

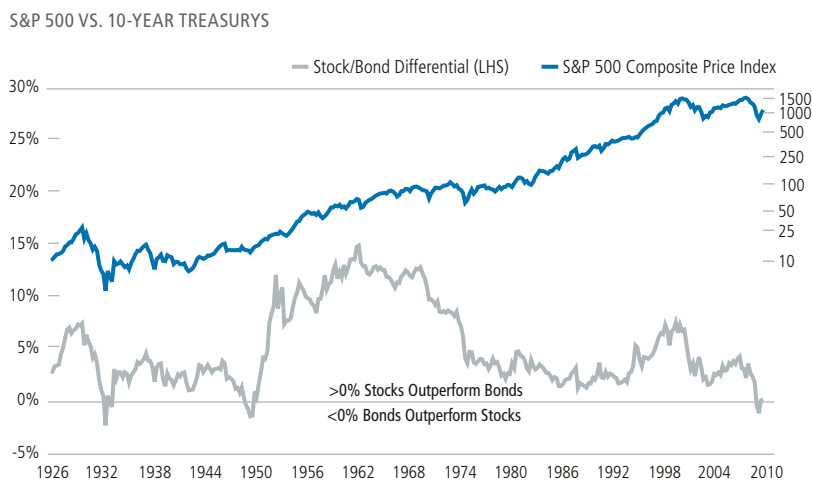
Tailwinds for Equity, Headwinds for Debt

By the Calamos Research Team

We caution against increasing debt holdings at the expense of equity allocations.

Long duration U.S. Treasuries witnessed strong performance this past decade, providing an annualized return of 7.59%, as measured by the Citigroup Treasury 10+ Years Index. During the same period, equities struggled, returning -0.95%, annualized, as measured by the S&P 500 Index. For many investors, wary of equities' lagging performance and higher volatility amid the current economic unease, increasing allocations to fixed income appears an attractive option. While fixed income is an essential part of any well diversified plan, we caution investors against letting uncertainty drive an increase of debt holdings at the expense of equity allocations. It is important to consider the long-term relationship between equities and fixed income, as well as to evaluate how the current fundamentals, such as the future direction of inflation and the growth in earnings per share, will affect these asset classes. In our opinion, we are entering an environment that will favor equities over debt.

**FIGURE 1. STOCK/BOND PERFORMANCE DIFFERENTIAL
20-YEAR TRAILING TOTAL RETURN (ANNUAL COMPOUND RATE)**



Source: The Leuthold Group

A look back

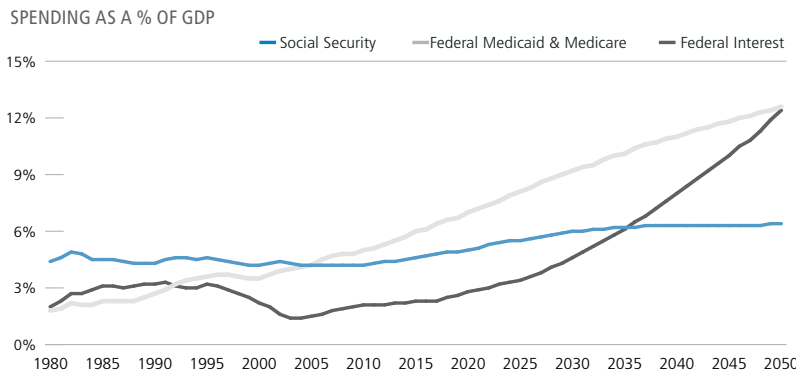
Figure 1 looks at the rolling 20-year return differential between equities and 10-year Treasury notes. When the bottom line crosses the 0% mark, the 10-year U.S. notes are outperforming the S&P 500 for the 20-year period. We saw this occur during 2009. The outperformance of Treasuries over such a long time period is notable in large part due to its rarity. This was only the third time in the past 80 years when the trailing 20-year return on 10-year U.S. notes had outpaced equities. It was the first time such a performance disparity had occurred in the past 60 years. But while noteworthy, on the few occasions when equities have lagged government bonds, the period of underperformance was brief and, more importantly, led to extended periods of equity outperformance.

