Global Economic Review and Outlook

CALAMOS®

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Up, Up and Away?

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In this Commentary:

The Calamos Investment Committee continues to have a cautiously optimistic global outlook.

We expect the U.S. and emerging markets to lead the recovery; euro zone GDP growth remains our major concern.

Equities, particularly U.S. growth equities, are compelling by many measures.

Although we are constructive on the markets and economy, investors should be prepared for volatility, including a correction off recent market highs.

Long-term perspective remains essential. History shows that secular bull markets don't announce themselves.

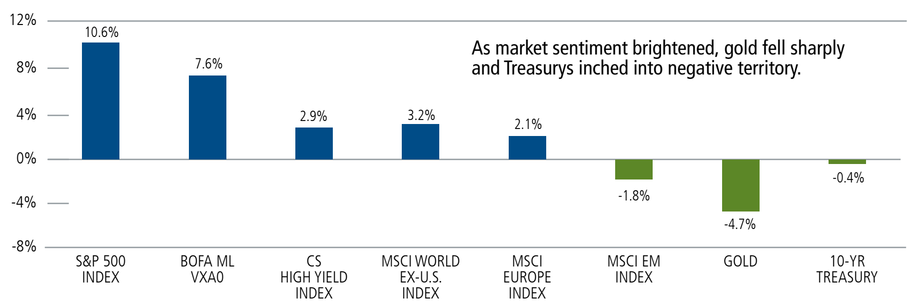
Market Review

Against the backdrop of accommodative monetary policy, the global economy continued its recovery, although at a decidedly uneven pace. Equity markets advanced on the whole (Figure 1). Once again, the news was most encouraging in the United States. Fourth quarter U.S. corporate earnings came in strong, with more than two-thirds of firms beating expectations. Sequestration worries contributed to volatility, particularly in the early portion of the quarter, but passage of a new continuing resolution prevented a shutdown in Washington. Both the Dow and the S&P 500 Index reached new heights, surpassing levels not seen since October 2007.

Despite the strong appetite for U.S. stocks, it was the more defensive sectors of the market that led (Figure 2). Within the S&P 500 Index, stocks in the lowest beta quintile outperformed those in the highest beta quintile, 9.9% versus 13.5%.[1] Paradoxically, lower quality names (those with lower ROIC and poorer balance sheets) outperformed as well.[2] Technology continued to underperform, with particular weakness in Internet software names.

FIGURE 1. U.S. EQUITIES LEAD, EUROPE AND EMs STALL

ASSET CLASS PERFORMANCE, 1Q 2013

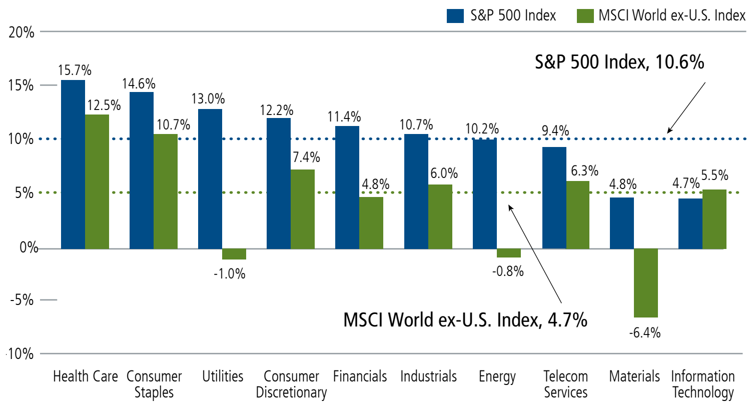


Past performance is no guarantee of future results. Source: Bloomberg.

[1]Source: BofA Merrill Lynch. [2]Source: BofA Merrill Lynch, based on S&P quality ranking.

