

## Market Review and Outlook

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“We strongly believe that many investment opportunities will be available in the future—just as they were in the 1970s and even in the 1930s.”

## Some Signs of Life and Hope for a New Recovery

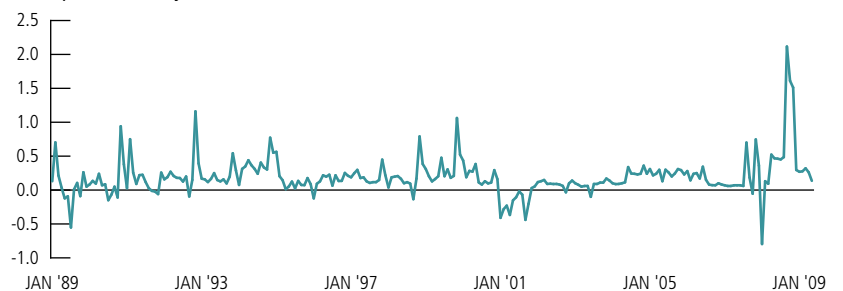
The Federal Reserve’s policy has restored a degree of confidence in the financial markets. Many key financial metrics are back to pre-Lehman levels. The frozen financial system is thawing and the short-term cash markets are back to more normal spreads. Liquidity has dramatically improved as measured by the TED and Libor spreads (Figure 1). We have seen a brisk stock market rally off of March lows, improving consumer confidence and indications of a bottom in housing. Gains in emerging markets and other higher-risk assets indicate that risk appetites are increasing.

The bleeding may have stopped in a few areas, but it is important to remember that the more recent economic and financial data is coming off of a much lower base. Recessionary influences are still very much with us. Retail sales are only positive year-over-year for the big box discounters. Although reduced to a more manageable level, credit spreads remain at recessionary levels nonetheless. The markets are less concerned about bank stability and credit, but there are still concerns about the overall credit risk of corporate America. We do not expect the number of bankruptcies in the U.S. to decline anytime soon, as the excess capacity and tight lending standards indicate further problems.

**Figure 1. Libor and TED Spreads**

The Libor and TED spreads have declined from panic levels and are close to a more normal spread.

**Libor Spread: January 1989–June 2009**



**TED Spread: January 2006–June 2009**



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**Past performance is no guarantee of future results.**

Source: Bloomberg LP. LIBOR spread measures the difference between the 1-month London Interbank Offered Rate (LIBOR) and the Federal Funds lending rate. The TED spread is the difference between the interest rates on interbank loans and short-term U.S. government debt.

## Is the Worst Over? It Better Be!

We are reading daily that the worst is over for the economy. We sure hope so—the recent collapse in global trade and global GDP is as bad as it has ever been and rivals the Great Depression. In past commentary, we have called this downturn a “re-depression”—that is, a recession significantly worse than the norm.

The equity markets are typically a leading indicator, and we believe they are not signaling a depression scenario. Nonetheless, the economy has sustained a significant shock and the recovery is going to be slow and painful. We are prepared for quarters that look and feel good, but are followed by quarters that do not. This start-stop, very low-growth or no-growth economy will present challenges for businesses and investors alike.

Yet, as long-term investors, we believe we can adapt to the challenges of today’s market, as we have done for more than 30 years. Our focus will be on valuations and Washington D.C.’s hand in the economy. (Of course, we continue to hope that this hand takes a lighter touch and that the government will extricate itself from the financial, auto, energy and health care industries as soon as possible!)

## Not Your Father’s Recession

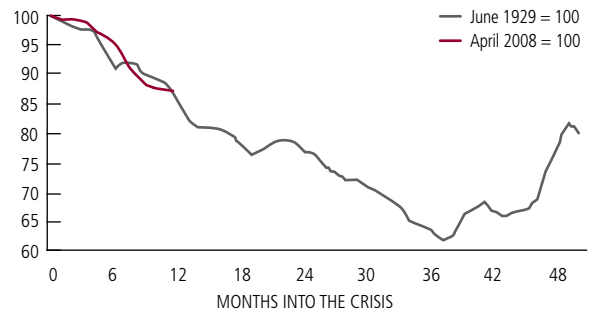
The global economic shock is not like your father’s recession, but probably closer to one your grandparents faced. The good news is that the U.S. economy has survived some devastating shocks—and with hard work, creativity and determination we have moved forward and prospered.

