

# Economic Review and Outlook

# CALAMOS®

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## In this Commentary:

Our global outlook remains one of cautious optimism.

We expect continued market volatility on the back of debt-ceiling negotiations and other global political uncertainties.

We believe it is highly unlikely that the U.S. government defaults on its debt, and expect continued moderate U.S. economic growth.

We are increasingly constructive on Europe and believe signs coming out of Japan have been encouraging.

The U.S. equity market looks to be in the mid-cycle of a secular bull market, with more room to expand. Valuations are especially attractive for growth-oriented U.S. equities.

## Tick Tock, Tick Tock

### October 9, 2013

The saying “If you don’t like the weather, wait five minutes and it will change” is quite popular in Chicago. While market sentiment hasn’t shifted quite that fast, the sunny outlook that followed the Fed’s taper delay has been replaced by storm clouds centered in Washington. As the government shutdown enters its second week, the optimism of the summer has been replaced by nasty rhetoric from both parties, reminiscent of August 2011. In the third quarter, market participants largely ignored the political brinkmanship that hit with full force in October, as a largely irrelevant government shutdown fueled worries that the U.S. would default on its debt. Markets have been increasingly roiled by the stalemate in Washington, and although we continue to believe that a debt default is highly unlikely, we’re prepared for a nail-biter.

### Market Review

Through September, the S&P 500 Index delivered a year-to-date return of 19.8%, and looked to be on track for its strongest year since 2009. Developed markets outside the U.S. also posted double-digit year-to-date gains. Emerging market equities—especially cyclically sensitive ones—enjoyed a nice bounce despite economic data that was mixed overall and lackluster among the BRICs. The concerns that hurt equities earlier in the quarter—centered on taper talk and a rapid spike in mortgage rates, the potential for military intervention in Syria, and uneven economic data in the emerging markets (EMs)—dissipated one by one; and the Fed’s decision to forestall the taper was met with a roar of approval from global equity markets.

The U.S. economic recovery continued at a moderate pace, led by housing and autos, even as job growth remained sluggish. The euro zone inched into recovery, supported by Germany and France. Austerity tensions bubbled up here and there, but by and

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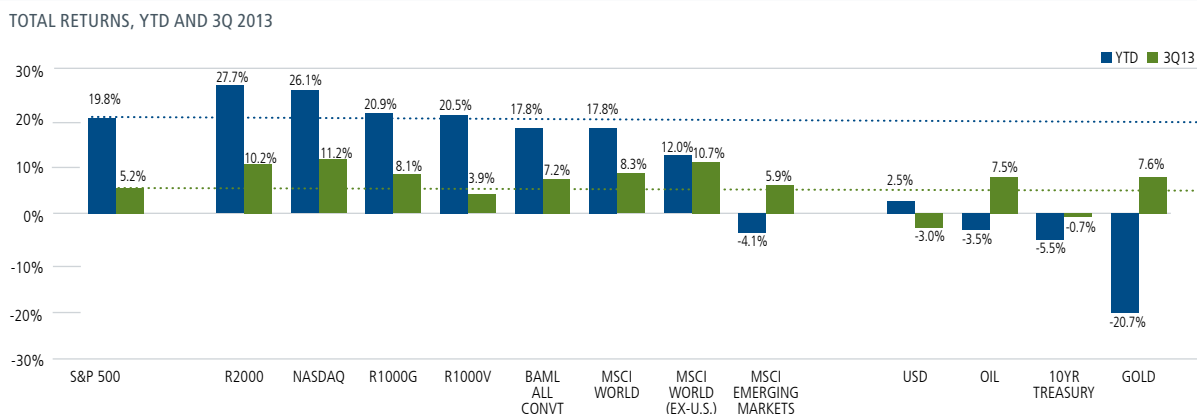
large it was a quiet summer as the euro zone discounted a victory for Chancellor Merkel in Germany. Markets also cheered election results solidifying Prime Minister Abe's coalition and opening the door to structural reforms, the so-called "third arrow of Abenomics," complementing monetary policy and fiscal stimulus.

As investors became more willing to embrace the global recovery and the Fed signaled tapering ahead, materials, industrials, consumer discretionary, health care and technology outperformed, while staples, telecommunications and utilities continued to lag (Figure

2). The divergence between consumer staples and discretionary reflected the bifurcation in consumption that emerged as consumers shifted toward bigger-ticket purchases, such as cars and housing-related goods.

