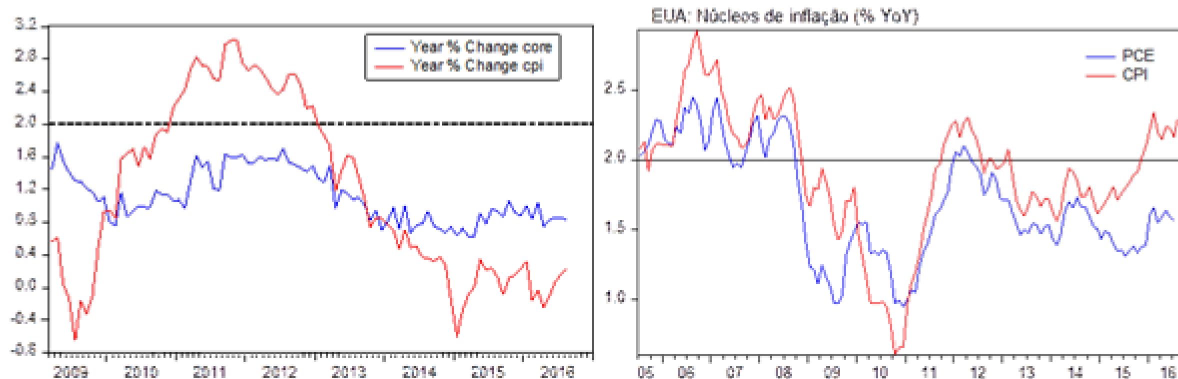
## FUND MANAGER LETTER – SEPTEMBER 2016

Months ago, we commented in our letters on the difficult task of taking decisions in extreme situations with scarce funding. In a way, we are coming back to the theme, with a new question: how to act in a situation where the chosen strategy loses efficiency, putting in check its capacity to resolve a problem?

Doctors usually face this dilemma whenever a patient fails to react to the chosen treatment: should I insist a bit more or try a new treatment? The change in procedure may be the only alternative, but the patient may not have sufficient time to react. A similar situation is faced by the owners of many soccer teams who, faced with the prospect of relegation, ask themselves if they should look for a new manager, even if the decision does little to help the team´s performance.

The current scenario of anemia in the global economy puts the main monetary authorities in a similar situation to doctors and heads of sports teams. Perhaps the most important economic of the month was the continuation of expansionist monetary policy by the world´s main central banks.

The first to move in this direction was the ECB. Although some PMIs and confidence data surprised positively, industrial production (-1.1%) and inflation indicate that economic activity remains very weak. Wages in the Euro Zone rose a mere 1.0% versus the year-ago period, the slowest growth pace since 1Q14. As a result, the ECB maintained its asset buying program and kept refinancing rates at their 0% all-time low. The yield on deposits remained at -0.40% p.a., meaning that commercial banks will continue paying to deposit money at the ECB. The head of the ECB also reiterated that they may extend the asset buying program (which ends in March 2017) if necessary.




**US: Core inflation measures (y/y, %)**

Days later, the BoJ decided to maintain its basic interest rate at -0.1% p.a. and the volume of asset buying in order to raise inflation from -0.4% p.a. currently to 2.0% p.a. It also established a new 0% target for 10-year yields, which has been negative for a while now. This change is relevant by reducing the risk of an abrupt increase in long-term yields in Japan.

In the US, recent comments by some FED directors signaled a more conservative FOMC stance on the pace of interest rate hikes. But the FOMC preferred to stick to short-term indicators signaling a cooling down in economic activity and low inflation levels, and maintained its basic interest rates between 0.25% and 0.50% p.a., reinforcing the rhetoric that it is waiting for more concrete data before taking this first monetary tightening step, but that the resumption of the monetary normalization process won't take long. We expect interest rates to start rising gradually in December, without causing any major changes in the scenario of abundant liquidity and search for yield. The risk to this scenario is acceleration in inflation, which would lead to a stronger-than-signaled pace of interest rate hikes.

The prolonging of this policy of super monetary expansion, without the expected effects in terms of a rebound in global economic activity, is already sparking discussions on the efficiency of these measures and of the potential distortions caused by such a long period of negative interest rates. The bank system, always the first channel of crisis contamination, is already showing worrying signs, as in the case of the recent problems at Deutsche Bank. And markets are now debating the possibility of central banks being left "without any ammunition" and the need for a new fiscal expansion strategy, with higher spending and tax cuts to spur demand.