In the 1950s and 1960s, “normal” recessions generally occurred as a result of excess inventory build ups, which then caused businesses to slow production. Recessions in the 1980s and 1990s were typically a result of the Fed raising interest rates to cool the overheating economy (that is, taking the punch bowl away). The currency mismanagement and spending excess of the late 1960s and early 1970s led to a dollar bust and a break from the gold standard, ushering in inflation and higher interest rates and causing a deeper-than-normal recession.

The 2008-09 downturn is a different type of recession—and for most of us, it is different than what our parents had to deal with, too. The 2008-09 recession was caused by excess debt and leverage in real estate, housing, financial markets and second mortgages. Leverage and the repeal of Depression-era safety regulations allowed for bank runs and financial asset destruction. Complex hard-to-value securities plummeted, while an already weak real estate market and an overburdened consumer increased the magnitude of the downturn. The debt unwinding and financial industry implosion sent the economy into a tailspin.

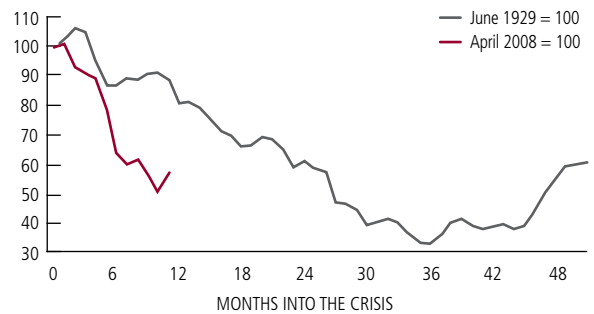
The charts to the right show the path the world economies and stock markets followed during the Depression of the 1930s. As Figure 2 indicates, world output today is tracking very closely to that period. The world stock markets have actually declined more severely in this period than they did at a similar point in

Figure 2. World Industrial Output, Now versus Then



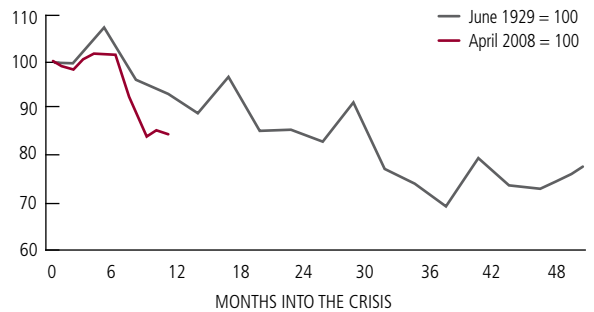
Source: Barry Eichengreen and Kevin H. O'Rourke © voxEU.org.

Figure 3. World Stock Markets, Now versus Then



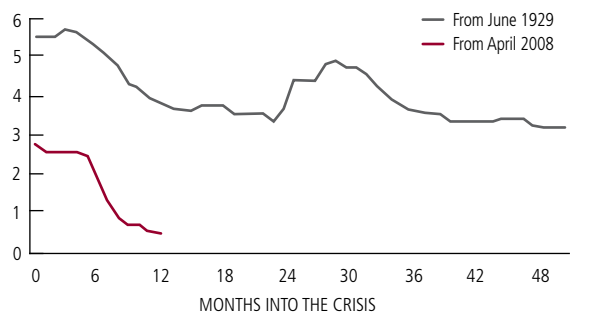
Source: Barry Eichengreen and Kevin H. O'Rourke © voxEU.org.

Figure 4. The Volume of World Trade, Now versus Then



Source: Barry Eichengreen and Kevin H. O'Rourke © voxEU.org.

Figure 5. Central Bank Discount Rates, Now versus Then (7 country average)



Source: Barry Eichengreen and Kevin H. O'Rourke © voxEU.org.

the Depression cycle. (In this case, we hope the markets are not a great leading economic indicator.) Thus far, global trade has contracted quicker than it did during the Depression era, as indicated in Figure 4.

So far, the message may sound very scary, but the future path for these indicators does not have to follow the Depression era's economic black hole. Figure 5 compares the central bank discount rate for the current period to the Depression era. The monetary response to the deflationary global collapse has been dramatically different this time around, with central banks pouring money into global economies. We are also experiencing some significant government fiscal stimulus that will also act as a buffer.