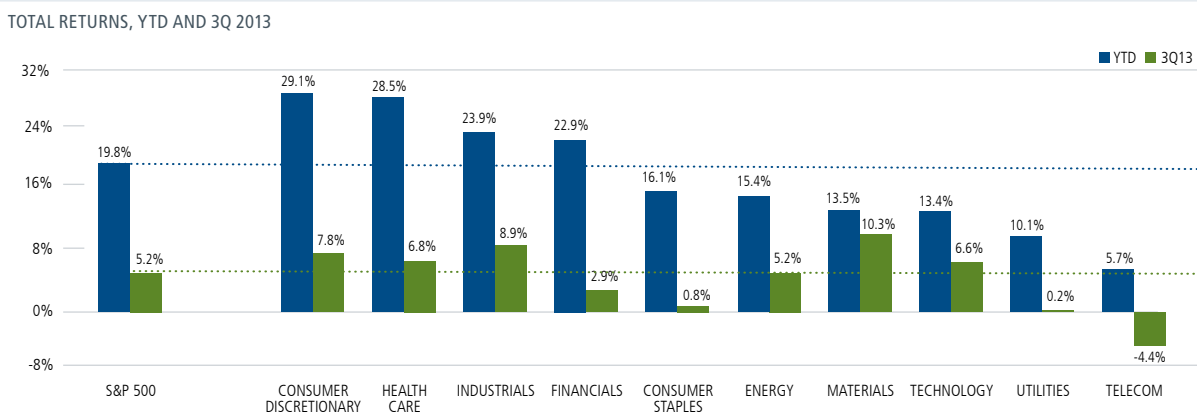
As the quarter progressed, investors focused more on future growth, and abandoned the yield surrogates favored earlier this year (Figure 3). In large measure, this was due to the unprecedented back-up in interest rates, notably mortgages (Figure 4). Stocks with the best long-term earnings prospects outperformed, while the highest dividend-payers lagged (consumer staples among

**FIGURE 1. A DEFERRED TAPER AND CONTINUED RECOVERY BOOST EQUITIES IN 3Q**



Past performance is no guarantee of future results.  
Source: Bloomberg

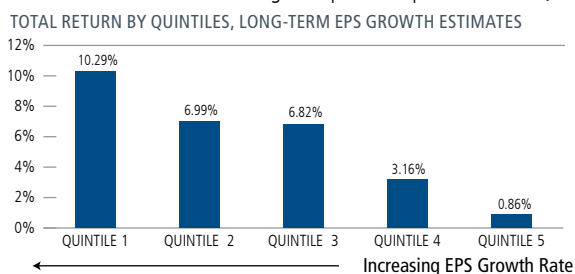
**FIGURE 2. S&P 500 INDEX SECTOR PERFORMANCE**



Past performance is no guarantee of future results.  
Source: Bloomberg

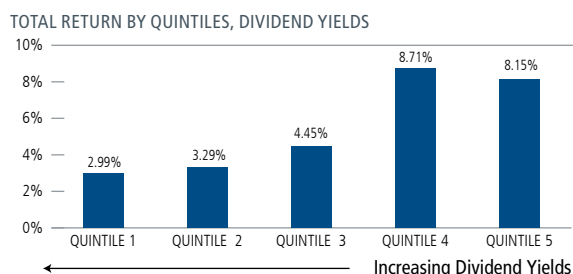
**FIGURE 3. IN 3Q, INVESTORS REWARDED GROWTH FUNDAMENTALS**

**3a. Stocks with the Best Earnings Prospects Outperformed in 3Q**



Past performance is no guarantee of future results.  
Source: Capital IQ. Based on companies within the S&P 500 Index.

**3b. Investors wanted more than income from their stocks**



**FIGURE 4. A RAPID ASCENT IN MORTGAGE RATES**

U.S. 30-YEAR FIXED MORTGAGE RATE, SEPTEMBER 2008–SEPTEMBER 2013  
Recessions indicated by shaded areas



Source: Freddie Mac via Federal Reserve Bank of St. Louis Database

them). Within the large cap U.S. equity market, growth outperformed value, and the Nasdaq Index handily outpaced the broader indices.

