MONTHLY LETTER – MARCH 2017

In recent months, the beginning of a government indicating a positive change in the economic policy and the perspective of structural reforms, together with a very favorable external scenario, created a scenario of relative tranquility in markets, with consequent gains in risk assets. The risk factors that are sufficiently strong to destabilize this environment of optimism have remained in a state of hibernation.

We always mentioned that the environment of gradual recovery in global growth, sustaining the prices of commodities, and maintenance of expansionist monetary policy by the main Central Banks, due to low inflation rates, was very favorable for emerging markets and was always a fundamental pillar for our positive view on the market.

In recent months, this scenario was threatened by doubts on important factors and events, including the impacts of the new economic policy of Donald Trump in the process of monetary normalization in the US, the impact of nationalist movements on the elections of key countries in Europe and China's real capacity to keep growing.

Since the 2008 crisis, the global economy has been sustained by unprecedented monetary expansion policy, capable of avoiding the generalized collapse and driving growth albeit moderate) in a number of regions. Now that the storm is over, it is time to remove the stimuli. And it is in this transition phase that we now find ourselves.

With the recurrence of positive economic data, especially consumer confidence, household consumption and the labor market, which is almost at full employment, the FED has been carrying out a gradual, successful process of monetary normalization.

In the weeks after the US elections, the market flirted with the possibility of accelerating this cycle, given prospects of a rise in inflation due to a protectionist and fiscal expansion policy in the US.

However, the latest events (e.g. defeats in the Obamacare revision) reinforce our view that the political-economic establishment will limit Trump's actions, enabling the FED to continue with gradualism in its cycle of interest rate hikes. At the last meeting, the FOMC decided to raise interest rates by 25bps, but the communique signaled that the Central Bank will make only two rate hikes this year. After the gains in the days following the election of Trump, still in November, the yield on 10-year T-Bills has remained practically stable at 2.3% in recent weeks.

In Europe, the latest data signal improvements in PMIs and industrial production, which rose 0.9% m/m in January. Inflation accelerated to 2.0% in February, reaching the highest level since January 2013. With deflation risks now minimized, the ECB decided to maintain interest rates and its (QE) asset buying program on hold, but the surprisingly optimistic tone indicates that there is no need for fresh monetary stimuli at this time.

It is also important to consider the reduction in political risk in the region, after the elections in Holland and recent opinion polls on the French elections, which signal a loss of momentum in the nationalist discourse and talks of these countries exiting the European Union.

Former fears of slowdown in the Chinese economy and the resulting negative impact on emerging economies, due to the decline in commodities, have also yet to materialize. The latest Chinese data show that the economy continues slowing down in organized fashion, and that its transformation to a consumption market should be slow and gradual. During the National Congress of the People of China, Prime-Minister Keqiang announced that the Chinese GDP growth target for 2017 is 6.5%, slightly below the 2016 target.

Chinese industrial production rose 6.3% and investments accelerated to 8.9% in the first two months of the year, surpassing economists' expectations. China's trade balance posted a deficit for the first time since 2014, reflecting a 38.1% y/y rise in imports, in February, reinforcing the scenario of economic growth.

Even the risk of FX devaluation was dissipated, with the announcement that the country's international reserves surpassed US$3trn. These signals have sustained commodities prices at record levels in recent years, reinforcing the positive scenario for Brazil and other exporting countries.

The second pillar sustaining this benign scenario was based on a reorganization of Brazilian economic policy and the outlook of structural reforms aimed at deactivating the fiscal bomb, improving the business environment and getting Brazil back on track for sustainable growth.

The government's efforts and the quality of the measures are already paying off, such as the first improvement in the risk rating of a major risk rating agency (Moody's) since the loss of investment grade last year.

However, the eagerly expected inflection point in economic activity has yet to occur, despite signs that the recession is close to an end. January industrial production fell 0.1%, better than market consensus. The market and the Finance Ministry forecast growth of only 0.5% in 2017.

The long period of economic depression and the Central Bank's contractionist monetary policy led inflation rates to plummet. The market forecasts that inflation should be around 4.0% in 2017, well below the Central Bank target, paving the way for even bigger interest rate cuts at upcoming Copom meetings.