FIGURE 2. DEFENSIVE SECTORS LEAD, WITH BROADER GAINS IN U.S. EQUITIES

1Q 2013



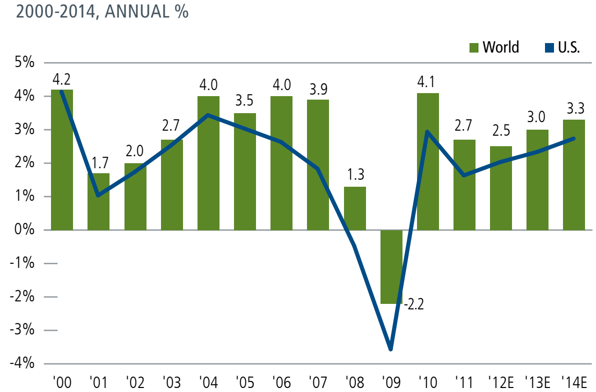
Past performance is no guarantee of future results. Source: Cap IQ.

The euro zone started the year on a relatively bright note. A proposed tax on trades in stocks, bonds and derivatives unsettled the markets in January, but investors seemed more constructive on the prospects of the EU on the whole. Yields on Spanish and Italian government bonds decreased notably and there was brisk convertible issuance. Germany showed signs of recovery, including improved company expectations for output and exports and a seemingly stable labor market.

However, positive sentiment gave way to anxiety as the quarter progressed, leading to far more muted returns in European equities for the quarter overall. A deadlocked election in Italy rekindled apprehension about bailouts and austerity, and the Cypriot financial crisis had market participants thinking about black swans. Contagion from Cyprus was averted, though not adroitly, and raised questions about how the EU might handle similar situations on a larger scale in the future.

FIGURE 3. GLOBAL AND U.S. GDP GROWTH

2000-2014, ANNUAL %



Source: World Bank, 2012-2014 World Bank estimates.

Emerging market (EM) stocks fared worse, slinking into negative territory amid concerns that monetary policies could tighten in China, with other countries following suit. Although many economic indicators point to measured recovery, pockets of inflation do exist across emerging markets. Additionally, while China looks to be on track for a stable recovery, the trajectory of economic data coming out of Russia, Brazil and India has been less reassuring.

Global Outlook: Cautiously Optimistic

Our global outlook remains cautiously optimistic. We expect the global economic recovery to continue at a measured pace (Figure 3), led by the U.S. and the emerging markets. Companies are prudently returning excess capital to shareholders rather than spending it on ill-conceived acquisitions. Our greatest concerns relate to euro zone GDP and a potential slowdown in earnings growth, globally.

As we will discuss at greater length, we believe that equities, especially U.S. growth equities, are attractively valued by a number of measures. Still, we expect financial market volatility will persist on the back of myriad global political uncertainties—those we are aware of already (sequestration, and austerity tensions in the euro zone) and those that will inevitably emerge (because something always does). The market's reception of March's disappointing U.S. job data highlights investors' jitters. **The equity markets may correct as markets bounce off their new highs,** but timing when to get in or out is always difficult. Investors need to look through the near-term volatility and stay positioned for the long term.

Think Long Term: Lessons from 1982

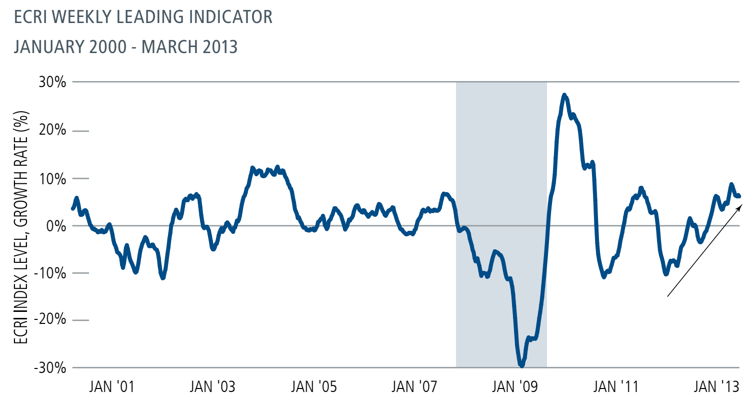
Given our expectation that the markets may correct near term, what are the implications for investors? Without uncertainties, there would not be opportunities. As we have noted in the past, bull markets do not announce themselves. The key is to look through the short-term noise and maintain focus on the big picture. In 1982, there were many factors keeping investors on the sidelines—unemployment of more than 16%, soaring oil prices on the back of the Iranian Hostage crisis, skyrocketing interest rates, near-20% mortgage rates and plummeting home sales. In short, if things feel bad today, they were awful then. But it was also the eve of the greatest secular bull market in American history. Those who waited till everything felt good again missed the upside.

