Global Economic Review and Outlook

CALAMOS®

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All Debt Gets Paid Back with Someone's Equity

A recent conversation between Nick Calamos and his nephew:

Nephew: *Hey, Uncle! Dude, did you hear that Prez Obama is going to extinguish my student loan? Awesome, don't you think?*

Uncle: *Well, if you don't pay your loan, who picks up the tab?*

Nephew: *The Prez?*

Uncle: *Wow, our Prez is so wealthy and generous that he will pay off hundreds of billions of dollars of student loans?*

Nephew: *I guess … or the government will pay them off?*

Uncle: *And where will the government get the money? You see, all debt that is "extinguished" is in fact a loss of someone's equity, be it savings, business expansion capital or future income. You can thank the productive and frugal members of society for your windfall, if it occurs.*

That's the same group you may be protesting against, by the way. You know, you might want to reconsider this class warfare idea, too. If the people you're protesting against don't get saddled with other people's debts, then they could use their capital to create jobs instead—either by investing in other businesses or by hiring people themselves. They could hire you. You could pay back your own debts, provide for yourself and make your way in the world as you choose.

In our January 2012 outlook ("All Clear on the Many Glacier Trail?"), we discussed the pick-up in global reflation and how engineered liquidity would push up asset prices again. We explained we were early in our expectations that asset prices would rise during the second half of 2011 and that our decision to overweight reflation sectors hindered performance.

The reflation we anticipated did occur, starting in mid-December. Globally coordinated reflation activities contributed to the best first quarter equity performance since 1998. Since the market bottomed in March 2009, reflation sectors have taken the performance lead once again (Figure 1, page 3).

We stated last quarter that "we are all reflationists now," as the developed world aligned monetary reflation efforts and emerging markets moved from monetary tightening stances to easing. Notably, the ECB commenced a round of quantitative easing referred

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SUMMARY:
CALAMOS GLOBAL OUTLOOK AND VIEW OF INVESTMENT OPPORTUNITIES

Global Economic Outlook:

> Coordinated reflation has provided a welcomed boost, but cannot sustain global growth. Historically, when liquidity has waned, equity markets faltered and economies weakened.

> A mild recovery and low growth for the U.S. For the foreseeable future, the U.S. economy will have good quarters followed by weak ones. We expect real U.S. GDP growth of around 2% until the debt reduction cycle plays out further around the world.

> Emerging markets can't do it alone. Until the major world economies reach more reasonable debt levels, global economic growth will likely be below the historic average. Currency wars and trade protectionism must be held in check to allow for the competition that fuels innovation and growth.

> A bull market, eventually. The developed world's fiscal and financial situation can be reversed and a new bull market will occur again. A secular bull market requires a few more years of debt reduction, normalization of rates or at least the likelihood of normal rates, fiscal solutions to developed world deficit spending and the creation of a pro-growth, pro-business environment.

Investment Opportunities:

> Equities are the most attractive asset class. We believe equities are the most compelling asset class over the next five or so years, although performance will be more measured than the bull market returns of the 1980s and 1990s.

> Emerging markets are driving global growth. The growth of a middle class is an exciting world-changing trend, as this group provides an increasingly prosperous customer base for global companies.

> Growth equities are undervalued, globally. Our valuation model shows that growth is at a discount around the world. Major global markets have median valuations based on free cash flow that are one standard deviation below their long-term averages, which indicates to us better-than-average return prospects. However, the backdrop of likely higher rates and debt deleveraging may hold off the valuation premium in the foreseeable future.

> Diversified global businesses will lead. Going forward, global businesses with global access to capital, global distribution networks, global marketing and production should command premium business valuations. Information technology companies are among those that are particularly well positioned as business productivity will be an even more important competitive advantage globally.

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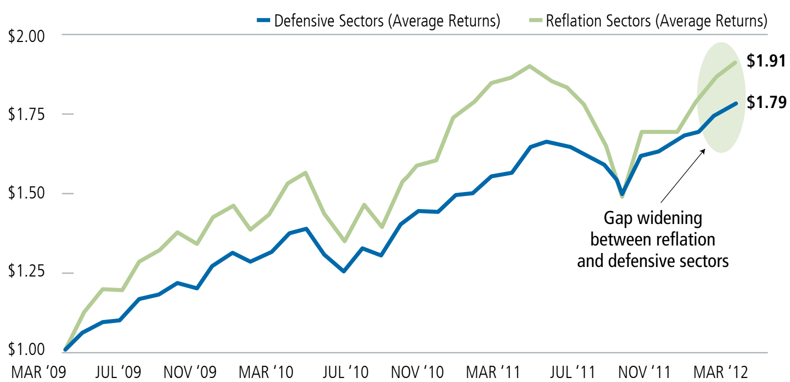
to as LTRO (long-term refinancing operation), injecting $1 trillion since mid-December. The U.S. supported these actions by providing U.S. dollar swaps to the ECB. The value of these swaps stood at $84 billion through December 2011, but essentially, the U.S. has supplied the ECB with an open-ended line of credit, upon which it continues to draw.

The recent reflation efforts by the Fed and the ECB have reduced short-term deflation risks, as banks are backstopped and debt on their balance sheets will be protected. China and many emerging markets are no longer fighting the developed world's monetary trend, as inflation pressures in emerging markets have subsided and growth concerns have taken center stage.

FIGURE 1. REFLATION CYCLE OF RUSSELL 1000 INDEX SECTORS

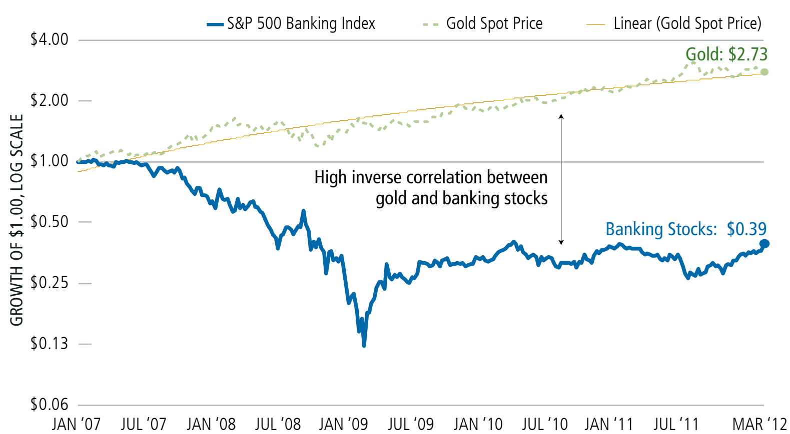
GROWTH OF $1, MARCH 3, 2009 – MARCH 16, 2012



Source: Capital IQ. The Russell 1000 Index measures the performance of large-capitalization U.S. stocks. Reflation asset sectors include energy, materials, financials, consumer cyclicals, capital goods and information technology. Defensive sectors include health care, utilities and consumer staples.

FIGURE 2. U.S. BANK STOCKS VS. GOLD PRICES

JANUARY 2007 – MARCH 2012, GROWTH OF $1, LOG SCALE



Source: Bloomberg. The S&P 500 Banking Index tracks the performance of the bank stocks within the S&P 500 Index, an index considered generally representative of the large-cap U.S. stock market. Gold spot price is based on U.S. dollars, per Troy ounce.

Will Gold Continue to Glitter?