**Global Outlook:  
We Remain Cautiously Optimistic**

Our global outlook remains one of cautious optimism. We are encouraged by favorable signs in the U.S., northern Europe and Asia, but we expect volatility to continue on the back of looming U.S. debt ceiling negotiations in the midst of a government shutdown, a weak recovery in southern European countries still plagued by structural imbalances, and the uneven economic data across many EMs.

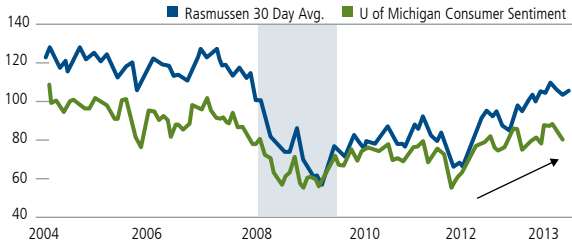
**United States.** The U.S. recovery seems poised to continue on its respectable pace. Corporate balance sheets are healthy and record high corporate cash levels could help fund new job growth and capital expenditures. Capex spending has been a largely missing piece in the recovery story thus far, but this could be changing. The Richmond Fed Manufacturing Index Cap Ex Outlook suggests acceleration, with its highest reading in 13 years. Also, despite expectations of a decline, U.S. manufacturing data delivered a welcome surprise on the upside, and came in strong at the end of the quarter. Profit margins tend to be mean-reverting and we are watching for signs of slowdown, but at this point earnings still look to be on the rise as we head toward 2014.

We have often pointed to the role of small businesses as the engine of job growth and, by extension, sustainable recovery. There was good news on this front, as small businesses have found it easier to secure loans and add jobs. While the employment recovery remains tepid, small business hiring has been robust, nearly twice the level of large businesses.

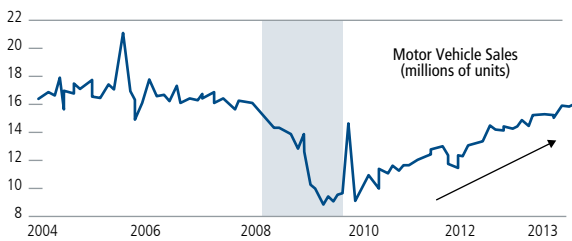
Assuming the debt-ceiling crisis is resolved next week, a resilient consumer looks set to remain as a key driver

**FIGURE 5. HEALTHY CONSUMER TRENDS SUPPORT THE U.S. RECOVERY**

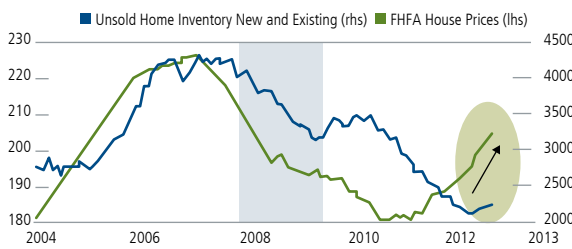
**5a. Consumer Confidence Has Risen**  
Recessions indicated by shaded areas



**5b. Auto Sales Are Accelerating**



**5c. Lean Inventories Are Boosting Home Prices**



Source: ISI Group, "50 Charts to Watch"

**FIGURE 6. U.S. CONSUMERS HAVE COMPLETED AN UNPRECEDENTED DELEVERAGING PROCESS**

Recessions indicated by shaded areas  
HOUSEHOLD DEBT SERVICE PAYMENTS AS A % OF DISPOSABLE INCOME, 1980-2013



Source: Federal Reserve Bank of St. Louis

in the recovery (Figure 5). Consumer debt levels have nearly returned to the levels of the 1990s, with debt/income ratios plummeting over recent years (Figure 6). Even with a spike in mortgage rates and the threat (now the reality) of a government shutdown, the wealth effect has gained traction, supported by housing price increases, equity market gains, and falling gas prices. The impact of the housing recovery has only begun to unfold as a potential boon to other sectors throughout the economy, such as homebuilders, and in turn, to GDP.

Turning to the taper, assuming that Congress resolves the shutdown in short order and avoids a debt default, we expect the Fed to gradually withdraw quantitative easing stimulus starting in early 2014, with accommodative policy continuing through 2015. As we explained in our previous commentary, "Recovery Trumps Taper Talk," we believe that less aggressive intervention will actually help the economy and markets. There should be more incentives for banks to lend money to smaller businesses and prospective homeowners, and fewer valuation dislocations in the equity market.