So, governments around the world have acted quicker and with more force than they did during the Depression. This global government response is an attempt at refutation and to jump start global economies, with the hope that this can reduce shocks going forward. The governmental response can lessen the severity and provide some safety nets but it will take time to move the global economy back to a normal functioning system. The government response does not correct the mistakes and excesses that occurred. These must be purged over time to allow the economy to function normally.

The trajectories of world industrial output, world equity markets and trade are not unlike those seen during the Depression. However, the central bank response has been considerably more aggressive. This action, along with fiscal stimulus, will likely keep this recession from becoming something more severe.

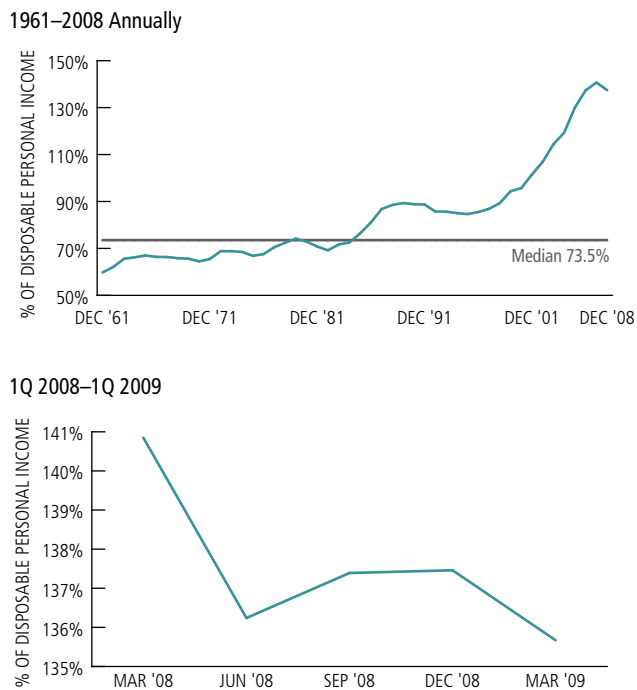
## No Pain, No Gain

Athletes understand and accept the "no pain, no gain" reality. A similar reality applies to economics at the extremes, though most are less willing to accept the implications. In our view, the refutation attempt and government policy to avoid pain and suffering will cause the corrective phase to be prolonged. We believe that while steps are being taken to correct some of the regulatory mistakes, a number of structural problems will remain. The correction of the structural issues will occur over a long time and act as a drag on the potential growth in the economy.

This is because the laws of economics and basic finance cannot be repealed. We can only delay the eventual reckoning, as consumer and business balance sheets seek a level of sustainability. The reality is that consumers cannot carry the heavy debt burden, nor can real estate and other assets appreciate at high levels indefinitely. Additionally, the U.S. cannot engage in unrestrained borrowing without higher costs resulting from either inflation or dollar devaluation. Moreover, banks and insurance companies should not mark-to-market long-term assets unless the assets are truly impaired from a cash-flow basis, and lending in a packaged vehicle (securitization) should include the lender retaining a slice of the risk.

**Figure 6. Mortgage debt to disposable income**

It will take quite some time for the mortgage debt to disposable income level to revert to more moderate levels.



Source: Federal Reserve Board (flow of Funds Report) for Mortgage Debt Outstanding; Bureau of Economic Analysis for Disposable Personal Income.

Last year, we estimated that the shocking decline in household net worth would result in the savings rate moving to 8% from near zero. The savings rate has increased to nearly 7% already, and the shift has had a predictable impact on the economy. We should expect a more conservative consumer for years to come as individuals concentrate their efforts on repairing their personal balance sheets and building savings. We can estimate how much additional savings impacts consumption and also estimate how much mortgage debt may need to be purged. Just how much mortgage debt is left to absorb is anyone's guess but as Figure 6 indicates, a move to a more normal level of mortgage debt to disposable income corresponds to a huge dollar value. Mortgage debt as a percent of disposable income could fall from 140% to 90%.

If we could choose one chart to tell the story of the current crisis, it would be an illustration of monetary base velocity growth (Figure 7). We have written many times about the velocity of money, and it is a gauge we watch to evaluate the Fed's actions and the resumption of a more normal risk environment. The incredible plummet in velocity that began in 2008 is a clear sign that commerce and risk taking rolled off the end of a table. By pouring additional money into the financial system, the Fed has sought to fill the hole created by the stunning reduction in the velocity of money. As the velocity of money returns to a more normal multiple, the Fed is expected to reduce the money in the system to avoid inflation.