The fact is that developed nations are posting very low growth and analysts are asking why. Despite attempts by central banks to accelerate economic activity via monetary expansion, market have seen this capital "dry up" due, among other factors, to ever tighter financial regulations. Similarly, these regions are suffering, to varying degrees, from their smaller workforces. The tough demographic reality and a new profile of young workers, less concerned with consumption and more concerned with the

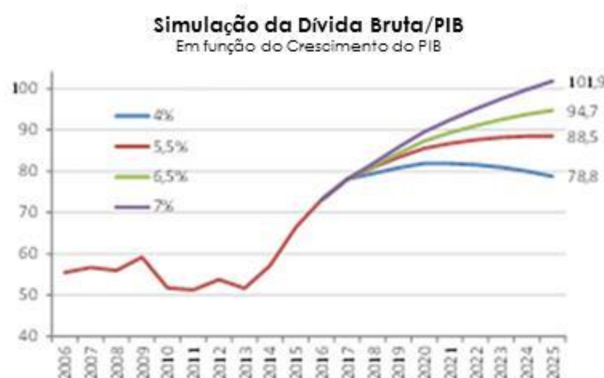
best use of their time, reduce the supply of labor in these economies. In a mature society, where additional capital supply appears ineffective, the growth alternative involves efficiency factor gains. But productivity indices aren't improving, reinforcing the need for structural reforms in these regions. In a keynote speech to kick off the ECB conference, at the end of September, Mario Draghi called upon European authorities, saying: "We need structural reforms to boost production potential in the Euro Zone and interest rates in the long term".

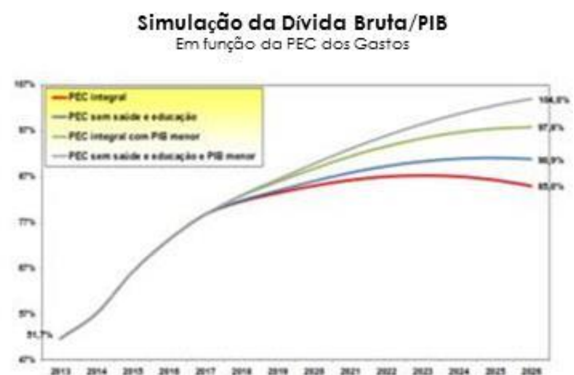
Another risk factor gathering momentum is the result of the US presidential election. With polls showing Donald Trump getting closer to Hillary Clinton, the market is now debating the possible consequences of a Trump government. Yes, it is tough to predict who will win, but we believe the political room for maneuver of the US president, especially in relation to economic policy, is less than imagined, mainly if the scenario of a split Congress (one party controlling the Senate, the other the House), as expected by political analysts, plays out.

In Brazil, September was a month of few developments in the economic field and of consolidation of the new government after the approval of ex-President Dilma´s impeachment. Michel Temer and most of his cabinet traveled abroad to attend the ONU and G20 conferences in search of political support and investments.

With a more structured political scenario and expected economic reforms, the market continued raising its GDP forecasts, in tandem with the improvements in consumer and business confidence, which reached their highest levels since January 2015 and July 2014, respectively.

The IPCA posted inflation of 0.44% m/m in August, with a strong slowdown in food and transport inflation, while 12-month IPCA inflation slowed to 8.97%. The mid-September IPCA-15 index recorded inflation of 0.23% m/m, below market expectations. The marginal improvement in inflation plus the perception that the spending cap amendment will be approved with no changes have increased the chances of an October start to the interest rate cutting cycle. The release of the Quarterly Inflation Report reinforced this view, reflecting the decline in Central Bank forecasts to numbers close to the target. Another round of data indicates an improvement in economic activity, mainly the rebound in industry, which rose 0.1% in July. Unemployment posted negative data, as the unemployment rate accelerated to over 12%, while Brazil´s primary deficit was R$22.3bn in July, signaling an annual deficit of R$170bn. Despite the clear need to pass spending control measures, it is patent that stabilizing debt/GDP depends on an urgent recovery in economic activity and the resulting boost to federal tax revenues.