Historically, when moderate interest rates (4% to 5% for 10-year Treasuries) have been accompanied by economic expansion, stocks have typically held up well, as improved growth prospects outdistanced increases in long-term rates. And by linking the end of QE to employment and financial conditions, and through its commitment to cautious execution, we believe the Fed will not begin a taper without a healthier economic environment.

**Euro zone.** We are increasingly constructive on the euro zone, especially the northern economies. The tail risk of a break-up appears very low at this point. However, just as the road out of recession was slow for the U.S., we expect the euro zone recovery to proceed in fits and starts, especially in light of persistently high unemployment and structural imbalances (Figure 7). Germany and France have led the euro zone out of recession, but even their economies are struggling. Although Germany has shown gains in manufacturing as well as in business and consumer confidence, high-profile companies have fired thousands of workers over recent months. Meanwhile, government debts in France have reached record-high levels.

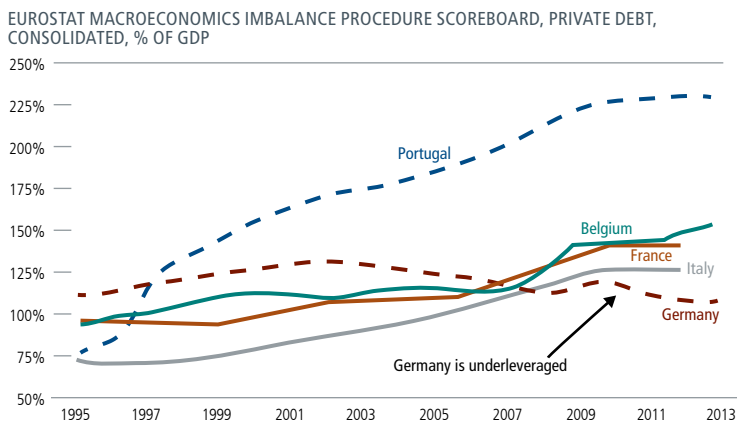
Still, the current problems are a welcome improvement versus those of the recent past. We believe that Chancellor Merkel has demonstrated the ability to navigate a course that can bring along the rest of Europe. Her leadership, coupled with the commitment and resolve of the ECB and other European central banks, may be enough to steady the euro zone until more robust and broader growth can take hold. The key will be for her to balance the often but not always overlapping priorities of stimulating economic growth in both Germany and the euro zone.

Indeed, the Chancellor and other EU leaders have their work cut out for them, as calls for more gentle austerity measures and a temporary debt repayment fund continue. While Italy has been the biggest problem area of late, it could easily cede that distinction to Greece, Spain, the Ukraine or, as some fear, even France.

**Emerging markets.** Longer-term secular trends are still very favorable and EMs should continue to contribute meaningfully to the global economy, but the relative risks are increasing in the short term and we are prepared for a slower and choppy growth trajectory. The emerging markets may have bounced back as taper talk quieted, but the taper has not been cancelled, only postponed. Significantly, the markets that bounced back the most were those with current account deficits, inflationary issues, and structural imbalances.

China is clearly struggling with some near-term headwinds, such as tightening credit conditions, structural reforms, and declines in manufacturing PMI, despite massive government infrastructure projects. Members of our investment team recently travelled to China, where they visited many companies, spoke with various levels of management, and met with local analysts. Factoring in insights from these travels, we expect China to muddle through for the next two to three years as structural reforms are enacted and debt-financed government spending is cut back. We expect data to turn incrementally more negative toward year

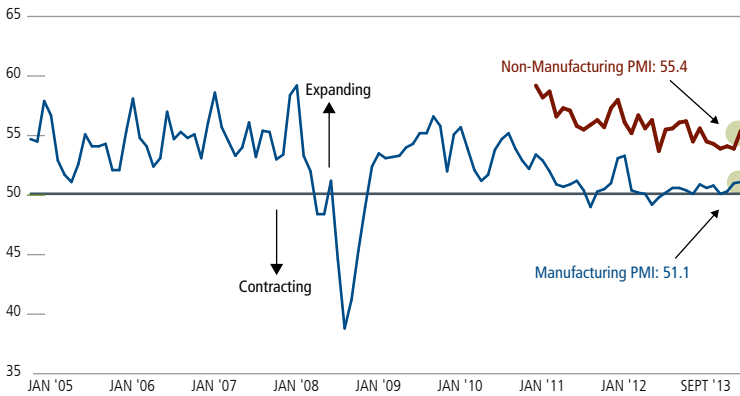
**FIGURE 7. DIVERGENT DEBT LEVELS IN THE EU**