U.S. Poised for Continued Recovery

The U.S. looks positioned to maintain its slow but steady growth trajectory. Thanks to an upward revision in fourth quarter GDP growth, the U.S. has tallied 14 consecutive quarters of economic expansion, and the ECRI Index continues to move in the right direction (Figure 4). Many of the dislocations resulting from the 2008 financial crisis have abated. The recovery in housing has broadened. Home values and housing starts are on the rise (Figure 5), inventories have plummeted and the economics of buying versus renting favor ownership. Loan growth has resumed and delinquent loans have fallen. Mortgages aren't being handed out, but they are becoming easier to secure.

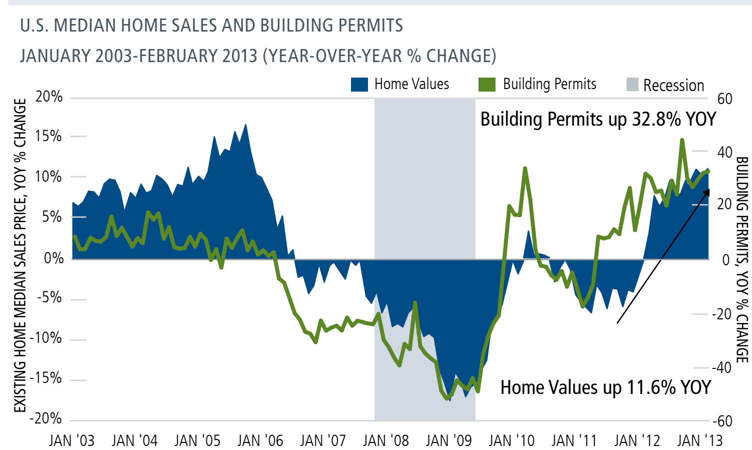
Consumer sentiment measures have bounced around, but the data is encouraging in aggregate. Consumer balance sheets are strengthening, as measured by a steep decline in debt as a percentage of disposable income, for example. A recovering housing market, rising equity market and increased access to low

FIGURE 4. U.S. LEADING ECONOMIC INDICATORS MOVING IN RIGHT DIRECTION



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

FIGURE 5. U.S. HOME VALUES AND BUILDING PERMITS RISING



Source: Bloomberg.

borrowing rates have contributed to a wealth effect that has carried through to better retail and auto sales.

But lest we get ahead of ourselves, there are potential headwinds to the U.S. recovery. GDP growth is estimated at 2% to 2.5% for 2013, but this annual expansion is likely front-ended. The impacts of sequestration have been relatively mild so far but could potentially deepen and lead to markedly lower GDP for the year. We are also watching corporate profit growth closely. Market participants are too, as evidenced by recent echoes of last year's "April Swoon." On the employment front, it's a few steps forward and a few steps back, underscored by March's steep hiring slowdown.

Japan: Turning a Corner?

Aggressive steps have been taken to reverse decades of deflation and economic stagnation (Figure 6). The Bank of Japan's unprecedented plan to double money in circulation in just two years represents a monthly balance expansion of 1% of GDP. Meanwhile, the government announced an inflation target of 2% for 2013. If these liquidity injections can't restart the economy, then we are hard pressed to see what could. We have seen already better factory output, consumer confidence and business sentiment. However, at this point, we believe that the market has priced in much of the effects of accommodative policy, so we are not rushing in headlong.

