

## MONTHLY BULLETIN – OCTOBER 2016

October was an important month to indicate the trend of two key risk factors and sources of doubts in the market. On the one hand, doubts on the de-facto strength of the government in the process of approving adjustment measures in Congress. On the one other, doubts on the Central Bank's behavior in handling monetary policy in Brazil.

The rapid approval of Provisional Measure #241, which caps public expenditures, by the House of Representatives is a clear sign that, right now, the government has broad support in Congress.

The result of the municipal elections can also be interpreted as a message of support, giving ammunition to the government in voting the economic adjustment measures, since it confirms the decline in left-wing parties and strengthens the coalition parties for the 2018 presidential race.

Over the next few weeks, the market will focus on the extent of the plea-bargaining agreements by executives of construction companies, and their impact on the government. For the time being, the market will closely track the progress and discussions on the government proposal for the pension reform. The government is indicating a broad proposal, involving the political class and civil servants.

As expected by the market, the Copom (Monetary Policy Committee) decided, for the first time since 2012, to reduce the Selic interest rate by 25bps to 14% p.a. The Central Bank indicated that the favorable behavior of food inflation and progress on the fiscal agenda in Congress give it confidence to start the interest rate cutting cycle, despite greater inflation resilience in sectors more sensitive to the economic cycle.

The Central Bank opted to convey a conservative message, indicating that a stronger interest rate cutting cycle will depend on an additional slowdown in inflation in the sectors most sensitive to economic activity and continued progress on the fiscal agenda in Congress.

We also highlight the new government's success in the first auction of concessions in the electricity sector, indicating market interest in future infrastructure projects.

In the international scenario, positive economic data in the US, especially in the services sector, reinforce the expectation of a hike in the Fed Funds rate at the December meeting, despite inflation remaining below the FED target.

In Europe, statements by Mario Draghi confirm that the ECB is unlikely to interrupt its monetary easing (QE) program, despite recent economic data indicating an improvement in economic activity in the Euro Zone.

We also saw positive data releases coming out of China, especially on the recovery in industrial inflation (PPI +0.1% YoY, the first positive result in 54 months) and consumer inflation (CPI +1.9% YoY). China has also been an important source of deflation pressure for the world and, thus, a price rebound could signal an improvement in the Chinese economy.

## EQUITIES STRATEGY

Fueled by the continued environment of global liquidity, by the start of interest rate cuts in Brazil and by the government's show of force in Congress, the Ibovespa soared 11.23% in the month.

Our equities funds posted excellent results, beating their benchmarks. The main highlight was the AZ Quest Top Long Biased fund, which soared 14.03%. The biggest gains came from the Oil and Petrochemical, Financial Services and Electricity sectors.

Our Long Short funds enjoyed another month of strong gains. The AZ Quest Equity Hedge fund posted a gain of 2.64% (251% of CDI) while the AZ Quest Total Return fund rose 3.54% (337% of CDI). YTD, these two funds are up 14.91% and 18.93%, respectively. The main contributions came from our long positions in the Electricity and Oil & Gas sectors, and from our relative value strategy in Retail.

We remain positioned for a market improvement, via companies with a high return on capital or with greater elasticity to the recovery in the economy.

## MACRO STRATEGY

The AZ Quest Multi enjoyed another strong month (+2.42%), while the AZ Quest Yield fund gained 0.88%, just below its targeted long-term return.

The main contribution to the result of our AZ Quest Multi fund came from our relative value strategy in equities. We also obtained gains from our short position in USD vs. BRL.

In the fixed income market, the yield curve oscillated heavily throughout October, with our positions in NTN-B pretty much breaking even. Despite the start of the interest rate cutting cycle, the Central Bank continues signaling that it is still focused on keeping inflation under control, despite the scenario of weak economic activity. This conservative stance by the Central Bank, plus the outlook of a fiscal adjustment to the extent possible, paves the way for a sustained cycle of disinflation and reinforces our view of a significant decline in interest rates in the medium term.

Our positions in NTN-Bs also posted a slightly negative performance, due to the implicit negative carry of the assets in a scenario in which monthly inflation was 0.08%. This result was compensated by gains from our flattening position in DIs, due to a more hawkish Central Bank.

## CREDIT STRATEGY

Our funds again posted returns above their long-term targets, for the same reasons seen in most months this year whilst still maintaining a conservative portfolio, with our cash position above its normal pattern (AZ Quest Luce: 56.0% and AZ Quest Altro: 26.2% of NAV).

We highlight the performance of our portfolios of LFs (junior), hedged debentures and free-market inflation. We exploited the recent gains of some hedged debentures in order to reduce the gross exposure of this strategy in the AZ Quest Altro fund, purely on valuation grounds.

We saw a slight improvement in market confidence in response to the better political and economic environment, securing continued demand for private credit assets. Despite the inclusion of three new assets via primary issuances, we believe issuances in the primary market still weren't sufficient to meet all the demand, causing yields to narrow in the secondary market.

For more details on the results of our credit funds, please consult the [fund manager letter](#).