## Outlook: Short-Term Bullish, Long-Term Scared

Throughout our history as a firm, we have often described ourselves as “short-term cautious, long-term bullish.” Lately, we have been leaning in the opposite direction—short-term (one to two years) bullish, longer-term scared.

**Short-term bullish.** In terms of our nearer-term bullish stance, we expect the Fed’s rapid balance sheet expansion and quantitative easing, coupled with the global expansion of many countries’ money supplies, to have an impact on the markets over these next years. As we discussed earlier this year, the “fix is in” and the markets have responded. Since global capacity utilization rates have plummeted—with the U.S. registering an all-time low reading of 67% (Figure 8)—the new money is unlikely to find its way into expanding property plant and equipment or any other means of production in the near term. Instead, the new dollars will work their way into the financial and commodities markets. The markets are no longer discounting a depression but instead a recession, albeit a prolonged recession in some industry groups. The SEC’s and FASB’s willingness to change the mark-to-market accounting standards in early March likely reduced the probability of a depression scenario and served as a catalyst for the market to heal.

The nearly 40% rise in U.S. stocks from the low in early March was surpassed by the surge in emerging markets (see Figure 9) and other higher-risk assets. We have seen cyclical stocks outperform the more stable company stocks, and a rally in high beta stocks in general. Corporate bonds—and especially high yield bonds—have rallied, generating significant moves from near-record spread levels. The money market mountain of liquidity is earning a near-zero return. With risk assets surging, it may become too painful for some investors to remain on the sidelines. Short term, the flood of money and the perception that a depression has been avoided has produced a rally that has reduced some of the investor pain while also increasing investors’ appetites for risk.

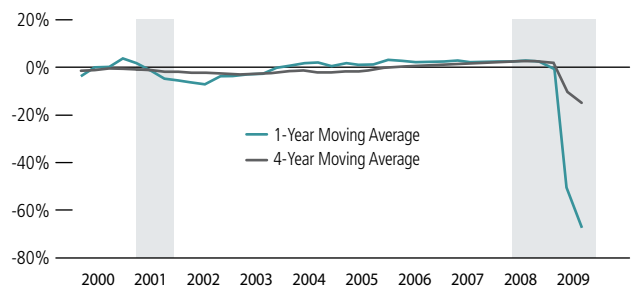
**Long-term scared.** Looking further out, we believe caution is warranted. The global economy has experienced a balance sheet-led debt deflation that is being offset with a huge inflow of money and fiscal stimulus that defies comparison. Through this great reflation, debt is being shifted from the private sector to the public sector. The drive to spend and reflate will put great pressure on the political class to inflate and devalue the currency.

Moreover, what we are seeing today is a Keynesian fiscal stimulus plan fuelled by massive spending and funded by government debt. If the economy is not turning around, then spend more. If that does not work, spend more still. No other option seems to be on the table. If you will not spend your money, the government will spend it for you.

With this approach, the assumption is that someone in the future will take care of the bill. Or, the responsibility will fall to the wealthiest citizens. The vast majority of the population has been led to believe that the wealthy will pay for this current government expansion. Yet, the belief that most of us can live

**Figure 7. Monetary Base Velocity Growth**

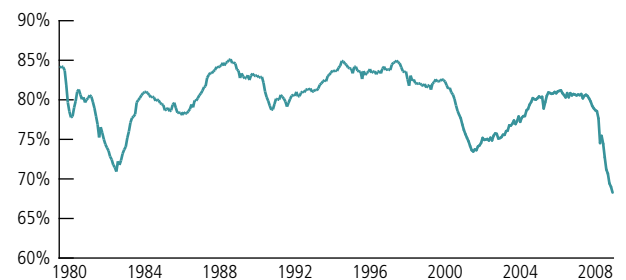
The collapse in monetary base velocity growth indicates that although conditions are improving, much needs to be done.



Source: Federal Reserve Bank of St. Louis, “Monetary Trends,” April, 2009.