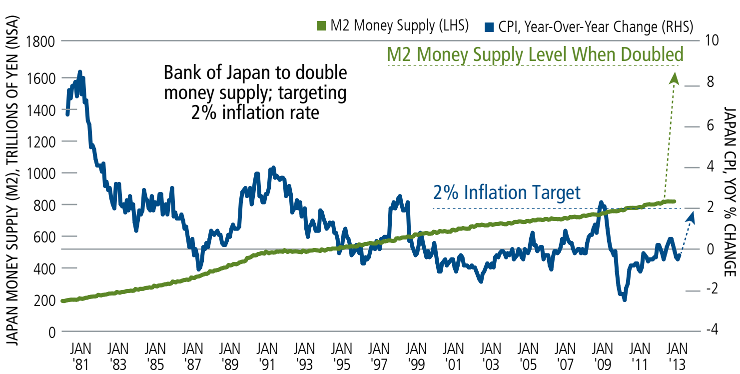
Euro Zone: The Fly in the Ointment

Euro zone unemployment is wretchedly high and still rising, and PMI data is bleak (Figure 7). Significantly, Germany has reversed its upward trajectory. The perseverance shown by euro zone members to remain united has reduced the tail risk of break up, but even so, we believe the gap between the haves and have-nots is too wide. We only hope it can be bridged by improvements in the weaker economies rather than by a continued worsening of conditions in the relatively healthier ones. Years in, it's still uncertain if austerity is the best medicine for the patient.

Italy's ill-fated election, as well as Cyprus' woes and the EU's missteps in addressing them, underscore the complexities of the bailout-austerity cycle. Contagion coming out of Cyprus was avoided, but taxing deposits (at any level) leaves a bad taste that won't soon be forgotten by global investors. In a sense, the Cypriot tax on deposits can be seen as a reverse convertible. A convertible security typically pays interest to the bond holder, with the option to convert to the stock of the company if the equity rises. In Cyprus, depositors have provided money to the banks and received some

FIGURE 6. JAPAN TAKES A NEW TACT

JAPAN M2 MONEY SUPPLY AND CONSUMER PRICE INDEX (CPI)
JANUARY 1980-MARCH 2013



Source: Federal Reserve Bank of St. Louis.

M2 is a measure of money in circulation, including all physical money and checking accounts, savings deposits, time-related deposits and non-institutional money market fund balances. CPI is a measure of inflation.

interest, but the stock conversion they've been forced into reflects the erosion of wealth.

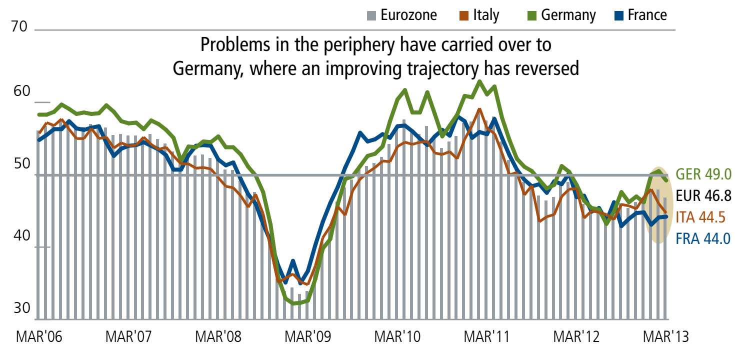
The biggest hangover from Cyprus is the reminder that unpredictable events are, well, impossible to predict. It may seem as if there is always another shoe to drop in the euro zone. We should expect more bumps in the road, given the complexity of the euro zone landscape. But change is always part of every investment landscape. In times like these, it is easy to forget that economies can also evolve rapidly to the positive, as we have seen in Chile and other emerging areas worldwide.

