MONTHLY BULLETIN – NOVEMBER 2016

November was a month full of major political-economic developments. Explaining their consequences in a few paragraphs is an arduous task even for the most talented journalist. Summing up, the main effect is that these events weaken the two pillars supporting our benign scenario for Brazilian markets.

Clearly, the main event was the surprise election of Donald Trump. More than a simple and recurring alternation of power between parties, his election suggests an inflection in the handling of US economic policy, which obviously has consequences for the entire world.

The profile of the Republican voter (lower educational and income levels) and the geographic breakdown of the votes, more concentrated in small counties in the US countryside and in urban centers with less economic growth, indicate that Trump made it to the White House at the hands of those who benefited little from the current globalized and liberal economic system. His campaign speech, albeit shallow and short on details, indicates that his mandate will focus on this voter group.

In this sense, we can expect increased protectionism and a more expansionist fiscal policy, with tax cuts and increased infrastructure spending. The outlook of negative fiscal results has contributed to higher breakeven inflation rates, driving a rise in long-term US interest rates and USD appreciation. In recent weeks, we have seen a strong technical adjustment, with the yield on 10-year US T-Bills rising from 1.70% to 2.40%.

We will have to wait for more clarity on the makeup of the government team and its first initiatives, but we believe the US political system imposes limitations on the President´s actions, and a constant need to negotiate with Congress. Even if Trump begins his mandate in a position of enormous strength, for having won the election without the support of Republican leaders, and even if the Republican party has a majority (albeit tight) in both houses, the President will have to convince the political and economic establishment, at the risk of having his measures rejected.

This new policy is already echoed in other regions, as evidenced by the comments of ECB chairman Mário Draghi, who argues that fiscal policy may help recover the European economy.

Due to the new political scenario in the US, the market is now pricing in a more restrictive monetary cycle, reflecting the idea that the FED will move to curb any inflationary pressures arising from the government´s fiscal expansion. Job, confidence and retail sales data reinforced the outlook that the US economy continues improving, and is already growing at an annualized rate of 3.2% QoQ in Q3, beating economists´ expectations.

Although Brazil should be less directly affected than other countries, due to its more closed economy and less dependence on the external market, the prospects of higher global inflation and interest rates leads us to believe that the room for and speed of the decline in local interest rates were affected. This was always one of the key factors in our scenario of inflection in economic activity in Brazil. The Brazilian Central Bank, as expected and despite the decline in inflation expectations for 2017, again cut interest rates by 25bps to 13.75%, which frustrated some economists and businessmen, concerned with the duration and depth of the recession.

Another key factor in the recovery of the Brazilian economy is the approval of reforms, mainly in the fiscal sphere. To that end, a pacified Congressional environment and a government with the strength to lead this process are fundamental. November wasn't exactly a calm month on the political front. On the one hand, we saw Congressmen acting with self-preservation instincts, more concerned with the consequences of the apocalyptic plea bargain agreement of Odebrecht. This ends up changing Congress´ agenda, delaying the voting of reforms and leading to mass nationwide protests again. On the other hand, the government is forced to manage the crisis caused by the discussion between two ministers, which ended up leading the PSOL party to file a request for the impeachment of President Michel Temer on the grounds of crimes of responsibility.

Finally, economic activity data confirm that the expected cyclical rebound in the Brazilian economy has yet to happen. Q3 GDP fell 0.8% QoQ. Monthly industrial production came in below expectations and unemployment continues to creep up. The consequence is the strong decline in federal tax revenues and the additional deterioration in the public accounts, which accumulated a deficit of R$188.3bn (3.1% of GDP) and is already affecting the capacity of some states to honor their commitments.

The continued economic depression and the population´s mounting discontent with politicians increase the uncertainties on the 2018 elections and put in check the previous scenario of a new cycle of long-term reforms.

Despite the setbacks in the external and internal environments, we still believe the positive scenario for Brazil remains in place. The enormous real interest rate differential makes Brazilian bonds a very attractive asset, especially given the outlook for reforms and a consequent reduction in country risk premiums. On the domestic front, we continue with a government that has the correct diagnosis of our problems, a very competent team to carry out these reforms and a Congress that seems both aligned and willing to approve this plan. If these conditions remain stable, we believe an acceleration in Brazil´s economic growth is possible at some stage in 2017.

We are aware of and alert to the risks of this path, starting with the acceleration in global inflation and the additional increase in long-term interest rates, as well as a political deterioration and consequent loss of popularity of the Temer government, making it impossible to approve reforms in Congress. For the time being, we believe it is prudent to reduce the risk of our portfolios and see what happens next.

EQUITIES STRATEGY

The Brazilian stock market was affected by increased risk aversion and profit taking, after strong gains since February. The Ibovespa fell 4.65% and the SMLL index slumped 8.44% in November.

Our equities funds underperformed their benchmarks, reflecting the strategy of their portfolios, more positioned for a market improvement, via companies with high returns on capital or with greater elasticity to an economic recovery. The main losses came from Homebuilders, Oil & Gas and Electricity. The main gains came from Steel and Mining, which benefited from rises in the prices of metal commodities.

Due to the new market reality, we decided to make some adjustments to the positions of our funds, but without significantly altering the strategy of the portfolios. We opted to reduce our position in the energy sector, the main beneficiary of the previous scenario of declines in interest rates and with excellent results in 2016. We also reduced our position in Homebuilders and, on the other hand, we increased our exposure to global cyclical sectors (mining and pulp), which benefit from a strong USD and the outlook of higher infrastructure spending in the US.

MACRO STRATEGY

In a highly volatile month, our Macro strategy funds posted hefty losses. The AZ Quest Multi fund fell 2.45% and the AZ Quest Yield fell 0.19%, for the first month since April 2013.

The main losses came from the interest rates market, where yields widened significantly, impacted by the US election and increased risk in Brazil. We also suffered negative results in our positions in the belly of the curve, via a flattening in DI contracts and the purchase of NTN-Bs. Our relative value equities strategy and our short USD x BRL position also incurred marginal losses.

With the change of scenario, we opted to reassess positions and reduce the consolidated risk of our portfolios. We shortened the duration of our exposure to nominal rates, closing the Jan18/Jan20 flattening position, and maintaining only the Jan18/Jan19 position. We believe the Central Bank has room to accelerate the pace of interest rate cuts at upcoming meetings, which is necessary to kick-start the economy. We also squared the purchase of BRL via futures, and are now exploring the thesis of a strong USD via the sale of Euro and Yen.