FIGURE 2. MEDIAN RETURNS (ANNUALIZED) FOLLOWING EQUITY/ BOND UNDERPERFORMANCE AND OUTPERFORMANCE

	3-YEAR		5-YEAR		10-YEAR	
	S&P 500	10-YEAR TREASURYS	S&P 500	10-YEAR TREASURYS	S&P 500	10-YEAR TREASURYS
Negative Stock/Bond Differential	27.4%	1.0%	21.4%	1.7%	19.8%	1.3%
Positive Stock/Bond Differential	10.9%	3.8%	10.6%	4.2%	10.9%	3.8%

Negative Stock/Bond Differential refers to periods when the S&P 500 Index underperformed the 10-year U.S. Treasury for a 20-year period. Positive Stock/Bond Differential refers to periods when the S&P 500 outperformed the Treasury for preceding 20-year period. Returns shown are the median return for the 3-, 5- and 10-year period following the under/outperformance. Source: Leuthold Group

FIGURE 3. U.S. GOVERNMENT LIABILITIES LONG-TERM TREND



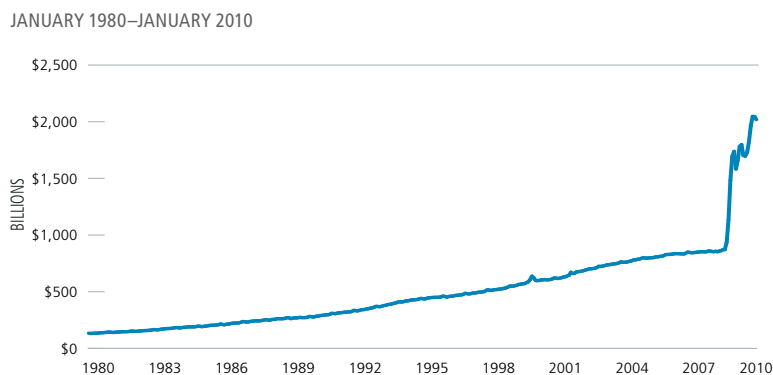
Source: Congressional Budget Office. Data for periods through 2005 is actual. Data for later periods is CBO estimates based on assumption of intermediate spending and lower revenues.

FIGURE 4. U.S. FEDERAL REVENUE AND EXPENSES

	2002	2003	2004	2005	2006	2007	2008	2009
Revenues	\$1,853.1	\$1,782.3	\$1,880.1	\$2,153.6	\$2,406.9	\$2,568.0	\$2,524.0	\$2,104.6
Outlays	2,010.9	2,159.9	2,292.9	2,472.0	2,655.1	2,728.7	2,982.6	3,518.2
Deficit	-157.8	-377.6	-412.7	-318.3	-248.2	-160.7	-458.6	-1,413.6

Source: Congressional Budget Office

FIGURE 5. ADJUSTED MONETARY BASE



Source: Federal Reserve Bank of St. Louis.

Figure 2 provides the median returns of the S&P 500 and of 10-year U.S. Treasuries for periods following the 20-year outperformance and underperformance of equities versus the Treasury. When equities have underperformed bonds for the 20-year period, such as we just experienced, the median S&P 500 annualized return for the following 10-year period is a remarkable 19.8%. For the same periods, the median 10-year Treasuries annualized return is 1.3%. It is also worth noting the median 10-year annualized returns for periods following long-term equity outperformance: 10.9% for equities and 3.8% for the 10-year Treasuries.

Looking ahead

The historical data paints a compelling picture for the future returns of equities over long-term U.S. government debt. More importantly, going forward we believe the current economic backdrop will provide an uphill battle for bond investors. The current high debt levels of the U.S. government and the tremendous growth in the monetary base suggest an environment of rising yields. These factors coupled with a federal funds rate near zero are ill omens for today's fixed income investor.