As in Chile, the EU's success will require a paradigm shift, with a greater focus on free markets. Instead of a market economy, banks and governments have been the primary source for capital and liquidity. But we believe that growth of the private sector and policies that support economic freedoms are what will pave the way for growth. Capital goes where it is treated best. Taxing bank deposits and the proposed financial trading tax create headwinds to investments and reduce confidence in capital markets, even if the scope is limited.

Human capital also goes to where it is treated best, and this may be the lynchpin for the success for the countries like Cyprus, where a very large percent of the younger population is highly educated. Countries like Cyprus, Greece, Spain and Italy can greatly improve their economic prospects by harnessing the considerable talents of their younger workers, rather than seeing them leave.

FIGURE 7. EUROPE PMI DATA DISCOURAGING

MANUFACTURING PMI LEVELS,
MARCH 2006 - MARCH 2013



Source: Bloomberg. PMIs below 50 are generally indicative of contraction.

EMs: Still a Source of Global Growth

As we noted, emerging market equities faltered during the first quarter, as concerns grew surrounding the potential for a shift away from more accommodative monetary policies and EMs, potential vulnerability to events in Europe. Of course, tighter policy could create headwinds for economic growth but, at this point, we believe that the emerging market economies are in good shape on the whole and can continue to contribute to global expansion. Inflation remains a concern in some emerging economies, particularly given its relationship to social unrest. Overall, the constructive long-term investment thesis is intact. The stronger balance sheets that many EMs still possess provide flexibility in managing policy, and secular consumer trends provide powerful tailwinds for growth.

Economic growth targets remain competitive relative to developed markets, but countries will likely have varying success in reaching them. China looks relatively well positioned to achieve its growth objectives. Data suggests a broad-based recovery is underway. In particular, construction has benefited as massive government infrastructure projects continue. Business confidence has also been on the upswing, and manufacturing PMI data indicates expansion, albeit mild (Figure 8). Inflation in China has remained largely contained as input prices have declined.

Meanwhile, India has put forth a growth projection above 6% for its 2013-2014 fiscal year, but relatively higher inflation pressures—including food inflation—create some added hurdles for growth as well as for economic reform issues. Brazil is edging close to its target for inflation, and has seen slowing industrial production.

Turning Off the QE3 Spigot

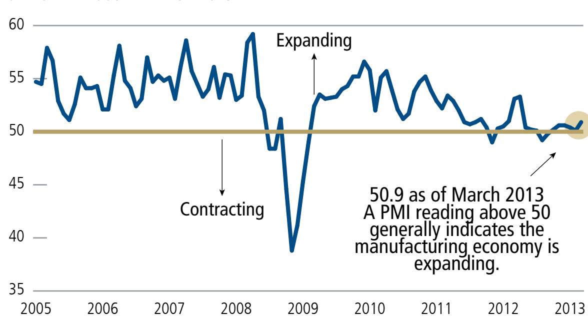
The Federal Reserve is pumping $85 billion a month into the economy via QE3. With an employment peg in place, there's little reason to believe the party will continue indefinitely. But it is too soon to know when and how the punch bowl will be taken off the table. Fed Chairman Bernanke's comments before the Senate Banking Committee support the expectation that the party (such as it is) will continue for a while. Despite improvements, the 7.6% unemployment rate in February is still a good ways above the Fed's 6.5% threshold range (Figure 9). The March employment report showing just 88,000 new jobs created—versus a forecast of 200,000—was the worst since last June.

Some have voiced concerns about what may happen when the Federal Reserve dials back its massive liquidity injections. The good news is that the Fed is likely more concerned than anyone and should undertake the process slowly and deliberately. The central bank has room to navigate, and the headline unemployment rate will be one of many measures that it considers.

Ultimately, we believe the return to a more typical policy, and therefore lending environment, will be a positive for the economy and equity markets. Large companies, large global financial institutions and capital markets have benefited from QE3 and artificially low borrowing costs, but low absolute yields provide banks little incentive to lend to small businesses, especially as the U.S. recovery has been atypical. Figure 10 tracks the Small Business Credit Condition Index, which indicates that loans are still difficult to obtain, despite growth in commerical and industrial loans. And historically, small businesses have been the engine of job creation.