Source: GK Research, "Ideas," September 20, 2013

**FIGURE 8. CHINA'S SERVICE SECTOR: CAUSE FOR OPTIMISM?**

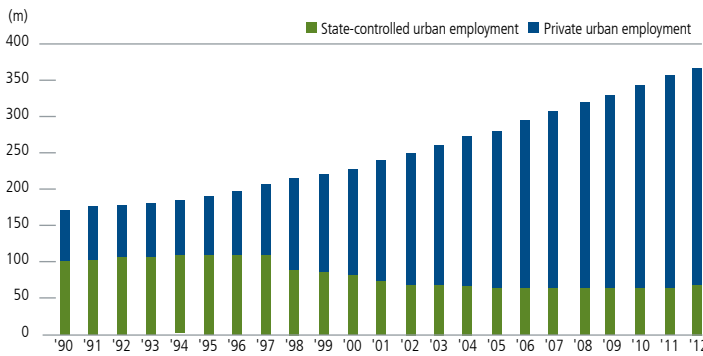
CHINA PMI: MANUFACTURING AND NON-MANUFACTURING  
January 2005 – September 2013



Source: Bloomberg. Corresponding non-manufacturing PMI begins in March 2011.

**FIGURE 9. "SOE RETREAT" SUPPORTS OUR BULLISH LONG-TERM CHINA SCENARIO**

PRIVATE SECTOR AND STATE-CONTROLLED EMPLOYMENT



Source: 20th CLSA Investors' Forum, 2013, "How to think about China, Slower growth with difficult problems, or crisis?" presented by Andy Rothman, China Macro Strategist, Shanghai, using data from CEIC.

end, which would weigh on EM performance. Although the Chinese government is sticking to a 7.5% target for annualized GDP growth for 2013, we think GDP growth in the 6.5% to 7% range is more likely for 2014. Of course, 6.5% or 7% is none too shabby in absolute terms and relative to most other countries.

While we are prepared for continued bumps along the way (and have positioned our portfolios accordingly), we remain bullish long-term on China because the secular story is intact. There are two important moves happening in the Chinese economy that support this

outlook. First, as we have discussed in the past, China is transitioning from a manufacturing-driven economy to a consumption-and-service-driven economy. The U.S. underwent a similar transition itself. If we look at just half of the picture—the manufacturing data that typically dominates China commentary—the picture is incomplete. The better news is that non-manufacturing PMI is at a six-month high (Figure 8), even as manufacturing PMI is hovering around contraction levels.

Second, jobs are migrating from state-owned enterprises (SOEs) to private enterprises. This trend of private sector job expansion (the "SOE Retreat," to borrow a phrase from one of the CEOs our team met with in Beijing) has significant positive implications for the Chinese economy, as capital is deployed best by private enterprises (Figure 9).

While we have near-term worries about China, we have more fundamental concerns about India, where economic growth reforms have stalled yet again and current account deficits are high. Inflation is largely unchecked, and it is particularly troubling that food inflation is running high, given food inflation's well-recognized incendiary social impact.

The good news is that the EM story is about more than the BRICs. Mexico, for example, is introducing positive structural reforms, such as providing more opportunities for international companies within its oil and gas industry. The government has also moved to liberalize the power sector. Our outlook on the Philippines is also quite positive, supported by favorable demographics (a young and relatively well-educated population) and a

healthy national balance sheet (low government debt); these two factors have often equated to economic growth.

**Japan.** Markets have responded ebulliently to Abenomics. While we see encouraging signs, we believe a wait-and-see approach is still prudent. After our investment team's recent visits to Japan, we continue to be concerned with structural overcapacity issues plaguing many industries within the country, such as stringent labor laws that prevent companies from laying people off and closing plants. We had hoped that our team would have heard more discussion of increased hiring, plans for wage and price increases, and broader capital expenditure plans beyond the recent pick-up, which has been focused more narrowly on retail and restaurants.