Figure 3 looks at the long-term trend in U.S. federal spending on liabilities. Net interest payments on government debt in 2009 were estimated at less than 2% of gross domestic product (GDP). Based on projections from the Congressional Budget Office (CBO), that number is expected to climb steadily. By 2050, CBO suggests that net interest payments could equal Medicaid/Medicare spending and far exceed Social Security payments. Based on current trends, the CBO estimates put government liabilities at nearly a third of the nation's GDP in the next 40 years. That trend is clearly not sustainable. In 2009 alone, deficit spending ballooned by nearly \$1 trillion (Figure 4). More importantly for bond investors, the cost of financing these liabilities with debt will put upward pressure on yields. As future yields rise, today's bonds, which offer rates below the long-term average, will lose value.

Another factor likely to increase yields is long-term inflationary pressure due to a doubling of the money supply (Figure 5). As Milton Friedman famously

quipped, “inflation is always and everywhere a monetary phenomenon.” The unprecedented increase of the monetary base has helped lessen the depth and breadth of the recession. Short term, this will likely continue to bolster the economy and help reflate assets such as real estate and commodities. Longer term, the effect is likely to be inflationary, which will devalue the U.S. dollar. For long-term bond holders, coupon and principal repayments of recently issued debt with low yields may see negative real returns. Whether or not we see a period of sustained, above-average inflation may be irrelevant to investors. Fear of negative real returns will likely push yields to higher levels.

For the past three decades, long-term U.S. government debt has seen strong real returns thanks to a general decline in yields. Prior to 1980, the real returns for investors were less impressive (Figure 6). The 1940s, 50s, 60s, and 70s posted negative real returns. U.S. government intermediate-term debt fared better, but for the periods with positive real returns the results were lackluster. High inflation clearly worked against investor interest during these periods. Inflation by no means aided equity returns, though with the exception of the 1970s and the past 10-year period, every decade posted positive real returns.

The stock rally is not over

Extended periods of negative equity returns are rare. Prior to this past decade, the S&P 500 Index had not posted a negative 10-year return since 1941—a return period that includes much of the Great Depression. As can be seen in Figure 7, equity performance following low-return periods was not only positive but often rose to levels far above normal returns. The recent downturn was painful, concerns remain, but a depression scenario seems highly unlikely.

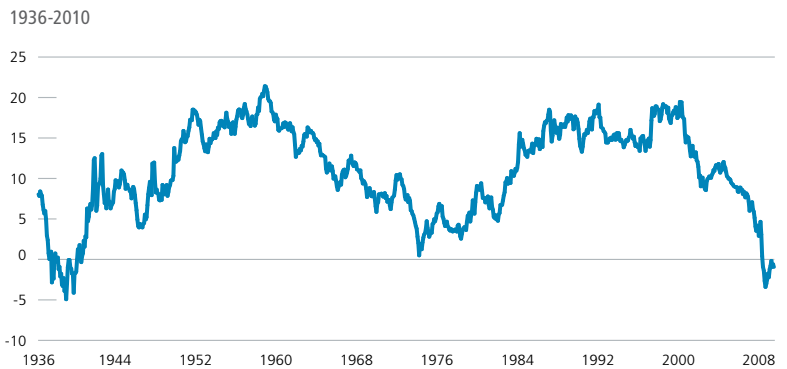
Since their lows in March, equities have enjoyed a strong rally. We believe this trend will continue in 2010, though at a more moderate pace. A look at equity returns after bear markets provides some context (Figure 8). Rallies following bear markets are normally much stronger than what we have experienced, often recouping more than the

FIGURE 6. REAL RETURNS FOR U.S. GOVERNMENT DEBT AND EQUITY

	CUMMULATIVE RETURNS							
	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s
Long-term U.S. government debt (real returns)	98.01%	-18.80%	-20.12%	-10.00%	-15.98%	99.66%	73.96%	63.52%
Intermediate-term U.S. government debt (real returns)	92.50	-29.24	-8.11	9.78	-3.56	87.54	50.23	41.81
S&P 500 Index (real returns)	22.34	41.96	371.89	65.29	-13.24	206.54	298.93	-29.16