FIGURE 8. MEASURED RECOVERY IN CHINA

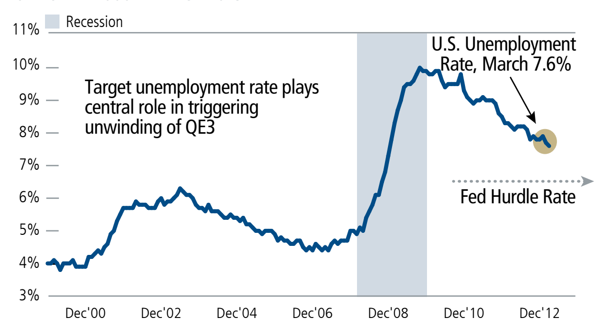
CHINA MANUFACTURING PMI
JANUARY 2005 - MARCH 2013



Source: Bloomberg.

FIGURE 9. WHEN WILL THE QE3 SPIGOT SHUT OFF?

U.S. UNEMPLOYMENT RATE
JANUARY 2000 - MARCH 2013



Source: Bureau of Labor Statistics.

Stocks Look Cheap

Although we would not be surprised to see the equity markets give back some ground, we are bullish on equities over the next 12 to 18 months, given improving global GDP growth, still-strong corporate profit growth, and accommodative monetary policy globally. Equity valuations remain compelling by a number of measures. Equity valuations are in the lowest 20% over the past 60 years (as measured by earnings yield less inflation), but margins and cash flow ROICs are near historic highs. The dividend yield on the S&P 500 is now well above the yield on the 10-year Treasury which, other than during the 2008 financial crisis, hasn't happened since the late 1950s.

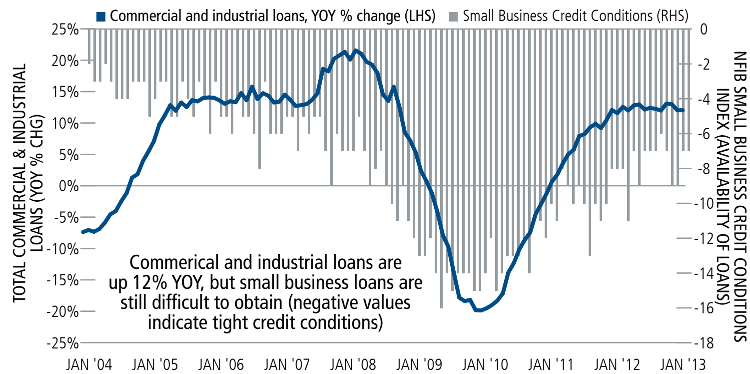
Growth equities look particularly attractive. Figure 11 shows free-cash flow yields versus 10-year Treasury yields. Again, we see levels more attractive than those over most of the past 60 years. On a P/E valuation basis, growth equities relative to the S&P 500 Index are well below average (Figure 12).

On a sector level, many technology stocks remain especially undervalued, in our view. After a run-up in the first half of 2012, we've seen the sector give some back, but the fundamentals still look attractive from both top-down and bottom-up perspectives. Sector weakness in the first quarter was attributable largely to Internet software companies, but these companies are also positioned to capitalize on many secular growth themes, including productivity enhancement.