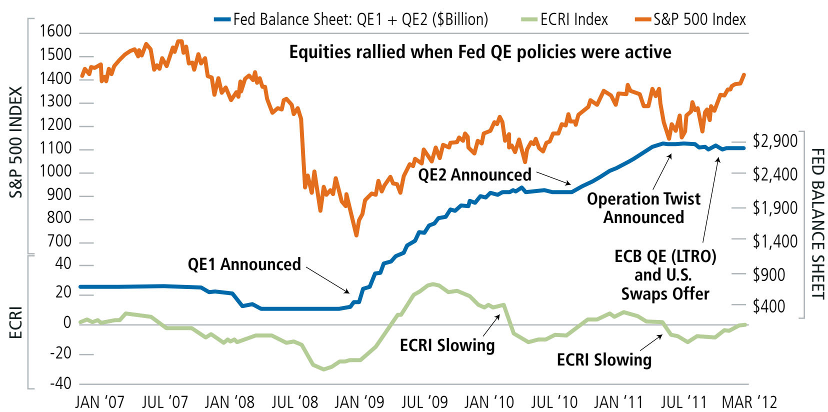
The relationship between bank stocks and gold has been highly inversely correlated since the beginning of the crisis (Figure 2). Will the latest round of quantitative easing by the ECB cause the bank stock/gold relationship to change? Is it time to overweight banks and short gold? The quantitative easing efforts of Europe and the U.S. have been directed at saving the banks from bad loans and ultimate demise. The ECB's latest round of easing has, at least for the near term, guaranteed the survival of European banks, and in turn, the survival of U.S. banks.

We've used positions in gold mining companies as a hedge against weakness (or even a meltdown) in banking and as a hedge against currency debasement resulting from efforts to offset bad debts and gain trade advantages. And, since 2008, our only significant reflation industry underweight was to the banking sector. During the recent round of reflation, we remained wary of bank stocks, viewing them as a short-term trade in an industry that is still very fragile and vulnerable to unresolved global economic debt problems. Going forward, we see banks, the whipping boys of the crisis, as little more than utilities with high regulation, higher capital requirements, lower ROA and expected higher fees and penalties. We envision bank stocks to have valuations like utility stocks, which trade around book value, on average. Gold holds some appeal against the possibility of a complete fiat money meltdown (although we see this as a very low probability).

When the Liquidity Ends, What's Next?

As we noted, the global markets rallied with central bank balance sheet expansion—a "the world is okay, risk-on" liquidity injection, not unlike what we saw in response to QE1 and QE2. Coordinated reflation is a powerful force that can alleviate short-term pain in the global economy, but it is not a real solution. Instead, it just buys time for inflation to work its magic on debt while the global political class finds the courage to tackle mountains of debt and face the reality that balance sheets matter. History provides cautionary lessons about reflation. In the past, when liquidity waned, the global equity markets faltered and economies weakened as risk-off market corrections set in (Figure 3).

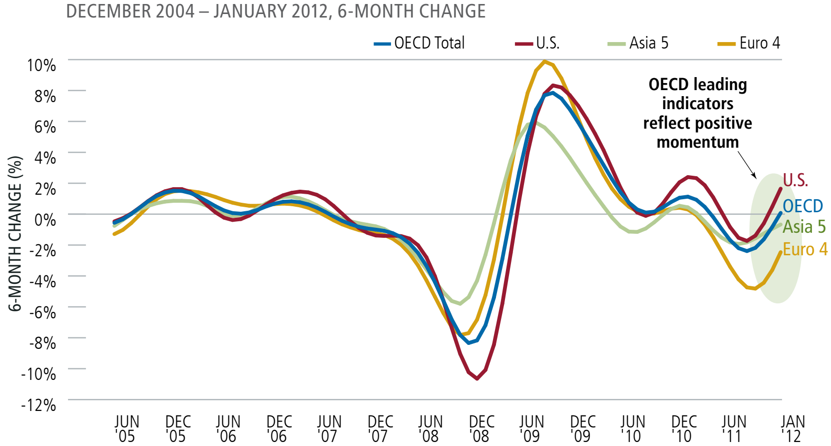
FIGURE 3. EQUITY MARKET SENSITIVITY TO FED INTERVENTION



Source: Bloomberg.

FIGURE 4. OECD COMPOSITE LEADING INDICATOR INDEX

DECEMBER 2004 – JANUARY 2012, 6-MONTH CHANGE



Source: OECD. Asia 5 = China, India, Indonesia, Japan, Korea. Euro 4 = France, Germany, Italy, UK.

The recent equity market advance and better economic data are welcome changes, but we must ask: Is this economic expansion sustainable or is it primarily a liquidity-influenced surge, like a caffeine jolt in a spent athlete? As we show in Figure 3, the rally corresponds to the liquidity injection, as past rallies have corresponded with past QE, similar liquidity events and monetary easing. So, there may be reason for skepticism. Let's take a closer look.

Euro Crisis, Part III

The ECB is following the U.S. lead of using reflation to support banks and buy time. But the structural problems associated with the euro have not been solved and further strains are emerging. For example, Greece's unemployment rate stands at 20%. The pain will not subside quickly for Greece's citizens, and the pressure will likely lead Greece to abandon the euro in an attempt to ease its pain through devaluation. Meanwhile, the crisis has been delayed but not resolved for teetering Portugal, Spain and Italy; and as matters stand today, we believe the big fish that will get caught in this euro net is France. The monetary union needs a fiscal union, which means all countries in the union would cede fiscal sovereignty to Germany and a broader union. Stay tuned as Europe weighs on global growth and the dysfunctional banking system. The U.S. helped bring down the U.S.S.R. with an economic weapon; this decade, others will do the same to the weaker European economies.

The OECD Leading Indicator Index (Figure 4) shows a slightly positive move above zero for the United States. Asia and Europe also appear to be recovering, but are still in negative territory. The eurozone PMI Index is at approximately 50, having bounced back from a lower level predictive of economic contraction (Figure 5). At its current level, the index indicates a very weak recovery. So, the U.S. and European economies are weak, and China is still slowing.

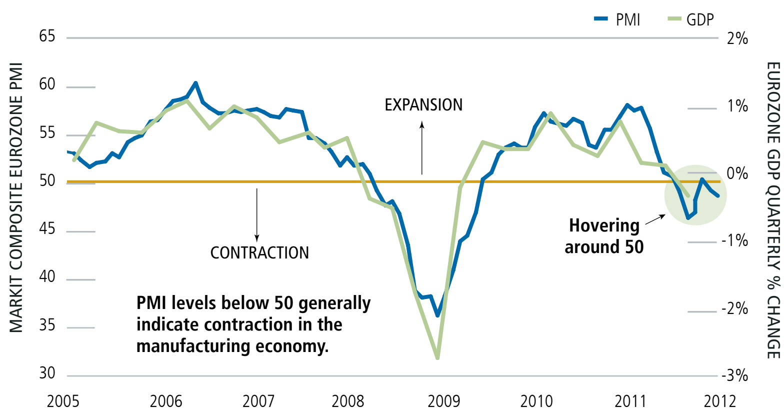
Is the U.S. Economy Moving Ahead?

Although the ISM Index and PMI Index indicate a mild recovery is underway in the U.S., it is too early to get excited about a new bull market. It's good news that the ECRI Weekly Leading Index is back into positive territory (Figure 6), having been in negative territory for most of 2011 and for the first two months of this year. Even so, caution is warranted. The ECRI has an excellent record of predicting a recession when it drops into negative territory, but there have been instances when recessions have come a few months after the index moved back to positive territory. The recent global monetary easing may have delayed weakness from showing up in the index, or the index may be giving a rare false signal.