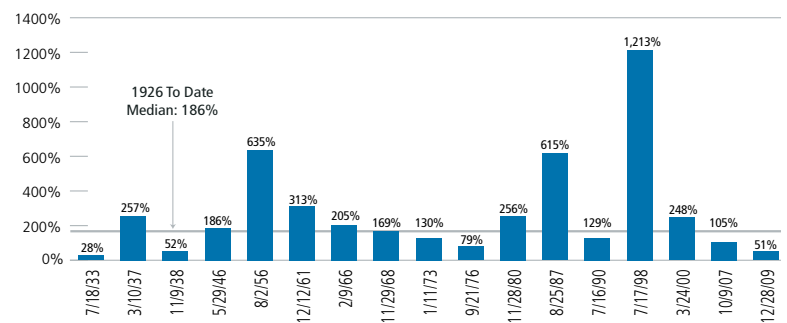
Source: Morningstar Direct. Cumulative returns. Representative indices: Long-term U.S. government debt: Ibbotson Associates (IA) SBBI U.S. Long-term Government Inflation Adjusted Total Returns Index; Intermediate-Term U.S. Government Debt: IA SBBI U.S. Intermediate-term Government Inflation Adjusted Total Returns Index; and S&P 500 Index: IA SBBI S&P 500 Inflation Adjusted Total Return Index.

FIGURE 7. TRAILING 10-YEAR PERFORMANCE OF THE S&P 500 INDEX



Source: Ibbotson Associates. S&P 500 Total Return Index (IA extended)

FIGURE 8. S&P 500: PERCENTAGE OF LOSSES RECOUPED FROM PREVIOUS BEAR MARKET



Source: The Leuthold Group

initial downturn. As of December 31, 2009, the S&P 500 had advanced nearly 70% from its lows, or about 51% of what was lost from peak to trough during the downturn. Rallies following bear markets since the Great Depression have recouped a median of 186% of their losses.

Looking forward, our equity valuation estimates remain quite attractive. Macro factors, such as the rapid increase of the monetary base—a negative for longer duration bonds—is a near-term positive for equities as it should spur economic growth. Also, governments around the world have put stimulus programs to work, which should also provide a short-term tailwind to equities. The reflation of assets is occurring globally and should continue to succeed, even if much of the developed world sees significant currency devaluation. While a difficult environment for bonds, we believe current equity valuations offer a more attractive entry point than we have seen during much of the past decade.

Past performance is no guarantee of future results. Investing involves risk, including potential loss of principal. Diversification does not insure against market loss.

The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice.

Risks associated with equities include volatility of the share price, which will vary over time, and the loss of investment, in part or in whole, due to bankruptcy. Risks associated with debt includes market risks such as price volatility, default risk (the risk that the issuer of the debt securities will be unable to repay principal and interest) and interest rate risk (the risk that the security may decrease in value if interest rates increase).

Index information

Citigroup Treasury 10+ Years Index computes returns for the 10-year on-the-run Treasury that has been in existence for the entire month. **Ibbotson Associates SBBI U.S. Long Term Government Inflation Adjusted Total Return Index** is a total return index of all public organizations of the U.S Treasury except flower bonds and foreign-targeted issues. All bonds have maturities of at least 10 years or more. The returns are weighted by market value including accrued interest. The bonds represented in this index are backed by the U.S. government, yet involve risk of principal loss if sold prior to maturity. **Ibbotson Associates SBBI U.S. Intermediate Term Government Inflation Adjusted Total Return** is a total return index of intermediate-term U.S. government debt. The returns are weighted by market value including accrued interest. The bonds represented in this index are backed by the U.S. government, yet involve risk of principal loss if sold prior to maturity. **Ibbotson Associates SBBI S&P 500 Inflation Adjusted Total Return Index** is the inflation-adjusted S&P 500 Index. The S&P 500 Index is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect any fees, expenses or sales charges. Investors cannot invest directly in an index.

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