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- > We believe that a patient approach remains particularly important, given our expectation of continued short-term volatility

## Perspectives on Recent Volatility

August 10, 2011

Throughout July, market participants grew increasingly apprehensive about global growth and government debts. As anxieties bubbled over in early August, the see-sawing in the markets gave way to frenetic gyrations. Investors are rightly concerned about many of the issues facing the U.S. and global economies, but we continue to caution against emotion-driven reactions, whether markets are advancing or declining.

### Outlook

In past commentaries, we have shared our view that the economy faces significant challenges, many related to debt, government policy and changing global relationships. For example, in our October 2010 Economic Review and Outlook, we wrote, "We expect there will be quarters that feel like we are still in a recession. We are in a stop-and-go economy and believe we will be for some time to come." While the future is impossible to predict, we continue to believe a slowdown scenario is more likely than a double-dip recession. Even so, in our investment process, we consider multiple outcomes, and believe that we will be able to adjust, adapt and capitalize on the opportunities that may come out of different economic scenarios.

As we consider the current environment, we are encouraged by the strength we see coming out of corporate America. On the whole, recent earnings announcements have been strong, revenues are up and balance sheets show healthy cash positions. We also believe that recent employment data supports an expectation of slow growth, not recession.

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## A Closer Look at the Downgrade

Broadly, the downgrade is in line with what we have said about fiscal policy in the United States. Running up more debt to get out of a debt crisis is counterintuitive and in the long term, counterproductive. The downgrade speaks more to the currency value than anything. U.S. Treasuries will be repaid in full, though that repayment may be with heavily devalued U.S. dollars. In other words, the bonds are money-good, but how good is that money's purchasing power? In light of the downgrade, government securities saw an increase in demand, so the ability to pay wasn't being questioned; the U.S. government still enjoys borrowing costs that other nations wish for.

Fortunately, like any other lender, "company management" at USA, Inc. is subject to shareholder vote, and both sides of the political spectrum need to hear what the downgrade and the equity market are saying in response to the current management's course of action. If the debt downgrade brings more attention to the budget issues and political process, perhaps there is a silver lining in an otherwise ugly moment.

## Have Equities Become More Compelling?

If anything, we believe the risk/reward characteristics of equities in a slow-growth environment look much improved. The forward price-to-earnings ratio of the S&P 500 Index\* is back at levels seen in early 2009. Prior to 2009, you'd have to go back to the early 1990s to find those levels again. By

our measures, growth stocks are trading at low multiples to future cash flows, indicating market participants' pessimism about companies' abilities to sustain or grow their businesses. However, at these levels, forward returns have shown to be most attractive. Today, we can purchase stocks of high-quality businesses at valuations that we believe will prove to be attractive over the long-run. We are seeing opportunities among well-capitalized companies (with debt-to-capital ratios nearly half that of the broad market) with significant cash (in one famous case, more than the U.S. Treasury) and capable management that efficiently utilizes capital on hand (strong ROIC).†

We believe that valuations in the most economically sensitive sectors and industry groups are starting to reflect a global recession. However, we expect a further Federal Reserve policy response in addition to the ECB monetary stimulus, which was announced over the weekend. We expect these actions to refuel liquidity and to support asset values and, importantly, bank balance sheets. Such actions may help to reduce the risk of a double-dip recession and refuel the reflation trades again. We also expect that falling commodity and energy prices will help to reduce the inflation pressures on emerging economies and that the emerging economies will move out of the monetary and credit restraint phase of this current cycle and refuel global growth.

We believe that companies in the industrials, energy, information technology and materials sectors will be direct beneficiaries of any reflation attempts by the Fed and

\* The S&P 500 Index is generally considered representative of the U.S. stock market.

† ROIC (return on invested capital) measures how effectively a company uses the money invested in its operations, calculated as a company's net income minus any dividends divided by the company's total capital.

European Central Bank, as well as any strength in emerging economies' growth. Our proprietary estimates show improved valuations of many companies in these areas.

### What to Do?

Given the volatility we currently see in the financial markets, we believe that a patient approach is particularly important. Timing the markets is an unreliable, even futile, strategy. Instead, we encourage investors to stay focused on company fundamentals, long-term growth trends and valuations. When making asset allocation decisions, investors must not lose sight of time horizons and risk tolerances. We strongly doubt that most investors' time horizons changed dramatically in the last five days, and their risk tolerances shouldn't have changed either, even if their short-term comfort levels have.

Within our strategies, we are actively seeking to capitalize on market dislocations, while maintaining a disciplined approach to identifying and managing the risks we see in the current environment. Given the volatility we see in the financial markets—and our expectation that it will continue—we encourage investors to stay focused on company fundamentals, long-term growth trends and valuations. This is what we ourselves are doing, and we strongly believe it is the right course, even in a volatile environment such as this.

Time and again, we have noted that the flipside of volatility is opportunity. It bears repeating because we believe it continues to ring true.

Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

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