First quarter GDP received a boost from very warm weather (if this is global warming, then sign us up), inventory buildup, and better employment data that may have enticed consumers to spend. Of course, QE in Europe also helped improve asset values and may have contributed to a small spending-wealth effect. Discussions about lower corporate taxes were another positive. (All corporate taxes are passed through to consumers, as well as to stock and bond holders of the company. Lower taxes can offset the importing of inflation resulting from dollar debasement.) Bank lending in the U.S. showed some signs of life with commercial and industrial loans turning up (Figure 7). And, significantly, the housing market appears to have found another bottom and some inventory has cleared—a very good sign. Housing is no longer detracting from GDP growth and in a few years may actually contribute to GDP growth.

However, other factors call the sustainability of growth into question. Non-defense capital goods orders looked weak in January. Although commercial and industrial loan activity rose, the velocity of money remains anemic. Other

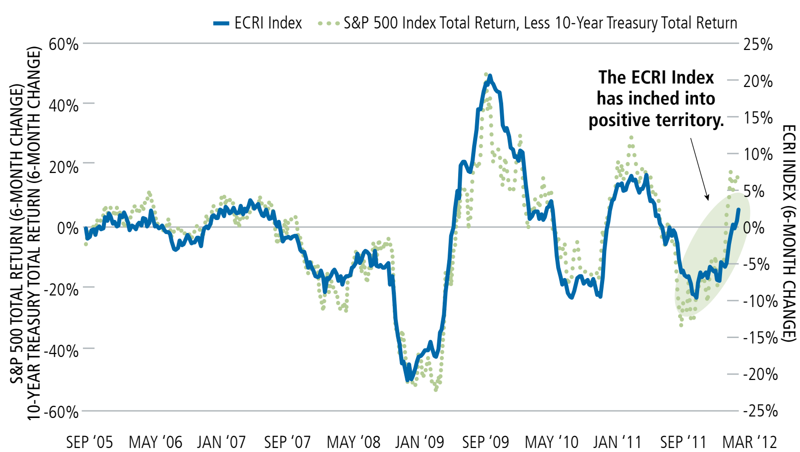
FIGURE 5. MARKIT (FLASH) EUROZONE PMI AND GDP



Source: Markit Economics Limited, News Release, March 22, 2012, "Markit Flash Eurozone PMI."

FIGURE 6. ECRI INDEX VS. S&P 500 INDEX TOTAL RETURN, LESS 10-YEAR TREASURY TOTAL RETURN

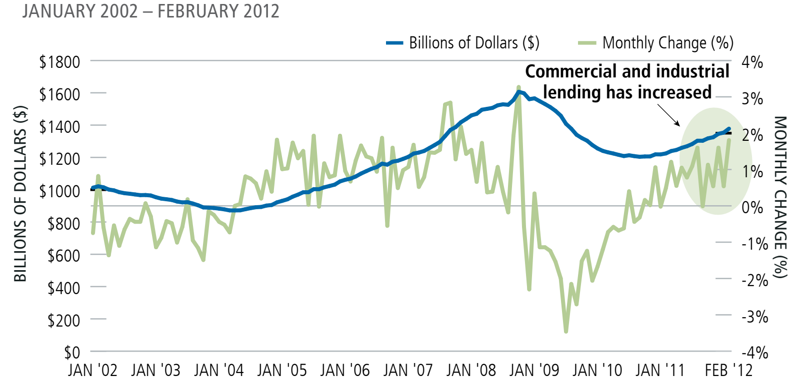
SEPTEMBER 2005 – MARCH 16, 2012



Source: Bloomberg. The ECRI Weekly Leading Index is a measure of leading economic indicators.

FIGURE 7. TOTAL COMMERCIAL AND INDUSTRIAL LOANS

JANUARY 2002 – FEBRUARY 2012



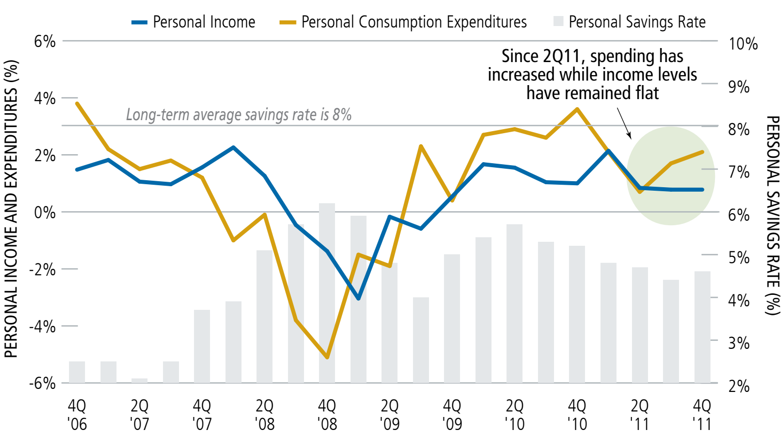
Source: Federal Reserve.

headwinds include higher oil prices, inventory surge (which is not sustainable), and a fourth quarter drawdown on savings.

While the U.S. consumer has reduced overall indebtedness, the rebuilding of real net worth via savings appears incomplete. The consumer debt pay-down is likely three years or so from establishing a reasonable balance. Nonetheless, U.S. consumer spending exceeded income growth in the past year, as shown in Figure 8. Cutting into savings appears irrational, but the average consumer may see something we don't. Historically, when debt-to-net-worth ratios are this high, the savings rate would be about 8% on average, not the 4% to 5% we currently see.

FIGURE 8. CONSUMER INCOME, EXPENDITURES AND SAVINGS

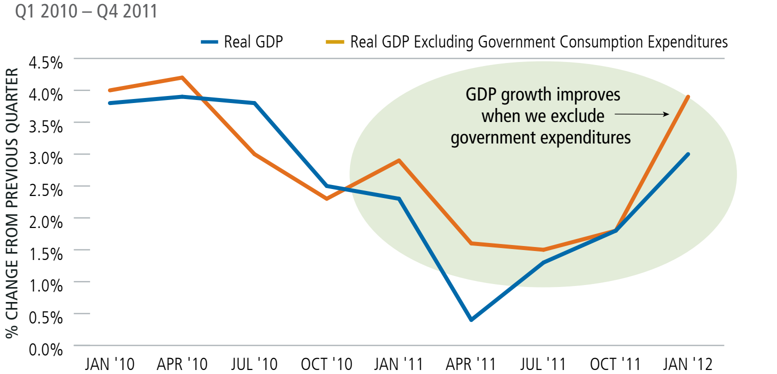
Q4 2006 – Q4 2011



Source: BEA.

FIGURE 9. REAL GDP GROWTH EX-GOVERNMENT EXPENDITURES

Q1 2010 – Q4 2011



Source: BEA

Enticing mortgage rates, low returns on savings and fears of inflation encourage spending beyond one's means. Some of the irrational spending and savings behavior may be difficult-to-kick bad habits—until the lack of savings reaches a crisis level that demands they must be kicked. Meanwhile, investors and businesspeople are operating in an environment that lacks clarity on taxes, health care costs and other regulations. As a result, future capital investment remains on hold or marginal. The federal debt level continues to climb, even as consumers slowly improve their balance sheets. The next bull market should be built on shrinking government debt and lesser federal intrusion in personal and business life.

The U.S. and European economies may not be strong enough to offset rising oil prices and a fifty-fifty chance of taxes rising in less than a year. Both economies are focused on austerity, but with high taxes, larger government and more regulation instead of pro-growth private sector fiscal policies. As we discussed, there's been no real structural progress in Europe in regard to the euro and fiscal issues, apart from supporting the European banks. Meanwhile, Japan continues to falter and drown in debt and China's economy is slowing due to too much financial strain and inflation.

