


MONTHLY LETTER – DECEMBER 2011

Dear Investor,

Please find attached our monthly letter for December. Over the next few days we will publish a Special Letter analyzing the Economic and Investment Scenarios for 2012.

Warm regards,



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MACROECONOMIC SCENARIO

The end of the year was dominated by uncertainties over the pace of global growth. The insecurity surrounding the next political steps in Europe, the heavy timetable of debt maturities in 1Q12 and the difficulty visualizing the point of stabilization in China kept markets in wait-and-see mode in December.

We are starting to see some signs of stabilization in global growth. Economic activity data were solid in the US in the fourth quarter and some leading indicators have also perked up in Europe and China. But there are still several reasons for skepticism, in particular in Europe. In China, the government is giving clear signs of stimulus – credit, monetary aggregates and fiscal policy were expansionary at the end of the year and should remain so in 1Q12 – and should ensure even more robust economic activity prints over the next few months.

In Europe, we are alert to the inevitable political ramifications of the recessive period currently underway. The potential for mishaps in the execution of agreements, in the national fiscal programs, in the Greek restructuring, to name just a few, is significant at the start of 2012.

In Brazil, the month of December was dominated by the confirmation of expectations of an economic slowdown in the second half of 2011 – Q3 GDP remained stable, where we highlight the weakness of internal demand, and leading indicators point to an only marginally positive result in the fourth quarter. We expect the Brazilian economy to accelerate gradually during 2012 and maintain our forecast of 3.5% GDP growth.

If there were no surprises in the economy, the Central Bank certainly brought a few. The minutes of the end-November Monetary Policy Committee (Copom) meeting reaffirm the favorable outlook for internal demand and, for the first time, call attention to the cumulative effects of interest rate cuts on economic activity. The Q4 Inflation Report also featured less favorable forecasts for 2013 inflation, which in the market scenario will total 5.3%. The result is a change in the balance of risks for the point of interruption in the cycle of interest rate cuts. We maintain our forecast of another three cuts of 50bps, bringing the SELIC rate to 9.5% p.a., but we have removed our downward bias.

MACRO STRATEGY FUNDS

In December, our Quest Brazil Macro Fund obtained return of -1.68%. In terms of contribution of results, we obtained gains in the inflation, equities and currencies strategies, but our local interest rate strategy ended up offsetting some of these gains.

The month was one of high asset volatility in general, both in Brazil and abroad. What most called our attention was the change in the Central Bank's interest rate policy stance. As a result, we changed the flattening (Apr12/Jul12) and Jan/14 positions to a more conservative position, short in Apr/12 and long in implicit inflation.

Before December, the balance of risks was in favor of a longer interest rate cut cycle, but following the Monetary Policy Committee (Copom) minutes, the credit stimulus measures and, later, the Inflation Report, the balance of risks shifted towards a smaller cycle, as we describe in the Economic Scenario. This change resulted in the repricing of 80bps in the curve (Jan/14). Our strategy is to maintain small positions while this movement lasts, but to increase the short position whenever the curve starts pricing in a cycle of interest rate cuts of less than 250bps again.

In currencies, we operated two pair trades: short AUD/BRL and short EUR/CAD, with the latter representing our main allocation. The long CAD position reflects more encouraging data on the US economy and oil prices (which seem to be supported in the short term). Our EUR position was established after the changeover at the helm of the ECB. The management of Mario Draghi has tackled the European crisis in a more similar way to the FED, and more removed from the inflation-only focus that marked Trichet's tenure. By expanding the range of collateral options to be accepted in the debt bond auctions, the more expansionist nature of the ECB changed the correlation of the EUR with risk assets. In terms of the BRL/AUD pair trade, the underperformance of the BRL against the AUD totaled 14% in 2011, with most of this underperformance coming in the last few months of the year. We expect this movement to revert course in the short term, also due to the slowdown in China.

In equities, we held a more tactical position in both Ibovespa futures and the S&P, taking up both short and long positions during the month. We formed a long Petrobras / short Vale position based on the rationale that emerging markets' energy demand should remain solid, while geopolitical tension with Iran is pressuring oil prices. In terms of iron ore, first quarter concerns over China may affect iron ore prices. In a 2-year horizon, we also note that the underperformance of PETR4 against VALE5 was relevant.

Looking ahead, we expect the first quarter of 2012 to be as challenging and unstable as the last quarter of 2011, with compatible price action and headline risk.

EQUITIES STRATEGY FUNDS

The Brazilian stock market was stable in the month of December, falling a mere 0.25%. The year ended with a loss of 18.11%, calling attention to the major overperformance of Domestic Defensives against Global Cyclical and Domestic Cyclical, which posted respective variations of +22%, -19% and -25%.

In December, we kept our stronger exposure to domestic cyclical and defensive sectors. In this sense, we are maintaining a long/over position in the sectors of Banks, Toll Road Concessions and Sugar/Ethanol.

In sector terms, we benefited in Financials (Banks and Diversified Financials), Agribusiness, Consumer Goods and Tollroads. The main contributions came from Santander Brasil, Itaú, Bradesco, MDias, CCR and Ecorodovias.

In terms of the sectors that posted a negative contribution to our portfolio, we highlight Oil, Telecom and Utilities Power. The main individual stock highlights were Petrobras, TIM and Eletrobras.

The Real Estate-Builders sector suffered strong losses of around 9% in December. We remain neutral on the sector in relation to the Ibovespa, but positioned in intra-sector pair trades that correspond to our valuation estimates for the companies.

In Global Cyclical, we continue carrying the November pair trade of long Petrobras and short Vale do Rio do Doce. We maintain our view that oil prices should remain pressured in the short term, with further upward price pressure coming from potential geopolitical tension in the Middle East. In the short end, we maintain our call of a possible slowdown in Chinese demand for iron ore.

We reiterate that the outlook for the Brazilian stock market will continue reflecting a better internal economic scenario vis-à-vis the external scene, while the valuation of some Brazilian companies linked to domestic demand remains very stretched, reducing the upside in some sectors – such as consumption, for example.

We maintain our view that the difficulties experienced in 2011 will continue into the first quarter of 2012, in terms of the outcome of the Euro Zone crisis and a possible slowdown in Chinese economic growth. From Q2 onwards, we could see a slightly more constructive scenario, corroborated by a rebound in economic activity in developed countries and the observation that Brazilian GDP bottomed between the fourth quarter of 2011 and the first quarter of 2012.