**Figure 8. Capacity Utilization**

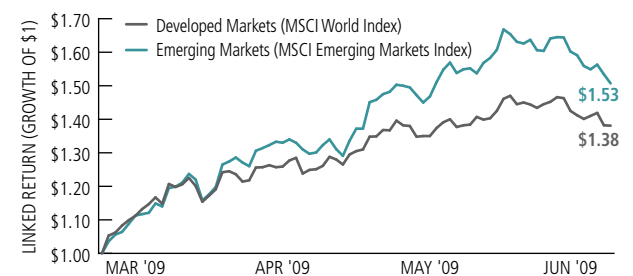
January 1980–May 2009



Source: Federal Reserve Board (frb.gov)

**Figure 9. Developed Markets versus Emerging Markets Performance**

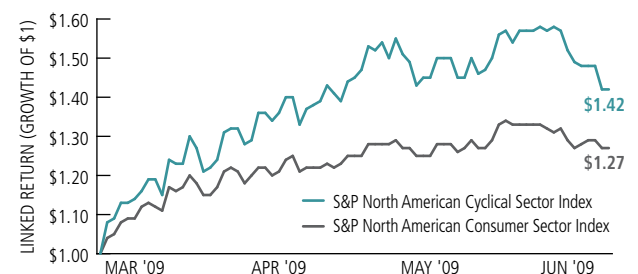
Since March '09 Market Lows



Source: Bloomberg LP.

**Figure 10. Cyclical Sector Index versus Consumer Sector Index**

March 9, 2009–June 23, 2009



Source: FactSet. Stable stocks are measured by the S&P North American Consumer Index and cyclical stocks are measured by the S&P North American Cyclical Sector Index.

off of a few of us is a great lie perpetuated by the broad media and some liberal politicians. Many economists have noted that even if the wealthiest Americans (those making more than \$250,000 a year) were taxed at a 100% rate, the tax revenue is nowhere close to the spending deficit.

Our concerns about government policy and its implications for economic growth increase when we consider the other initiatives currently under discussion on Capitol Hill. Are we ready as a nation to trust the efficiency and effectiveness of the government to control health care costs, financial industry risk management and all matters relating to energy? Most likely, those in power will seek to address these issues in a way that also increases their own control. At least, that has been the case throughout history, as greed for power has led government to seek an expanded role. This has often been accomplished through complex bureaucracy and regulation. For example, the tax code started with a post card that stated an individual's income and multiplied it by the tax rate to calculate the tax due. These two lines have since exploded into an incomprehensible maze of rules and regulations, each favoring or penalizing certain behaviors or groups of citizens. If you think the tax code is complex, wait until you need to navigate a government health care system to get something important done correctly and quickly.

Social Security and Medicare are unfunded liabilities that we believe will be solved by the following expansion of the government's reach: first, increase the age to collect Social Security payments to 72 and increase the payroll tax cap for Medicare, sell assets owned by the government, raise taxes on the wealthy and add a consumption tax or value added tax that hits everyone; and finally, ration health care to control spending.

The current cap and trade tax is very close to a value added tax—combined with some protectionist measures to boot. Cap and trade will tax corporations for their carbon footprint, and every layer of production will pay this tax just as a value added tax would work. Unfortunately, a corporation is a legal document and legal documents do not pay taxes—people do. So, expect higher prices or lower wages to pay this tax. In our view, this is not the solution consumers need in the face of the worst economic crisis in many decades.

To assume that the government will compete on the same grounds as others must compete is delusional. Warren Buffett, I believe, has stated that "You are only as smart as your dumbest competitor." To have a competitor that makes the rules, has unlimited funds and has no profit motive would surely put great stress on your business. For example, the government competing in health care insurance lends itself to the following analogy. Imagine if NBA referees announced that they will own one team. The team's players and expenses will be funded by the entire league, but the budget and needs will be decided at the discretion of the referee-owned team alone. Just one guess regarding what NBA team will dominate in the next decade!

Businesspeople must understand the rules of the marketplace and they need some level of stability before risk taking can resume. We are not currently moving the private sector in this direction.

## Global Monetary Environment

To understand the inflation or deflation cycle, as well as currency and global trade pressures, investors must understand the global monetary regime, which appears to be undergoing some major changes. In our July 2008 commentary "If you're not confused, you don't know what's going on," we examined the current monetary regime:

In the Bretton Woods agreement (BWI), the center country was the United States and the peripherals were Europe and Japan. In the new monetary regime, which we'll call "Bretton Woods II" (BWII), the United States remains the center country, but the peripheral country is China ... The current China-U.S. relationship works exactly the same way as BWI. China pegs its currency to the dollar at a low rate and exports products to the center country while building dollar reserves and a competitive capital stock. This relationship has been profitable to both countries and was given a significant boost with the entrance of China into the World Trade Organization in 2001. As China benefits from a quick build-up of infrastructure and capital stock, the U.S. benefits from less-costly imports and low interest rates on debt.