It is for such reasons that we still believe a secular bull market is years off and stick to our main thesis that the economy will bounce around low growth for the foreseeable future, with good quarters followed by weak ones. We expect real U.S. GDP growth of around 2% until the debt reduction cycle plays out further and fiscal reality occurs. But the underlying U.S. economic engine, excluding the government portion of GDP, is proving to be more resilient, as Figure 9 indicates.

Although there are signs of life in the non-government sectors, consumer spending is growing faster than income and leverage is still very high. So, the longevity of this recovery is suspect. Shrinking state and local governments, and hopefully a shrinking federal sector, have been a drag on GDP as well, but housing looks to have stabilized, and as we noted, is not detracting from GDP. Overall, the consumer still has a ways to go to establish a more "normal" balance sheet and build net worth, so spending from the consumer side of GDP will likely be less robust. All in all, the debt deleveraging cycle will still weigh on GDP growth for a few more years, at least.

Since all debt gets paid back with someone's equity (preferably the borrower's), then wealth destruction means the economy is smaller and more risk averse. In our previous outlook, we discussed how, in many instances, the government decides whose equity is wiped out by bad debts, while it adds to the debt that future generations will have to pay back out of equity. Equity is taken from savers, including pensions and retirement plans that invest in fixed-income assets via extremely low interest rates. Equity is taken from capital providers, and that is part of the deal unless contract laws are trampled and select stakeholders are protected at the expense of others, as we have seen. Equity is taken from energy users via inflation due to currency debasement and other forms of inflation. Equity is taken via higher taxes on capital and wealth, higher user fees and increased regulation.

A Problematic Equation: Inflation + QE + Financial Repression

QE is designed to fill the large gap created when the velocity of money collapsed during the crisis. The idea is to provide the same amount of money to the country as was being generated prior to the velocity collapse. Irving Fisher's equation states that MV=PQ, where M, a measure of the money base multiplied by V, the velocity of money is equal to P, the price, multiplied by Q, the quantity of all production. Under this equation, the decline in V would need to be offset with an increase in M to avoid deflation or a fall in P along with a decline in output, or Q.

This is a logical mathematical expression in a closed society. In an open society, however, other countries' trade, interest rate and currency policies influence the price and quantity of output. To complicate matters further, P can represent the price of assets such as gold and government bonds, both of which do little to improve the productive capacity of the nation. The U.S. dollar's status as the world's reserve currency also muddies the beauty of the equation, as U.S. monetary policies have a dramatic impact on energy pricing, global trade and global money flows. Finally, the measure of money should include credit created outside the banking system of the host country. In the end, the above factors make it very difficult to measure the correct amount of M to supply. The U.S. Fed is likely to overshoot and create asset bubbles (a form of inflation) or trouble in other countries, due to the dollar's reserve currency status.

An important component to the financial repression and QE plan is engineering inflation at a 3% to 4% annual rate in an effort to reduce debt. We are concerned not only about managing inflation with such a large debt load, or shrinking bank balance sheets when necessary, or even the banking system reserves multiplying without recourse, but also about the import price inflation (oil) and stress on emerging markets (the engine of growth) as a result of policy implications. Finally, asset inflation, driven by cheap and widely available credit and leverage, not CPI inflation, is at the heart of many of the global economy's problems; and this same asset inflation model is intact today! Reflate assets (QE) and the wealth effect starts to kick in while the credit process eases. Keep on with debt-financed spending to guarantee something for free from our political class and delay the pain, at least for now. The inflated assets are leveraged via easy credit, so when the bubble breaks again, only the debt remains because much of the asset price appreciation is the result of inflation and not real wealth.

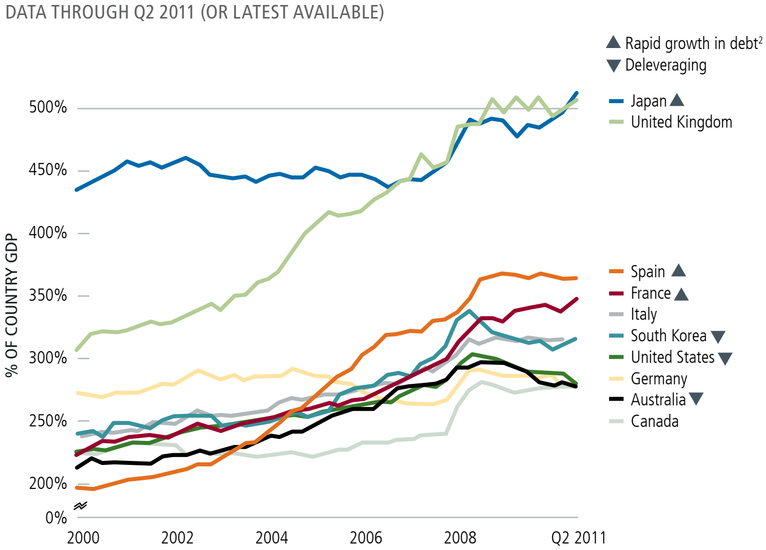
Update on the Debt Deleveraging Cycle

Last quarter, we noted that the U.S. appeared to be further through the debt deleveraging cycle than Europe or Japan. McKinsey Global Institute published an excellent white paper "Working Out of Debt" (January 2012), that addresses this issue. They summarized:

> *Leverage levels are still very high in some sectors of several countries—and this is a global problem, not just a U.S. one.*
>
> *To assess the sustainability of leverage, one must take a granular view using multiple sector-specific metrics. [McKinsey's] analysis has identified ten sectors within five economies that have a high likelihood of deleveraging.*

FIGURE 10. DOMESTIC PRIVATE- AND PUBLIC-SECTOR DEBT[1] AS % OF COUNTRY GDP

DATA THROUGH Q2 2011 (OR LATEST AVAILABLE)



Source: McKinsey Global Institute, "Working out of debt," Karen Croxson, Susan Lund and Charles Roxburgh, January 2012.

[1] All credit market borrowing, including loans and fixed income securities.

[2] An increase of 25 percentage points or higher

> *Empirically, a long period of deleveraging nearly always follows a major financial crisis.*
>
> *Historic deleveraging episodes have been painful, on average lasting six to seven years and reducing the ratio of debt to GDP by 25 percent. GDP typically contracts during the first several years and then recovers.*
>
> *If history is a guide, we would expect many years of debt reduction in specific sectors of some of the world's largest economies, and this process will exert a significant drag on GDP growth.*

The authors of this paper provide a global illustration of the debt reduction (Figure 10). Australia, the U.S. and South Korea appear to be making decent headway in reducing debt at the private and public sector (state and local) levels. Japan, Spain and France are still accumulating debt. Until the major world economies reach more reasonable debt levels, global economic growth will be below the historic average. Because two of the four major economies are still expanding their debt levels, we believe growth will probably be slow for the next five years. We have seen the debt ignorers move aggressively on reflation of monetary authorities' balance sheets and they will probably implement additional monetary debasement. This will likely result in a weakening of the yen and the euro in the next year.

The United States of GM

If the U.S. were a company, it would have a lot in common with General Motors. Let's take a closer look at a hypothetical case, "USAGM Corporation," and analyze its investment merits from a wealth creation, cash-flow and balance sheet perspective to understand its sustainability and competitive position. (This metaphor could work for many of the developed economies, not just the U.S.)

USAGM Corporation has substantial future health care and benefit obligations (Social Security and Medicare) that do not appear on the company's annual budget or financial statement release. As a result, no plan or financial set-aside exists for these future liabilities. The extent of the liabilities is five times the company's annual revenue (GDP), many more multiples of its operating cash flow (tax revenue), and many multiples again of its available free cash-flow (discretionary federal government spending).