Markets are already discussing a reduction in the inflation target for 2019, due to the anchoring of market expectations for 2018 and 2019, reflecting the sizable output gap, BRL stabilization and the indexation of our economy, which is generating a downward dynamic in prices due to the decline in current rates.

In the first months of his transition government, Michel Temer focused on the fiscal question, the main risk factor of our economy and the loss of confidence of economic agents. The approval of PEC #241 is fundamental to the stabilization of spending and public-sector net debt, but the main battle is still the pension reform. The sending of a medium/long-term solution to this question is crucial to reendow the State with its investment capacity.

Amid accusations of involvement of ministers in corruption scandals, and as we await the ruling of Brazil's Electoral Court, which could annul the ticket on which he ran as vice-president, Temer sent Congress a widesweeping reform proposal.

Pressured by economic agents, by Operation Car Wash and by the state governors involved in the biggest fiscal crisis in history, Congress should approve some changes to the retirement rules, after the exclusion of themes sensitive to organized groups, in order to build a bridge so that future governments start proposing other measures aimed at guaranteeing the sustainability of the system in the long term.

After the discussion of the pension reform, the government should focus on economic growth. The microeconomic measures proposed so far (labor reform, tender law, oil regulatory framework) are important to improve the country's business environment, but are unlikely to impact economic activity, or the government's popularity, in the short term.

The permission to draw down FGTS funds helps boost consumption, but the economic team will need to seek out new ways of stimulating the economy via private investment, such as concessions and privatizations. We remain constructive on a gradual recovery in economic activity, but it is fundamental that the population feels the improvement in the economy, via growth in income and better employment data, so that the group supporting the government arrives at the 2018 elections in a strong position.

That's what we believe !

EQUITIES STRATEGY

In a month of profit-taking in stocks and a decline in the Ibovespa (-2.52%), our equities funds posted losses, while our Long-Short strategy funds underperformed the CDI interbank lending rate.

Our positions in Steel, Mining and Paper & Pulp, more linked to global dynamics, were among the main negative drivers in the month. Our position in the Mining sector was the main positive highlight in the quarterly result.

During the quarter, we reduced the exposure of our Long Only funds in the global cyclical sectors, linked to commodities, which are already pricing in the pace of global growth and the new economic environment in the US.

Although we believe the current price of Vale shares still reflects an average iron ore price heavily traded right now of $80-90/ton CFR China, there are fundamental reasons for the commodity not to remain at current price levels, which should pressure the stock price.

In March, we also suffered losses in Sanitation, a position that we reduced strongly during the month.

The main positive contribution in March came from the Shopping Mall sector, via which we explored the theme of a structural decline in Brazilian interest rates. We also obtained marginal gains in the Health and Financial Services sectors.

In our Long-Short funds, we highlight the gains from our short positions in Banks, and in the Proteins sector, due to the strong stock price losses in the wake of Operation Weak Flesh.

The outlook for approval of part of the pension reform sent to Congress and the resulting reduction in risk premiums, together with a deeper cycle of interest rate cuts, should lead to a reduction in the discount rates in asset pricing models. For this reason, we maintained our exposure to companies with greater financial leverage and recurring cashflows readjusted by inflation, who should benefit from the reduction in the cost of capital, although we reduced our exposure to Sanitation and increased our exposure to Energy and Shopping Malls.

We also increased our exposure to the sectors most impacted by the rebound in consumption, recovery in income and credit expansion, since the inflection in economic activity should occur this year, albeit at a slow and gradual pace.

In our Long-Short funds, we remain short in companies with a defensive profile, especially basic consumption and food retail, trading at higher multiples and whose results shouldn’t benefit that much if out scenario of macro economic recovery materializes.

We also maintained low exposure to the sectors most impacted by the rebound in consumption, income recovery and credit expansion, since the inflection in economic activity should be very slow and gradual.

MACRO STRATEGY

Our funds performed well in the month. The AZ Quest Multi fund gained 1.50% (143% of CDI),while the AZ Quest Yield fund rose 1.52% (145% of CDI).