The Bretton Woods II regime may not be maintained, however. The U.S. is devaluing the dollar, making imports more costly and foreign purchase of U.S. government debt less attractive. China is less willing to purchase U.S. government bonds and to hold additional U.S. dollars. The global trade picture is changing as developed countries may attempt to devalue their currencies to remain competitive with the U.S. dollar. We are seeing more direct free-trade restrictions from every corner of the globe—including our own. These restrictions include the U.S. government's requirement to use U.S. goods and production for fiscal stimulus projects, and portions of the cap and trade bill.

U.S. government bond interest rates may have to increase to encourage Japan and China to hold dollars. This changing monetary regime will have a significant impact on world trade and currency movements, although we do not yet know what the results will be. It appears initially at the margin that China, India, Russia and Brazil will move to strengthen the global currency basket option to reduce dollar dominance as a trading currency. China will have to be cautious because it does not want to accelerate the devaluation of its huge stake in U.S. dollar holdings.

**Figure 11. U.S. Dollar Index**

January 1980–June 2009



Source: Bloomberg LP

**The Next Monetary Regime.** G7 countries currently must externally finance large amounts of debt. A race to devalue may ensue among the U.S., Britain and Japan, while the euro is caught in a tug of war between monetary stimulus desires and hard currency promise. The stress of the emerging eastern European economies and the global recession may put extreme pressure on the euro and weaken the European Union. European banks are struggling with bad debts from the Eastern Bloc while Greece, Spain and Ireland risk deflation without the monetary lever available to devalue.

“The global economic shock is not like your father’s recession, but probably closer to one your grandparents faced. The good news is that the U.S. economy has survived some devastating shocks—and with hard work, creativity and determination we have moved forward and prospered.”

How and when will the U.S. government formulate an exit strategy from its current expansionary monetary policy? The historical record leaves us less than convinced of the Fed’s ability to correctly time the end of its balance sheet expansion and its quantitative easing. It may be more likely that the rise in commodity and energy prices over the last few months is a sign of concern regarding paper money (fiat)—not a sign of rapid demand growth. During the past 30 years, most asset bubbles were fuelled to a large extent by Fed policy and overreaction. This does not inspire a high comfort level in regard to changing policy to avoid inflation or deflation.

Many developing economies are still dependent on commodity and energy demand. They may need to move to strong currency stances and increased domestic consumption. The long-term implication of this should be improved living standards in developing nations, and a growing middle class with less economic dependency on the developed nations. We believe that emerging countries would be well served by pursuing a consumption-growth model, possibly with the promise of medical, retirement and social safety nets to stimulate consumer spending.

China’s growth story is still compelling but China is subsidizing production and employment, thus risking inflation and possibly stalling productivity. We are watching this important nation

closely as a barometer for trade, U.S. dollar valuation and geopolitical implications.

The U.S. dollar store of value may be waning in the near future as the panic mode resides—taking the dollar’s leadership role may be gold, the euro, and/or the Swiss franc. Such a shift could also have a negative impact on the value of the dollar.

## **The Seeds of the Next Expansion**

Many market experts and economists speak of “green shoots” appearing in the economy. We believe that the most fertile seeds will be the ones that are cultivated with the highest degree of economic freedom. However, almost all activity in the current U.S. environment runs counter to encouraging the seeds of future prosperity. Until this begins to change at the margin, we believe it will be difficult for a new bull market to begin.

Unfortunately, we believe that broad wealth creation and improvements in living standards will not be substantial and the overall economic picture will be sobering over the next decade. The sustainable level of economic growth will be lower than we have been accustomed to while unemployment will likely remain stubbornly high.

Yet, in our view, the markets continue to offer the potential for shorter- and longer-term wealth creation, albeit on a highly selective basis. We strongly believe that many investment opportunities will be available in the future—just as they were in the 1970s and even in the 1930s.