2010 U.S. Debt-to-GDP	512%
2010 U.S. Debt-to-Tax Receipts	3468%

2010 U.S. Debt (w/Social Security and Medicare)	$76.3 trillion
2010 U.S. GDP	$14.9 trillion
2010 U.S. Tax Receipts	$2.2 trillion
2010 World GDP	$61.9 trillion

U.S. Debt Exceeds World GDP by $14 Trillion!

The on-the-books debt-to-assets and debt-to-revenue ratios are already approaching a major negative credit event. Despite its already highly leveraged state, USAGM has financed its operating deficit through debt offerings. The company is also issuing stock (currency) and diluting its value to repurchase debt (QE) in an attempt to hold down interest rates and to create the illusion of extra demand. The operating deficit holds only a small promise of future growth, as most of the spending is for current operating expenses and not for future capital investments, research or development.

As debt levels rise and stock value dilutes (currency debasement), management responds by self-insuring health care liabilities and substantially raising the prices end users pay for USAGM products (tax increases) to cover the rising costs (hoping or assuming they can keep the customer base). All in all, there's a high degree of disrespect for shareholders and capital providers. In the end, all debt is paid back with equity, a model for certain wealth destruction. The equity may be future earnings promised to debt holders or equity from innocent bystanders if the government bails out the company. The equity will also come from investors foolish enough to go along with this charade.

A company doesn't survive this sort of deception unless the government decides it's "too big to fail." Unfortunately, governments run the same charade but have more latitude and can sustain the game for longer. Governments can issue stock (currency) to purchase some of the debt they issued while holding down the rate of interest on the debt through manipulation, outright mandate or collusion. The power to tax (take what is not earned from people who earned it and raise prices to consumers) without recourse is an all-too-easy choice because the debt will become the obligation of future generations, long after the current politicians and recipients are gone. But the Achilles' heel of this charade is the inflation risk we discussed earlier, which includes the possibility that interest rates need to rise significantly to entice buyers for the huge amount of debt and in turn further implode the company's financial health and competitive position.

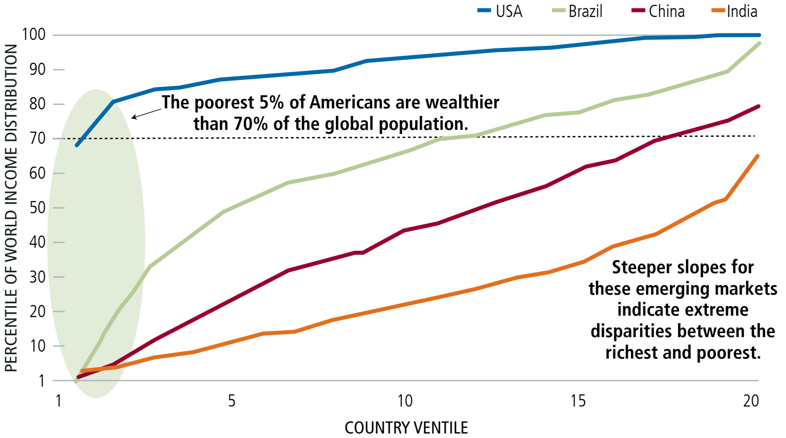
Rethinking Global Trade

Global markets, global trade and global consumers create global wage conversions and the distribution of global income differences aligns. Worry less about income equality in America and more about income inequality around the world. Global markets are the great equalizer for wages and skills. Unskilled labor rates will converge and that's bad news for unskilled workers in the U.S. This does not mean massive unemployment forever, but likely points to continued mediocre wage growth for unskilled positions in many industry groups. The argument for trade protection is easy now: China and Asia are stealing jobs because of their abundances of cheap labor and undervalued currencies.

Figure 11 compares income inequality among the U.S., Brazil, China and India. The vertical axis displays the percentile of the world's income distribution and the horizontal axis charts the percentile of the wealth distribution for each country, broken up into 5% groups (ventiles). The chart indicates that the poorest 5% (the first ventile) of Americans are wealthier than 70% of the global population while the poorest 5% of Chinese, Indians and Brazilians are among the poorest of the poor.

The unskilled labor or low-skilled labor discrepancies between the growing emerging markets and the U.S. are shocking. It is very feasible to expect that the huge income differences for low-skilled wages will converge as the high-income groups around the world have, as the chart indicates. This will be the developed world's issue in the future. Despite the rhetoric that the U.S. is an unfair nation favoring the wealthy, we believe the lack of real median income growth over the past 15 years is directly related to the growth of the emerging markets and the poor K-12 education system in the United States. Wage conversion will mean less income growth for less skilled workers. It also means that even highly skilled U.S. workers will increasingly compete with an incredibly educated and skilled global workforce, again limiting the upside growth across the income distribution. Calls for trade protection and currency manipulation will become more widespread until the U.S. reverts to a growth agenda and becomes fiscally responsible and educationally competitive.

FIGURE 11. GLOBAL INCOME INEQUALITY, BY COUNTRY AND INCOME CLASS



Source: *The Haves and Have-Nots: A Brief and Idiosyncratic History of Global Inequality*, Branko Milanovic, Basic Books, New York, 2011.

We expect that history will refute the protectionist utopia over the medium and long term as a lack of competition and choice slow productivity, creativity and growth. The marginalization of a great country occurs when it is not prepared for global competition, looks inward and fails to make fiscally sound decisions for the long-term health of its citizens. If this does not sound true, then think of monopolies, think of government services, think of protected industries and closed-off countries. In almost every such situation, decay and poor quality set in, followed by a collapse in growth.

The currency wars have not gone away. Moreover, in periods of financial repression and debt deleveraging, currency devaluation plays a large role as years of slow economic growth and structurally higher unemployment become a recipe for attacks on free trade and for embracing protectionism. The rhetoric of class warfare and paying your fair share is one step away from dividing a nation. It is also one step away from dividing many nations. As an example, we note that the recent round of Republican debates featured China bashing—an easy target to blame now for a lack of discipline in the U.S.

The global economy is experiencing tremendous changes that drive large income discrepancies that in turn fuel trade and currency wars. Without improvements to developed world growth and debt reduction this year, round two of the currency wars will ignite soon. From an investment standpoint, we see opportunity in the growth of a middle class in emerging markets. We are excited to participate in this excellent, world-changing trend. We are also aware of the strains that this trend will put on the developed world if the same inaction, lack of accountability and fiscal profligacy continues. There is no turning back, because that would lead to global collapse and economic depression. The path forward is to compete globally and grow with the emerging markets' consumers.

Forecasting the Equity Investor's Opportunity

As we rationalize equity investing with the previous discussion on debt, inflation and currency debasement in the developed world, one may wonder if we are biased, based on our focus on growth equity and growth-oriented fixed-income strategies. Over the past three years, we have explained why we believe equity investing offers the best opportunity for real return on your assets, especially relative to cash, government bonds and even high-quality corporate bonds. We still seek to understand some of the potential outcomes that have and may still occur in a financially toxic and unstable world.

History tells us that when financial repression accompanies the unwinding of debt deflation, the possibility of an inflation surprise has occurred only 15% of the time. Even so, we diligently look for warning signs that would tell us to shift more quickly and significantly into assets that typically benefit from inflation. Deflation is also a concern for us and we keep the perilous example of the Great Depression top of mind during this period of debt contraction and wealth destruction. In particular, we remain aware of past instances when inflation has taken hold as governments have engineered to offset a collapse in output and huge debt burdens. This high inflation leads to rising interest rates that choke off the little growth that is occurring. Meanwhile, debt levels and debt servicing costs spiral out of control. Ultimately, the economy collapses into a debt deflation cycle. The remedy for the debt problem creates an inflation problem that ushers in a larger debt deflation collapse. Again, this is not a likely scenario, but it is not outside of historical precedent, either. Therefore, we must watch carefully and understand what could happen if inflation takes hold before enough debt reduction occurs. Our product positioning and asset allocation must account for, or be prepared to adjust for, the possibility of outlier events.