While we are encouraged that business confidence has recently risen to multi-year highs, we'd be more constructive if we saw a stronger consumer; this is unlikely without wage increases and more robust hiring trends. Instead, salaries continue to fall, creating further headwinds to the consumer activity that Japan desperately needs. Rising energy costs—a byproduct of shutting down nuclear power facilities—have taken a toll on household budgets as well.

We will be closely monitoring the impact of the increase in the value-added tax (VAT) from 5% to 8%, beginning April 2014. Philosophically, we believe that higher sales taxes act as a disincentive to consumer spending, but in the case of Japan today, we view the VAT as an overall positive because it is estimated to generate 8 trillion yen, with 5 trillion earmarked for further stimulus.

Also nearer term, as consumers seek to avoid the VAT, we have seen a pull-forward of spending; while we expect a slowdown during the first half of 2014, we are hopeful that this early ramp-up in spending and threat of inflation will help to change the mindset of the Japanese consumer and unlock additional demand in the second half of 2014.

### Longer term, we believe that asset reflation and stimulus can help change the conservative consumption culture in Japan

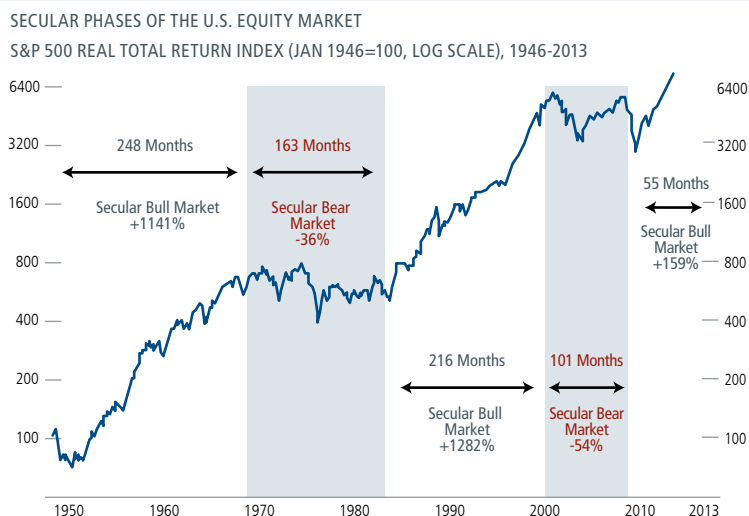
Longer term, we believe that asset reflation and stimulus can help change the conservative consumption culture in Japan, thereby unlocking spending in a very wealthy nation where millionaires comprise more than three percent of the population already. Recent equity market performance and improvements in the real estate market may help catalyze the sort of wealth effect that has been so instrumental in the U.S. recovery.

Finally, Prime Minister Abe has announced a host of reforms, including plans to encourage foreign investment and promote greater participation of women in the workforce; delivering on such goals could move the needle in a meaningful way.

## Perspectives on Equities

Given our outlook for continued global growth, we remain constructive on the U.S. equity market. We look to be in the mid-cycle of a secular bull market, with a cumulative total return for the S&P 500 Index of 159% since the trough in 2009 (Figure 10). Still, we believe valuations have more room to expand and that they remain very attractive at current levels.

**FIGURE 10. A SECULAR BULL MARKET LOOKS INTACT**



Past performance is no guarantee of future results.

Source: BCA Weekly Report , A Secular Bull Market? Feb 11, 2013. Updated image as of September 20, 2013. Rebased to 1946 Jan =100, log scale

**FIGURE 11. EQUITIES ARE ATTRACTIVE RELATIVE TO BONDS**



Past performance is no guarantee of future results.

Source: Robert Shiller, National Bureau of Economic Research, Federal Reserve Board, Standard and Poor's, Corporate Reports, Empirical Research Partners Analysis. <sup>1</sup>Capitalization-weighted data.

Those readers who follow us with some regularity will recognize Figure 11, an update of one of our favorite charts. We believe it's an excellent illustration of the case for equities versus bonds. Equity earnings yields of 6.8% (inverse of the forward P/E estimate of 14.6x) provide a 410-basis point advantage relative to 10-year Treasury yields, which are now around 2.7%. This 410-basis point equity premium would still rank among the cheapest 20% equity yields (relative to bonds) over the past 60 years.