The AZ Quest Multi fund beat its targeted return this quarter (233% of CDI), reflected in the growth of its NAV to R$315mn. We recall the launch of the AZ Quest Multi Max, a fund that will follow a similar strategy to the AZ Quest Multi, with a bigger risk budget.

We obtained a positive contribution in many of our strategies, especially the result of our nominal interest rate positions and in the purchase of Mexican pesos. Due to the uncertain political scenario and the low cost of hedges, we have used several safety positions against the tail risks generated by political and economic events in Brazil and abroad.

Local interest rates continued to narrow, with a steepening of the curve. Our position in the shortest DI contracts posted strong gains. The sharp decline in inflation indices paves the way for the Central Bank to accelerate interest rate cuts.

Despite smaller premiums in this section of the curve, we still believe in the viability of additional rate cuts, above market expectations. We remain long in medium-term NTN-Bs, a position we have carried for several months, due to the breakeven inflation in these assets. We expect to see convergence of real interest rates over the next few months.

We also flag the good result of our currency position, mainly via the purchase of BRL and Mexican peso against the USD. We closed our short Euro position due to lower political risk and the release of positive economic data, which raise the chances of the ECB following the FED and bringing forward the start of monetary normalization over the next few months.

The BRL should remain strong, mainly due to the flow of foreign currency, reflecting a trade surplus of potentially USD70bn if the expected record harvest plays out and metal prices keep rising. This movement is also boosted by the potential entry of foreign capital in the process of privatizations and concessions established for the coming semesters. With dollar swaps drying up, we wouldn't be surprised if the USD drops below R$3.00.

Our relative value strategy in stocks posted losses, mainly due to the long positions in global cyclical sectors (Steel and Mining) and Utilities (Sanitation and Energy). We kept our long position in equities, on expectations of a gradual recovery in economic activity and an improvement in confidence levels due to partial approval of the pension reform.

CREDIT STRATEGY

The AZ Quest Luce fund returned 109% of the CDI. Despite maintaining a conservative portfolio (cash and LFTs = 59% of NAV), the good results of our debentures and LFS-N portfolios led the fund to again outperform its long-term targeted return.

The AZ Quest Altro gained 111% of the CDI in the month, in line with its long-term targeted return.

We decided to temporarily close the fund in order to preserve its capacity to meet its long-term target, in response to current conditions in Brazil´s private credit market and rapid growth in the fund´s NAV. Its reopening to new investments is subject to the decision of the fund manager, which will assess the future conditions of the credit market.

The issuance market was more active in March and remained vibrant at the start of April. Our perception is that this traction is more structural and may continue if there is no rupture in the current political and economic scenario. In our segment of operation (High Grade assets), we see this strong activity via public offers and private placements and club deals. This is very positive for our funds and will make our risk management x return more efficient.

This month, we analyzed 8 primary offers for AZ Quest Luce and 10 for AZ Quest Altro, allocated into 3 and 6 of these offers, respectively. Another 2 primary offers will only have their book building in April.

We were very active in the secondary market, at both the buying and selling ends, especially in the AZ Quest Altro. We zeroed our position in an energy company due to the clear deterioration of its credit conditions. We also reduced some hedged debenture positions, since their prices were already at levels we deemed attractive to sell.

ARBITRAGE STRATEGY

For the fourth consecutive month, the AZ Legan Low Vol fund beat the CDI, gaining 1.10% (105% of CDI).

The strategy that most drove the fund was Financing and Tripod Reversal of PETR4 and VALE5. We also obtained positive returns from our Four Ends Box strategy (Options – BVSP / BMF),Cash & Carry and Forward Financing in the stock market.

The increased liquidity of the market, plus the reduced cost of the fund at the end of 2016, create a very favorable scenario for our strategy and make the product more efficient. We believe that, with the continuation of the current scenario, the fund will start posting the consistent returns seen in prior periods.

The AZ Legan Termo fund rose 0.99% (94.57% of CDI), impacted by the transfer of Administrators and change in the accounting method of forward financing operations.