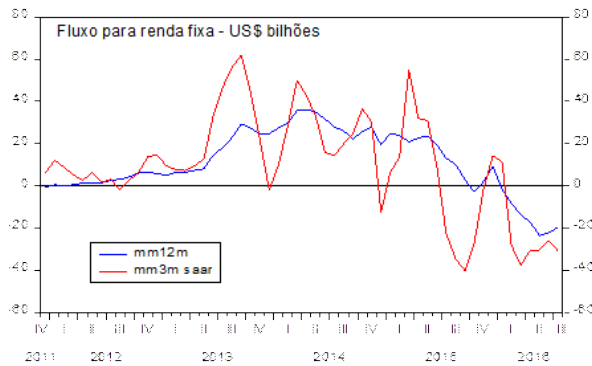

**<u>Simulation of gross debt/GDP (based on GDP growth) Simulation of gross debt/GDP (based on amendment capping spending Full amendment Amendment ex-health and education Full amendment with lower GDP Amendment ex-health and education and lower GDP</u>**

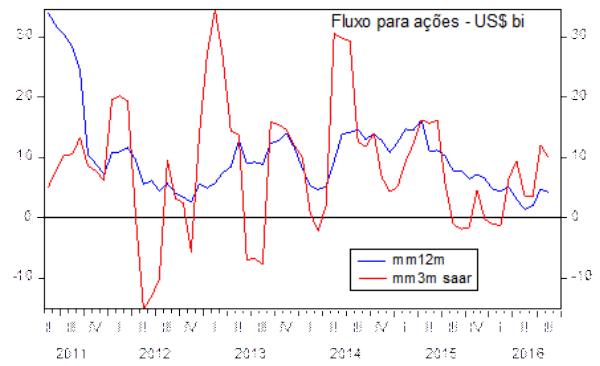
After the impeachment vote, the government felt freer to take a firmer and more intransigent position on the fiscal question, fully vetoing the draft bill on the subsidy of the federal public defender and not bending to requests from North and Northeast state governors for financial support.

Now sees the start of a phase of negotiating and passing more important (polemic) economic reform measures, mainly the constitutional amendment proposal capping public spending, and labor and pension reforms. The market will clearly monitor these votes. Despite general approval of the proposed measures, there are still many doubts on Congress´ willingness to pass often unpopular measures.

We are confident the government can negotiate the approval of many of the proposed texts. To do so, in addition to the political block ( PSDB, DEM and PPS) that led the impeachment process, it will need the support of Congressmen from the so-called "Centrão", keen for scarce federal government funding and government support in the 2018 elections. Rogério Rosso, a leader of this group, recently submitted to President Temer a note of "commitment to and support of" the government´s actions.

If the government is successful in this process, we will see across-the-board falls in Brazil´s risk perception, which should unlock pent-up private-sector investment in financial assets and the real economy.




**Fixed income flow** **Equities flows (US$bn)**

## EQUITIES STRATEGY

Despite virtually breaking even in September (+0.80%), the Ibovespa swung both high and low in the month. After rising at the start of September, uncertainties on the process of reducing monetary stimuli, mainly in the US, and oil price volatility led stock markets to fall. Following statements by monetary authorities of Europe, Japan and the US, reaffirming the commitment to a joint policy of liquidity expansion, markets rose again.

In Brazil, one important event was the publication of Petrobrás´ business plan for the period 2017-21, whose main aim is reducing its financial leverage. The target is to bring down net debt/Ebitda from 5.3x at YE15 to 2.5x in 2018. To do so, the company announced a 25% cut in investments, which could total US$74.1bn in the period, with a greater focus on oil exploration and production. The company is also planning an ambitious asset divestment plan, which could total USD40bn in the next 10 years, mainly in biofuels, distribution, fertilizers and petrochemicals. CEO Pedro Parente was also explicit in the goal of "promoting a market price policy and maximizing margins in the value chain". The market welcomed this move, with preferred shares rising 5.6%.

Our equities funds posted small losses, below benchmarks, mainly on losses in the Energy and Homebuilders sectors, on profit-taking after strong gains in recent months. The main contributions came from Oil, Agribusiness and Retailers, mainly our long positions in Petrobrás, Raia Drogasil and São Martinho. Our Long Short strategy funds rose (AZ Quest Equity Hedge: 0,61% and AZ Quest Total Return: 0,47%), below the CDI (+1.11%).