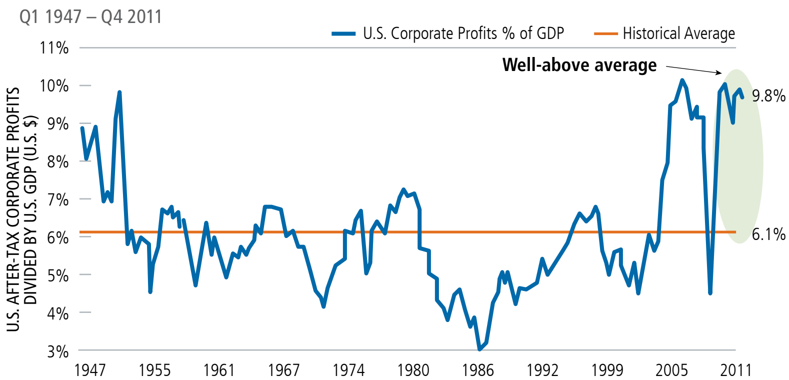
The Fed has vowed to avoid deflation even if it risks higher inflation, and the ECB has moved to reduce the near-term risk of deflation. So, we are not advocating being long 20- to 30-year government bonds to reduce this risk. In the end, we believe the odds based on history and policy action indicate equity investing offers the best alternative. Commodities have had a great run and may still offer some protection, but, again, we favor commodity and mining company stocks instead of the raw materials. We may have a bias, but that's because we believe history is on our side.

What do equity valuations tell us about the market return opportunity going forward? If we normalize profit margins and revert to the long-term average 7% compound annual growth rate in earnings per share with normalized interest rates, then what returns might U.S. equity investors expect in the next five years? The first determinant is whether the current high level of corporate profit margins can be sustained. If profit margins are mean reverting, then a normalized profit margin should be used to determine price-to-earning (P/E) ratios (Figure 12).

We believe that one should still normalize profit margins because they still are mean reverting. No doubt trade and

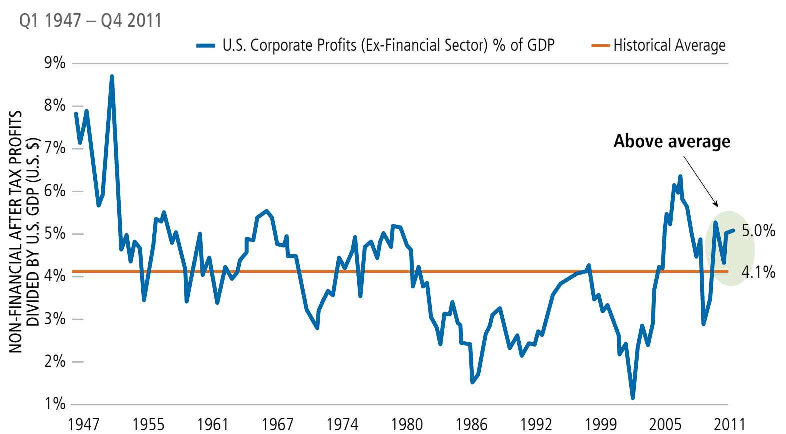
FIGURE 12. U.S. CORPORATE PROFIT MARGINS

FIGURE 12A. U.S. AFTER-TAX CORPORATE PROFITS AS A PERCENTAGE OF U.S. GDP ($)



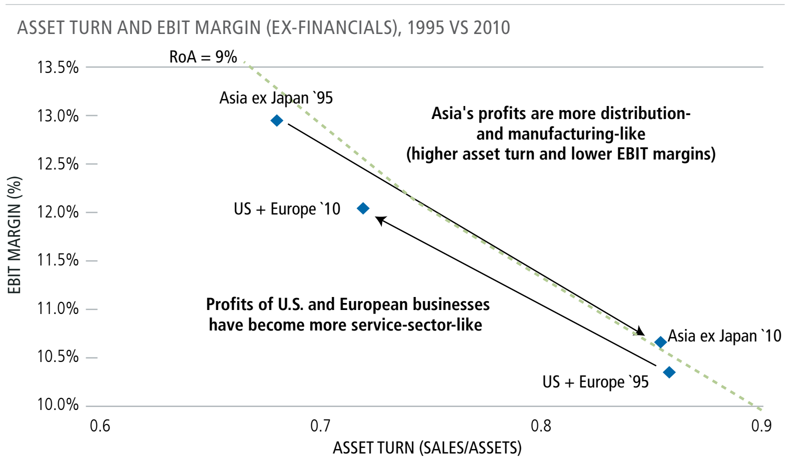
Source: Federal Reserve Bank of St. Louis.

FIGURE 12B. U.S. AFTER-TAX CORPORATE PROFITS (EX-FINANCIAL SECTOR) AS A PERCENTAGE OF U.S. GDP ($)



Source: Federal Reserve Bank of St. Louis.

FIGURE 13. CHANGING GLOBAL BUSINESS MODELS



Source: Citigroup Global Markets, Global Equity Strategist, March 14, 2012. EBIT stands for earnings before interest and taxes.

currency wars would cause an abrupt reversion in the profit margin picture, and the character of profits will also change. In our view, profit margins can and will regress down to and below the mean again if interest rates or oil prices spike significantly, growth collapses, or the balance of wages to profits becomes unsustainably low.

Figure 13 indicates that since 1995, the character of profit and type of business have dramatically changed in the U.S. and Europe as compared to Asia. Profits of U.S. and European businesses have become more service-sector-like with higher EBIT margin and lower asset turn while Asia's profits are more distribution- and manufacturing-like with higher asset turn and lower EBIT margins. This shift in the character of profits makes perfect sense. Asia has become a global manufacturer and U.S. and European companies have shifted the more cyclical, capital dependent and labor-intensive business to Asia, while retaining much of the work that is less cyclical, and less capital and labor intensive. The question in regard to the characteristics of profits and profit margins is whether this shift is permanent or if it will also mean revert. Globally, wages of unskilled labor will continue to be set at the margin by the low-cost producer, placing a significant drag on wages for all competing labor at that level. So, profit margins should remain mean reverting and the adjustment to the mean to estimate equity returns is necessary.

Given the likely reversion to the mean in profit margins and a global backdrop of financial repression and debt deleveraging, what chance do equity investors have? What equity risk premium and therefore, what P/E ratio, would be typical in periods of zero interest rates (ZIRP) and financial repression? Clearly, if the Fed's QE and deficit spending from the federal government are artificially boosting the economy, we should not expect P/E ratios to be above the average level. Historically, the equity risk premium (return on equity investing above the risk-free rate) was generally above average from 1946 to 1980, a period of financial repression (Figure 14). Don't count on P/E expansion to add much to the return on equity investing as P/Es are already close to the long-term average.