In our view, while investors are not paying for growth, they are by and large (over) paying for yield. This will likely change as the Fed reduces its $85 billion monthly

FIGURE 10. SMALL BUSINESSES INDICATE DIFFICULTY IN OBTAINING LOANS

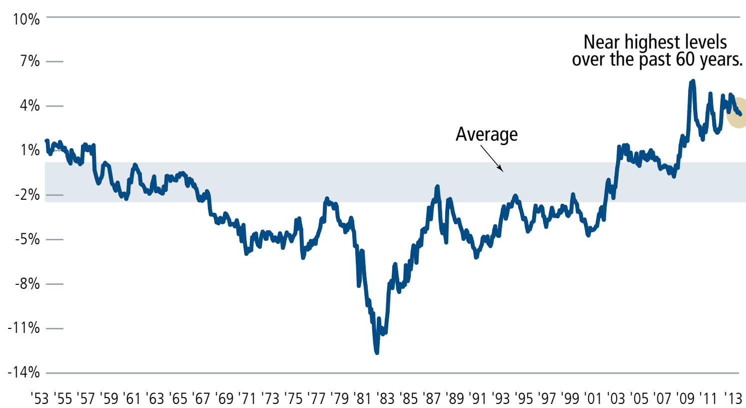
JANUARY 2004 - MARCH 2013



Source: Federal Reserve and Bloomberg.

FIGURE 11. ATTRACTIVE VALUATIONS FOR GROWTH EQUITIES

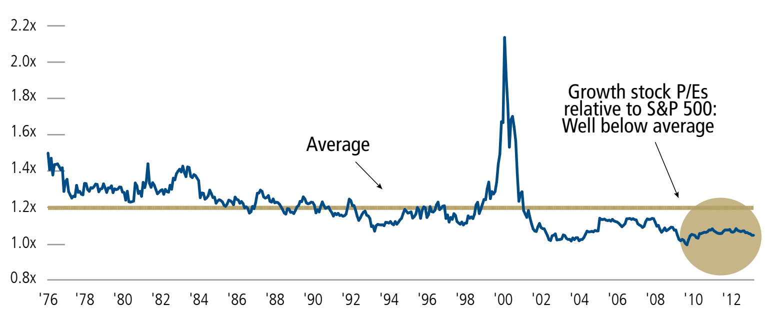
LARGE-CAPITALIZATION GROWTH STOCKS, SPREAD BETWEEN FREE CASH FLOW YIELDS AND 10-YEAR TREASURY YIELDS
1952 THROUGH EARLY MARCH 2013



Sources: Standard & Poor's, Corporate Reports, Federal Reserve Board, Empirical Research Partners Analysis.

FIGURE 12. ATTRACTIVE VALUATIONS FOR LARGE-CAP GROWTH EQUITIES

LARGE-CAPITALIZATION GROWTH STOCKS, RELATIVE FORWARD-P/E RATIOS
1976 THROUGH LATE MARCH 2013



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

commitment via QE3 and long-term rates begin to rise. We would not be surprised if long-term risk-free rates move modestly upward over the next year.

The Opportunity of Convertibles

As we discussed in our previous commentary as well as in our recent whitepaper ("The Case for Strategic Convertible Allocations, An Analysis of Global Convertible Market Opportunities"), economic growth supports convertible issuance, and we have seen this relationship affirmed over recent months, globally. Year-to-date issuance is off to a strong start at $20.7 billion through March, marking the most brisk start since 2008. Additionally, a recovering global economy provides a favorable environment for a widening pool of convertibles, including undercapitalized segments of the market, such as mid caps, financials and some areas of consumer discretionary.

We believe that a choppy but upwardly moving equity market can provide a particularly compelling environment for convertible securities, as the convertible's embedded option will allow for upward participation. Within a lower-volatility equity allocation, convertibles can therefore provide equity participation with potentially less downside, should markets correct (as the bond value provides a potential floor). Additionally, convertible yields remain very competitive relative to traditional fixed income investments. Although coupon rates of convertibles may be lower than in the past, this reflects a global low interest rate environment—the impact of which has been felt across the fixed income market as a whole.

Conclusion

We are encouraged by the continuing strength in the global economy—particularly in light of where we've been. We expect that choppiness will continue, both in the pace of recovery as well as within the markets. Of course, a straight-line and rapid recovery might feel a little nicer, but the dislocations are what create the opportunities for long-term investors. And we continue to see many good growth opportunities for active investors in a number of asset classes.

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