Our portfolios remain positioned for a scenario of improvement in the Brazilian economy, with greater net exposure and exposure to companies with high ROIC and sectors with greater operating leverage.

## MACRO STRATEGY

In a month of strong oscillation in the international interest rate market, our flattening position in the belly of the DI curve proved to be well protected during the sell-off at the start of the month. However, after Central Banks from the US, Europe and Japan confirmed the maintenance of expansionist monetary policy, yield curves in Brazil fell in parallel, and our short position in this flattening prevented us from extracting maximum gains. Between some toing and froing, our NTN position didn't post any major gain.

We still have a position in the belly of the curve via a flattening position in DI contracts and a long position in NTN-Bs. The release of the Inflation Report, confirming the expectation of inflation of 4.5% in 2018, plus the outlook for approval of fiscal measures, paves the way for a major decline in real and nominal rates in Brazil. We expect the Central Bank to initiate an easing cycle, with a conservative rate cut at its October meeting.

The currency market also showed erratic behavior, with an eye on international interest rate markets. We continue betting on devaluation of the dollar against cyclical currencies. We have preferred to explore this theme by buying BRL via an options structure that grows as the BRL appreciates against the dollar, due to the outlook for dollar inflow via capital repatriation and international investors´ interest in new fixed income issuances and the program of privatizations and concessions. Despite the outlook for BRL appreciation, we need to monitor FED moves and any Central Bank interventions to curb over-appreciation.

Our relative value book posted a small loss in September, after strong positive contributions in recent months. In terms of the stock market, we remain net long in sectors and companies with high ROICs and/or with more elasticity to an improvement in the Brazilian economic scenario.

We also maintain hedge positions for the two political risks that could affect this scenario, either if Donald Trump wins or if new leniency agreements in Operation Car Wash directly affect senior government officials. We are thus keeping our Ibovespa and S&P put spreads for December, with correlations that we deem highly positive.

In this scenario, our funds posted gains in the month (AZ Quest Multi +0.44% and AZ Quest Yield +0.97%), despite underperforming the CDI rate in the period.

AZ QUEST
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**CREDIT STRATEGY**

Our credit funds beat their long-term benchmark returns in September (AZ Quest Altro 115.3% of CDI and AZ Quest Luce 105.9% of CDI).

The main contributions came from the same factors of the last three months, especially the debentures portfolio. In the AZ Quest Altro fund, we also highlight the results of our portfolios of hedged securities and senior LFs.

We highlight the returns of our portfolios of LFS and LFS-N bonds, since the former underperformed the CDI and the latter slightly exceeded the CDI rate, reflecting two completely different events. On the other hand, the widening of credit spreads, especially in the portfolio of LFS-Ns due to a major issue by a large company, which ended up equalizing the secondary and primary markets. On the other hand, we saw a narrowing of the yield curve, which has a negative impact on assets pegged to the CDI (when their MTM is above par).

We maintained the conservative profile of our portfolios, with most funds allocated in Cash and LFTs (54.9% of AZ Quest Luce and 32.7% of AZ Quest Altro).

We flag that the entire political-macroeconomic scenario in place in the last 2 months has been important in companies´ decision to start issuing again in the capital market. As another potential catalyst, we saw some offers in August and September, symbolizing that now may be the appropriate timing for primary offers. There will be nine offers taking place in October and November (that we are analyzing) that accurately illustrate the current moment. So far we believe most of these offers match the mandates of our funds.

In September, we also liquidated new operations in the fund, coming from primary offers in which we participated at the start of the month. We also added, via the secondary market, names that we already had in the fund in order to allocate our available cash.

We can see the same supply/demand dynamics for credit assets as commented on in previous letters. Investors are still under-allocated in credit and there is a need to buy assets to ensure an appropriate portfolio composition. However, investors are demanding prices at the levels of a market in crisis (i.e. as if we were still experiencing the same conditions of 1H16). We believe these high premiums, a good credit analysis and a responsible management enable us to build a portfolio with a very interesting volume of premiums.

For more details on the results of our credit funds in this period, click here to download.

Finally, we reinforce the launch of the AZ Quest Debêntures Incentivadas and AZ Quest Icatu Previdenciário Renda Fixa funds.