## **Current Positioning**

Because we are not in a secular bull market, investing discipline is even more important. We believe these are the rules for today’s environment:

1. Washington D.C. is the new growth city
2. Valuations will not get as stretched in the equity markets and growth expectations will be revised down considerably
3. Old-fashioned dividends mean something
4. G7 competitive devaluations and protectionist legislation will become the norm
5. To grow, emerging nations must become consumption-driven and attempt to become independent of the developed nations
6. Knowledge is free, but capital may be much harder to get
7. Real returns after tax will take on new meaning
8. Baby boomers will reprioritize spending
9. The rules will change often!

**Sector exposure and positioning.** As we have noted, we believe that even in this challenging time, there are opportunities for long-term investors. Broadly speaking, we continue to favor growth over value. Growth stocks are, for the most part, priced below sustainable growth and offer better balance sheets and cash flows than value stocks.

In terms of sectors, the table to the right summarizes some general portfolio positioning details.

**Ultimately, we remain confident.** We maintain high conviction in the enduring power of the private market's entrepreneurial spirit and creative problem solving—even in the face of significant challenges. So, despite our concerns about the investment landscape, we believe that we will get past these current crises and again move forward as a nation. This will not happen overnight, especially given the present political backdrop, but we believe it will happen.

As we have discussed, significant changes and influences are reshaping the global economies—and therefore, the opportunities for long-term investors. Even in an environment of uncertainty, we believe that our portfolios are advantageously positioned to seize upon the most compelling investment prospects.

Sector	Positioning*	Key Considerations
Financials	Underweight	<p>A significant amount of excess leverage resides in this sector, deleveraging will continue and at the same time regulations will be expanding.</p> <p>We expect shrinking balance sheets, shrinking ROAs and ROEs, consolidation, less risk taking and more government meddling.</p>
Consumer Staples	Underweight	<p>Valuations are reasonable, but expensive on a relative basis.</p> <p>There is presently a narrow risk/reward band, but as emerging economies improve, we may consider adding to exposure.</p> <p>We favor low-cost producers with global reach.</p> <p>High-end consumer items are still under pressure but stock values reflect an opportunity for high returns.</p>
Technology	Significant Overweight	<p>Productivity enhancement and cost controls should help technology spending.</p> <p>We see consumers remaining willing to purchase certain “special” products such as iPhones, laptops and flat-screens.</p> <p>We have found software companies offering stable revenue streams, strong balance sheets with lots of cash, and products that offer solutions for cost reduction and productivity.</p> <p>The sector will also benefit from global infrastructure stimulus spending.</p> <p>Stock valuations are attractive and the risk/reward is compelling.</p> <p>The sector may be re-establishing its leadership position in the equity market for the first time since last decade's collapse.</p>
Industrials	Overweight	<p>Most stocks represent valuations that are attractive and imply a very weak economic cycle for the next decade.</p> <p>Global infrastructure stimulus spending will benefit many companies in this sector, so we expect that overall growth should be above the average global growth rate.</p>
Materials	Overweight	<p>Muted recovery implied in stock valuations.</p> <p>Further U.S. dollar devaluation and global stimulus spending should help boost commodity prices.</p> <p>The small capitalization of this sector and volatility of commodity prices will again make it prone to large price swings.</p>
Energy	Overweight	<p>U.S. dollar devaluation should help support energy prices.</p> <p>Mid-East turmoil adds to the attractiveness of this sector as it can hedge unforeseen energy price spikes.</p> <p>Stock valuations appear reasonable but government intervention will make this a difficult sector to value.</p>
Consumer Discretionary	Underweight	<p>Stocks offer significant discrepancies in values and opportunities.</p> <p>This sector has been in a tailspin for three years. Anecdotally, a bank president we know commented that this bank does not lend to restaurant and retail establishments since it is not a question of if these companies will go bankrupt but when.</p> <p>Overall potential minefield with some gems buried within.</p>
Health Care	Neutral	<p>This sector may be undergoing some significant changes with the government taking on a more activist approach, and becoming a major player and insurer.</p> <p>It is important to follow government actions and adjust accordingly.</p>

\*Sector overweights and underweights are general indications for the broad sectors. Each portfolio may hold different overweights or underweights due to characteristics particular to individual asset classes utilized.

The MSCI World Index which **MSCI World Index** is a market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America, Europe, and Asia/Pacific region. **MSCI Emerging Markets Index<sup>SM</sup>** is a free float-adjusted market capitalization index. As of August 2005, the index consisted of the following 26 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela. The index represents companies within these countries that are available to investors worldwide. Investors cannot invest directly in an index.

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