AZ QUEST
AZIMUT GROUP

MONTHLY LETTER – AUGUST 2016

August was a month of few relevant events in the economic sphere and wait-and-see mode on the political front.

In Brasília, Brazil´s political capital, it was a period of negotiations and few votes in the Lower House. In the Senate, we saw speeches by Senators targeting their voters, while they carried out the procedural rites of a game whose outcome was already certain. On the last day of the month, the Senate confirmed, by a wide margin of votes, the impeachment of Dilma Rousseff.

The most important consequence of the appointment of Michel Temer as Brazil´s President is the freeing up of a political scenario that was preventing him from accelerating the approval of reforms and adjustment measures capable of putting Brazil back on a path of economic growth.

The government knows that its honeymoon period with markets has a short-term shelf life. But although they are a bit disappointed with the salary increases granted to several groups of civil servants, so far economic agents have understood the difficulties that the interim transition imposed on the government. Starting now, the new government will have to show results. We believe that, despite the electoral period, the next few months will be full of new developments in Congress.

In the economy, it is increasingly clear that the worst period of the economic depression is already behind us. June retail sales grew 0.10% MoM, above the 0.4% decline expected by the market.

The data published in August confirm the resilience and slower rate of decline in inflation. The July IPCA index came in at 0.52%, above the 0.45% print expected by the market. As a result, market consensus for 2017 IPCA inflation worsened marginally. The Central Bank reaffirmed its conservativeness, indicating that the cycle of interest rate cuts will only start when there is more clarity on the pace of disinflation and approval of fiscal measures. Our scenario remains one of interest rate cuts starting in November, with the Selic at 12% next year.

In the FX market, the Central Bank expanded the volume of reverse dollar swaps offered to USD750mn per day, indicating the intention to reduce the stock of dollar swaps.

In the US, the PCE (inflation measure that guides FED decisions) came in at 0.8% YoY in July, slowing down from 1.0% in June. The core measure, which excludes food and energy, came in at 1.6%, below the 2.0% target.

Fresh batches of employment data surprised positively. July saw net job creation of 255k, the unemployment rate remained at 4.9%, and wages grew at an annual rate of 2.6%. Although these numbers indicate a greater chance of fresh interest rate hikes, negative labor productivity and retail sales data, plus low inflation rates all lead us to believe that the Federal Reserve will remain cautious in the process of monetary normalization, a view reinforced by comments by President Janet Yellen at the Jackson Hole conference.

Fresh data confirm the fragility of the global economies and bring back the discussion on the inefficiency of this policy of monetary super-expansion in restoring dynamism in these economies. Global inflation rates remain low, mainly in Japan and Europe. There is already speculation on the possibility of fiscal stimuli in the main economies. We continue to believe that this environment of low interest rates and low global liquidity will persist in the coming months.

EQUITIES STRATEGY

Once again, our Long Short funds posted very positive results. The AZ Quest Equity Hedge fund returned 1.74% (144% of CDI) while the AZ Quest Total Return gained 1.99% (164% of CDI). Most of our equities funds posted positive results, in line with their benchmarks.

We obtained gains from our long exposure to the Electricity, Oil & Gas and Steel sectors, and from our relative value strategy in Consumer Goods, mainly our long position in Localiza, one of the main positions in our funds. We also obtained gains from options structures used for managing our net exposure.

We continue to have greater net exposure in our funds, and we remain allocated in sectors that will benefit from the economic rebound and the improvement in the business climate.

MACRO STRATEGY

Our AZ Quest Multi fund again outperformed the benchmark CDI rate (+1.92%). The AZ Quest Yield posted a return of 1.27%, in line with its targeted long-term return.

Our flattening position in the belly of the DI yield curve performed well in the month, reflecting a more hawkish Central Bank and more resilient short-term inflation. We remain long in NTN-Bs, as we believe a position in real interest rates is a defensive way of expressing the constructive scenario in the long term.

The main contribution to the result of our AZ Quest Multi fund came from our relative value strategy in equities, with a portfolio positioned for a market improvement via the purchase of companies with high returns on capital or greater elasticity to an economic recovery. The negative highlight of the fund came from our long position in a basket of cyclical currencies.

CREDIT STRATEGY

Our credit funds again easily outperformed their long-term objectives, for pretty much the same reasons as last month. Although we have a conservative portfolio, we obtained good results from our debenture and LF (bank debenture) portfolios, reflecting increased demand for bank assets with higher yield (especially subordinated LFs), since banks haven´t made new issuances. There is still a supply/demand imbalance in the secondary market, causing a significant reduction in trading rates and the mark-to-market of these assets.

In the case of our AZ Quest Altro fund, we also highlight the good result of our hedged bond portfolio, reflecting the narrowing of spreads of almost all assets in this strategy. We increased the size of this portfolio due to the possibility of adding new names at attractive prices.

Additionally, we opted for a small position in real interest rates (always via credit assets) in order to add an asymmetrical return in relation to the risk, in line with the call of our macro area. The result of this strategy was positive, but most of the gains came from the narrowing of the credit spread.

For more details on the results of our credit funds, access the fund manager´s letter.