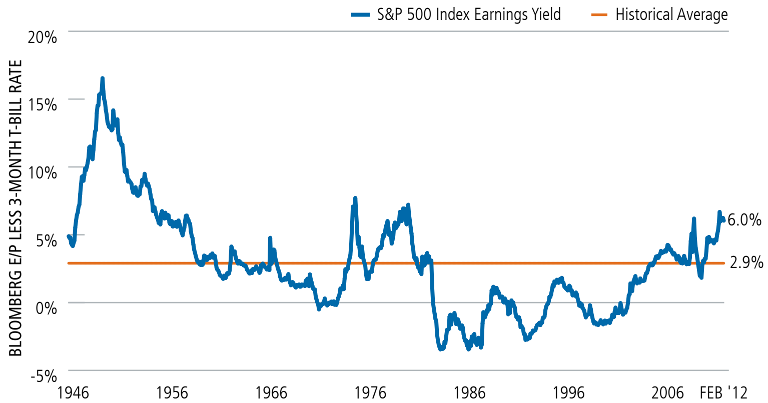
But, as we discussed in "All Clear on the Many Glacier Trail?", equities have proven to be a much better investment than bonds during debt deleveraging cycles and financial repression periods, once the debt reduction becomes clear and is well underway. Figure 15 indicates that during periods of financial repression and debt deleveraging (1945–1980, in most cases), equity markets have on average outperformed 61.7% and 68.4% of all the rolling one- and two-year periods. For five- and 10-year rolling periods, the odds improve to 76.7% and 88.7% of the time. For the younger readers, equity outperformed debt nearly 100% of the time for the 20- and 30-year holding periods during financial repression.

In fact, once a new equity bull market starts, bond yields and equity prices demonstrate a positive correlation for a sustained period as interest rates normalize (go up) when the training wheels come off the economy and growth is considered more sustainable. Of course, the other possibility is that interest rates are going up because of high inflation, creating a 1970s environment. In that situation, bond yields and stock prices will not have a positive correlation as stock prices decline while bond yields rise (cash and hard assets outperform).

We have been calling for the end of the great bull market in government debt for more than a year and still believe we are in the last stages of that bull market. Going forward, we expect stocks to be a better wealth building alternative

FIGURE 14. S&P 500 INDEX EARNINGS YIELD (S&P 500 INDEX E/P LESS TREASURY BILL RATE)

JANUARY 31, 1946 – FEBRUARY 29, 2012 (5-YEAR ROLLING AVERAGE)



Source: Bloomberg and Federal Reserve Bank of St. Louis. E/P prior to 1954 from Robert J. Shiller. Earnings yield is earnings divided by price, less the three-month T-bill rate.

and government bonds to not provide a positive return after taxes and inflation. But equity returns will not approach the bull market returns of the 1980s and 1990s in the developed world for the reasons discussed above. We would expect a scenario in which earnings grow in line with the long-term (post-1960) average, with stocks offering a 7% to 9% annualized return over the next five or so years, reflecting minimal P/E expansion (as P/E levels are near the long-term average). If the scenario includes a mean reversion in profit margins, EPS growth in line with the long-term average, and a P/E at the long-term average, then the actual annualized returns would be closer to 5% to 7%. Although hardly the annual returns that we would have anticipated coming out of a major bear market, they are still much better than what we believe bonds will offer.

We have been asked about the likelihood that the EPS growth rate for U.S. companies will be as high as the long-term average, due to the impact of the debt overhang, a weaker consumer, and lower-than-average GDP. In a closed society, those factors would cause us to reduce our expectations for the EPS growth rate. However, the emerging world is

FIGURE 15. PERCENTAGE OF TIME STOCKS OUTPERFORM BONDS OVER VARIOUS HOLDING PERIODS

COUNTRY	SAMPLE PERIOD	STOCKS OUTPERFORM CIR HOLDING PERIODS (IN YEARS)						STOCKS OUTPERFORM HPR HOLDING PERIODS (IN YEARS)					
		1	2	5	10	20	30	1	2	5	10	20	30
Austraila	1945-1980	64	71	75	96	100	100						
Belgium[1]	1945-1974	58	60	66	89	100	100	53	51	63	59	65	100
France[2]	1945-1980	56	66	72	78	94	100						
India	1949-1980	66	68	79	83	100	100	66	71	82	87	100	100
Italy	1946-1980	64	63	59	67	82	100	64	63	59	67	76	100
Japan	1946-2008	61	77	94	100	100	100						
South Africa[3]	1949-1980	62	65	88	100	100							
Sweden	1945-1990	58	63	78	89	100	100	64	66	78	89	100	100
UK	1945-1980	61	77	78	100	100	100	53	77	75	100	100	100
US	1945-1980	67	74	78	85	100	100	69	74	78	81	100	100
Average		**61.7**	**68.4**	**76.7**	**88.7**	**97.6**	**100**						

Source: "Debt and Inflation during a Period of Financial Repression," M. Belén Sbrancia, December 5, 2011.

Notes: The geometric return for different holding periods was used. CIR stands for contractual interest rate. HPR stands for holding period return. CIR is the fixed rate for a bond. HPR is the total return on an asset over the holding period and includes capital gains and losses.

[1] Missing data for 1964-1968. [2] Missing data for 1953-1958 and 1960-1963. [3] Total return data for the stock market

becoming larger and more significant, and offers global companies the opportunity to reach a larger consumer base that is growing wealthier. Our valuation model, which normalizes capital costs and profit margins, shows that growth is still at a discount around the world.

Stock investors are willing to pay far less for future free cash flow growth (percent of the median stock value based on future economically profitable growth) than they have on average since 1994. In fact, all major global markets have a median valuation that is one standard deviation below their long-term averages (from 1994-2010), which indicates to us better-than-average return prospects (see Figure 16). But the backdrop of likely higher rates and debt deleveraging may hold off the valuation premium in the foreseeable future. The P/E ratios of the 1950s may be a better guide, because the world was dealing with a similar situation as a result of the debt buildup associated with WWII. So, a degree of caution is logically priced into equity valuations and that caution manifests itself in paying less for future "free cash flow" growth.

Our Song Remains the Same

Our investment and global theses have remained the same since the early stages of the crisis in 2008 and 2009. The Fed will do anything to avoid debt deflation cycle from taking hold. This means printing money, repurchasing debt and holding government rates below inflation and GDP growth. Below, we summarize our key views, and the implications and opportunities we have seen—and continue to see.

(1) Inflation in oil prices for U.S. consumers and for imported goods occurs alongside dollar devaluation.

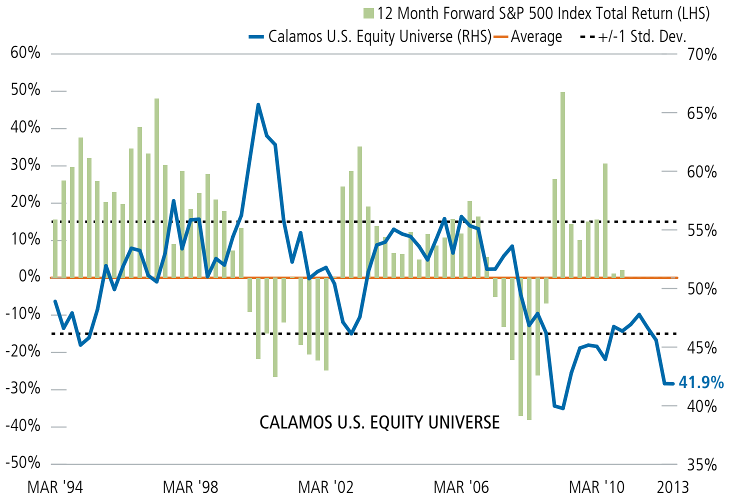
(2) Inflation is exported to emerging markets that are tied to the U.S. dollar or Chinese yuan.

(3) Consumer debt will act as a drag on GDP growth until net worth and/or income levels to debt normalize and improve.