Putting this into the context of valuation, we expect S&P 500 earnings to grow from \$110 in 2013 by 5% per year to around \$133 in 2017. With a 2% expected inflation rate, we expect long-term interest rates to move up to the 3% to 4% range by 2017. We would expect a normal P/E multiple of 17x to 18x, based on what multiples have been over the past 50 years under similar inflation and interest rate conditions. This would equate to an S&P level of 2250 to 2400 by 2016, and a compound growth rate of 10.5%, plus a current dividend yield of 2.0%, for an annualized total return on equities of 12.5%.

### WITH 3%-4% LONG RATES AND 2% INFLATION, AN APPROPRIATE P/E COULD BE 17X – 18X.

2017 S&P 500 EPS	\$133/share (5% nominal growth)
"Normal P/E"	17x – 18x
2016 Year End S&P 500 Index	2250 - 2400
Compound Growth Rate%	+ 10.5%
Dividend Yield	+ 2.0%
Total Return	+ 12.5%

Past performance does not guarantee future results.



While the case for equities is strong, the case for growth-oriented equities is particularly so. Valuations for growth stocks remain attractive versus value stocks (Figure 12), which is especially compelling against the backdrop of sustained economic recovery, an eventual tapering of quantitative easing, and signs of increasing investor interest in growth fundamentals.

In this environment, we've emphasized cyclical growth over defensive growth names within our growth and core portfolios. We're focused on companies with strong fundamentals and increasing returns on invested capital that are selling at attractive valuations. We have maintained conviction in technology, having found businesses with sustainable competitive advantages, strong unit and revenue growth, margin expansion, and secular tailwinds. Within the sector, our portfolios are currently more geared toward emphasizing long-term secular themes, such as those related to big data, mobility, cloud computing, 24/7 access to information and entertainment and electronic payments. We are more cautious regarding more cyclical technology exposure, such as companies levered toward corporate spending. We are closely watching for further developments on the capex spending front.

Most of our portfolios hold sizable allocations to consumer discretionary stocks, where we have found many opportunities among companies positioned to benefit from improving U.S. consumer balance sheets and the up-and-coming consumer class in developing markets.

**FIGURE 12. VALUATIONS SUPPORT THE CASE FOR GROWTH**

LARGE-CAPITALIZATION GROWTH STOCKS RELATIVE TO NON-GROWTH STOCKS, RATIO OF FORWARD-P/E RATIOS, 1976 THROUGH EARLY-OCTOBER 2013



Past performance is no guarantee of future results.

Source: Corporate Reports, Empirical Research Partners Analysis. Capitalization-weighted data.

Our team is also finding opportunities in the energy sector, where valuations remain attractive. We see opportunities among exploration-and-production companies that have sizable low-cost positions in the most prolific U.S. shale plays, as well as in equipment-and-service companies that are capitalizing on spending, particularly in offshore and deep-water drilling. We've generally avoided utilities and telecommunication stocks because historically a high level of regulation in these sectors has dampened growth potential.

Much attention is now focused on the Affordable Care Act and its ramifications to health care in the U.S. Working within this evolving framework, our team has identified narrower secular themes, such as cost containment and innovations that support improvements in care. This has led us to companies benefiting from the growing role of genome-based diagnostics and those involved in helping hospitals run more efficiently, for example.

### **Washington: We've Seen this Movie Before**

Up until a couple of days ago, the equity markets largely shrugged off the impasse in Washington, as they have in past shutdowns. But as the government shutdown and debt-ceiling debates have morphed together, market uncertainty has risen sharply over the past week, as shown in the increase in the VIX and rise in short-term U.S. Treasury rates. We're still of the mindset that a resolution is likely to be reached in short order, whereby a "clean" debt-ceiling bill is passed by the Senate and then the House, averting a credit crisis. In fact, we have viewed recent price weakness as an opportunity to buy equities. If we are wrong and the U.S. government defaults on its debt, we would expect global markets to respond harshly. However, we continue to believe the odds of default remain very low.

**Euro zone equities.** We are becoming constructive on select euro zone equities. In aggregate, valuations are inexpensive relative to longer-term growth and current interest rates. However, there is significant disparity in this valuation picture, reflecting risks associated with individual countries (e.g., Germany and France do not reflect the discounts we see in areas with higher risk premia). Within the euro zone, our bottom-up approach has favored companies with geographically diversified revenues. We have found attractively valued, fundamentally compelling opportunities in manufacturing and technology.

