no intent to modify the retirement age for women (set at 60 years old). However, there will be some incentives to address the pay equity gap between male and female workers. This might require an additional 5% contribution from the employer to be applied gradually in 6 years.

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