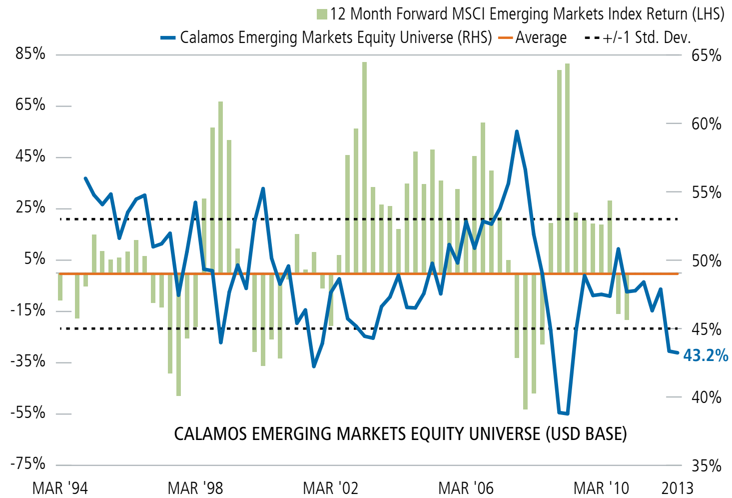
(4) China will be pressured to revalue currency and become more consumer-consumption focused while depending less on exports. The U.S. will become more investment- and export-driven and less consumer-consumption dependent.

FIGURE 16. MEDIAN % OF MARKET VALUE BASED ON FUTURE CASH FLOWS (FCF)

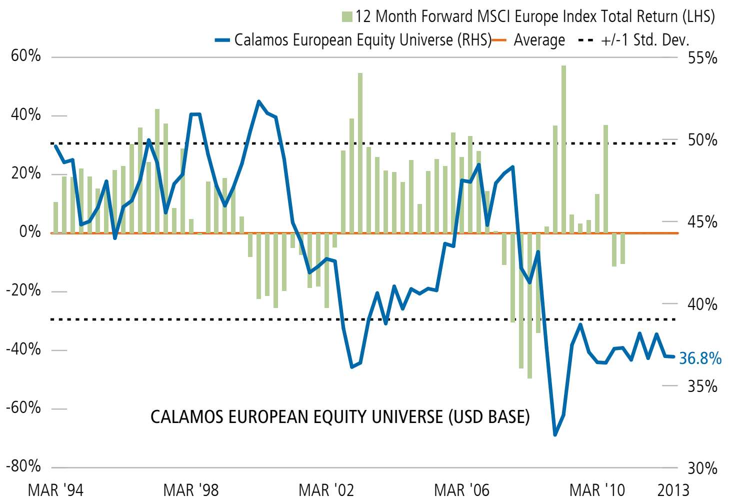
CALAMOS U.S. EQUITY UNIVERSE REPRESENTATION
QUARTERLY FROM 3/31/94 TO 12/31/11 (THEN ESTIMATED 2012 AND 2013 RESULTS)



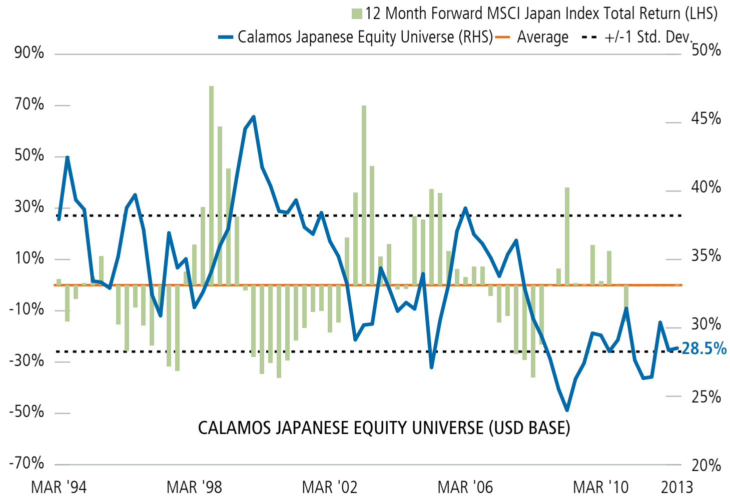
CALAMOS EMERGING MARKETS EQUITY UNIVERSE REPRESENTATION
QUARTERLY FROM 3/31/94 TO 12/31/11 (THEN ESTIMATED 2012 AND 2013 RESULTS)



CALAMOS EUROPEAN EQUITY UNIVERSE REPRESENTATION
QUARTERLY FROM 3/31/94 TO 12/31/11 (THEN ESTIMATED 2012 AND 2013 RESULTS)



CALAMOS JAPANESE EQUITY UNIVERSE REPRESENTATION
QUARTERLY FROM 3/31/94 TO 12/31/11 (THEN ESTIMATED 2012 AND 2013 RESULTS)



Source: Calamos Advisors LLC, Model Station and the Federal Reserve Bank of St. Louis. 12-Month Forward Return is the total return of the index from the end of the quarter looking out 12 months The return plotted therefore is lagging by 12 months. Future cash flows are an estimate of potential cash flows a company may generate in the future. The MSCI Emerging Market Index is considered generally representative of the performance of emerging market equities. The MSCI Europe Index is considered generally representative of the performance of European equities. The MSCI Japan Index is considered generally representative of the performance of Japanese equities.

(5) Business productivity will be an even more important competitive advantage globally, favoring information technology and information technology consulting services.

(6) Banks and financial companies will become more like utilities with low capital returns and low growth due to increased capital requirements (lower leverage) and regulatory constraints, along with new penalty fees and political pressures that will limit ROA as compared to the past 30 years.

(7) Emerging markets with better fiscal positions, monetary flexibility, easier productivity growth and better demographics offer better wealth creation opportunities.

(8) Global businesses with global access to capital, global distribution networks, global marketing and production will command premium business valuations.

(9) Global savings, spending, debt and consumption imbalances will work out via currency wars and/or growth in real GDP. Convergence in global wealth will accelerate.
(10) The great bond bull market is coming to an end.

Conclusion

"Risk on" is in favor and global markets have responded to QE and the liquidity surge, but we think it makes sense to be cautious about the sustainability of the current expansion. We are maintaining healthy skepticism. As we noted, we believe that a secular bull market requires a few more years of debt reduction, normalization of rates or at least the likelihood of normal rates, fiscal solutions to developed world deficit spending and the creation of a pro-growth, pro-business environment.

Of course, every country can take many paths in response to the debt crisis. Our job is not to predict perfectly what each will do, but to adjust to the path that is likely as policies and economic forces change. We are still in a world of debt deleveraging and that means wealth creation is slowed. All debt is paid back with someone's equity and that means someone (anyone working, saving or with wealth) will continue to have a strong negative pull on their growth in net-worth on a real basis while inflation, taxes and defaults get their share of the pie.

We are slightly de-risking Calamos portfolios into current market strength but remain convinced that equity investing will offer the best five-year returns against most asset classes. The developed world's fiscal and financial situation can be reversed and a new bull market will occur again. Even though we've seen a return to "risk on," many market participants are overlooking global growth opportunities. As a result, government debt and low-risk assets are overpriced, while higher-risk assets offer better risk/return characteristics, or at least a much better chance of generating a return compared to the alternatives.

When investing feels easy and comfortable, there's the least amount of money to be made as prices reflect the excitement. Today, investing in risk assets is uncomfortable and at times downright jarring, but, generally, better return prospects exist when investors are uncomfortable. Despite the challenges in the global economy, we continue to find some incredible global companies and believe many opportunities lie ahead.

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