**Japanese equities.** Although Japanese equities have risen significantly over recent months and valuations are not low, structural changes to the investor base could lend support to valuations over the medium term, such

as a reallocation to equities by Japanese pension plans, and new tax-free investment programs for individuals.

Our global portfolios are still underweight to Japanese equities, as we await more concrete progress on third-arrow reforms. We have been increasing Japan exposure at the margin—namely, potential beneficiaries of Abenomics companies profiting from the weaker yen via exports, as well as brokerage and asset management firms that would be served by asset reflation and increased equity market participation. We also see growth potential for property development and construction firms due to trends including a movement to core cities, a decline in adult children living with parents, and 2020 Olympic spending.

**Emerging markets.** Investors shouldn't lose sight of the volatility we saw in the emerging markets as taper talk began. The Fed's decision to hold off on tapering allowed the emerging markets to bounce, but tapering will happen—we just don't know when. We've pared exposure to India and Brazil; both are countries with large current account deficits and, therefore, increased vulnerability to any weakening of their currencies. However, we are still finding opportunities in these countries as well as in China, focusing on secular growth tied to consumption rather than cyclical growth. We are also identifying increased opportunities within a broadening range of countries, leading to larger allocations to countries such as Mexico, South Korea, Taiwan and the Philippines. Here, we believe we can include a higher degree of cyclical exposure alongside secular growth stories because the country fundamentals are stronger.

## Opportunities In the Convertible Market

Although moderately higher interest rates shouldn't be a concern for U.S. equities, it's clearly a different story for bonds with long-term rates still expected to rise by the most since the 1994 bond market massacre. The delay in the taper has provided fixed-income investors some time to respond, but with more than \$3.0 trillion\* in U.S. bond and money market funds, there's a great deal of money at risk, when rates rise.

In contrast, convertibles may perform well in volatile but upward-moving equity markets, while their fixed income characteristics can provide resilience during periods of downward equity volatility. Also, equity characteristics may help reduce a convertible's interest rate sensitivity. Capitalizing on the potential benefits of convertibles requires active management, particularly given the factors influencing the equity and fixed income markets today, the range of characteristics within the evolving convertible market, and the structural complexities of convertibles. As we have observed, it is not simply the inclusion of convertibles that affects an outcome, but how they are managed. Through active management, we focus on capturing more equity market upside than downside.

We are encourage by the direction of new issuance trends over the past year, and believe that a combination of economic growth (already underway) and a more normal interest-rate environment can provide added incentives for companies to issue convertibles.

## Conclusion

As we write this, markets are facing a number of issues that fall into the "wait-and-see" category—from the government shutdown and debt-ceiling negotiations in the U.S., to next steps for the euro zone and third-arrow reforms in Japan. These uncertainties are largely political in nature, and we expect them to foment considerable market volatility. However we believe that the global economy has healed considerably since the 2008 financial crisis, and the twin pillars of accommodative monetary policy and stimulative fiscal policy can allow global growth to continue in the 2% to 3% range.

Perhaps most importantly, the markets have navigated their way through challenges that seemed insurmountable at the time, including the collapse of Lehman Brothers and Bear Stearns, the housing crisis, bailouts of auto makers, TARP, and a euro zone on the brink. It's important to remember that the market has ultimately marched on through the turbulence. By following a fundamentally driven, long-term approach, we believe we are well positioned to capitalize on the volatility that may roil the markets over the shorter term.

\*Source: Morningstar

The S&P 500 Index is considered generally representative of the U.S. equity market. The MSCI World Index is considered generally representative of the market for developed market equities. The MSCI World ex-U.S. Index is a market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America (excluding the U.S.), Europe and Asia Pacific regions. The MSCI Emerging Markets Index is a free float adjusted market capitalization index cited as a measure of the performance of emerging market equities. The Russell 1000 Growth Index is considered generally representative of the U.S. large-cap growth stock market. The Russell 1000 Value Index is considered generally representative of the U.S. large-cap value stock market. The Russell 2000 Index is considered generally representative of the U.S. small-cap stock market. The BofA Merrill Lynch VXA0 Index is considered generally representative of the U.S. convertible market.

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