

Global Economic Review and Outlook

CALAMOS®



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All Clear on the Many Glacier Trail?

Last year on a visit to Glacier National Park, members of our family embarked upon one of our annual wilderness hikes. We chose a few hikes with varying degrees of difficulty. Most were easy, because a certain unnamed President of Investments (let's just call him Nick C.) was present and not quite as enthusiastic about long hikes as the others. We were to finish the day at a lodge on a lake called Many Glacier. "Many" referred not just to the views of glaciers but also to the abundance of grizzly bears visible in the distance from the lodge deck. As we assembled along a forested trail that encircles the nearby lake, we were abruptly told to hold off since grizzlies had been spotted on the trail. "Okay, let's head back to the car. We'll come back next year," exclaimed our protagonist.

Our team continues to find what we believe are great businesses, at good valuations, particularly among multinational companies.

His wife, however, wanted to wait and take in the scenery in hopes of getting a chance to hike the trail. In less than 20 minutes, the rangers gave the "all clear." Now you don't have to know a lot about grizzlies to assume they could return just as quickly as they left. Being the first family out on the trail seemed like a bad idea. "Let's wait for more hikers to improve our odds. Better yet, let's head back to the car and call it a day!" our hero suggested.

Meanwhile, Nick's wife's logic was simple: If the rangers said it was clear, then it was clear! But our hero maintained that clear and staying clear are different ... wouldn't an all-clear with a guarantee of a few hours be much better?

Needless to say, we ventured out onto the trail. Our protagonist's wife and children were going with or without him so he thought he had better man-up and at least attempt to protect his family. The hike was full of tension. The kids were on high alert as every sound elicited concern ("What was *that?*"). Armed with the knowledge that you never want to surprise a grizzly, Nick's youngest son spent most of the hike singing loudly, confident

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Past performance is no guarantee of future results.

SUMMARY: GLOBAL OUTLOOK AND INVESTMENT OPPORTUNITIES

Global Economic Outlook:

- > **Two steps forward ...** Over these past quarters, it's felt as if the global economy moves forward, only to move back. It should be "more of the same" in 2012 and 2013, with quarters that feel like recovery followed by quarters that feel like slowdown.
- > **A long road back.** Economies going through debt deleveraging cycles should continue to bounce around zero growth, maybe plus or minus 2%, until a reasonable amount of debt clearing is achieved. This debt clearing will take years, not months.
- > **The U.S. economy is on a two-tier track.** We anticipate muted growth or continued contraction in the financials, housing and construction industries overall. Meanwhile, the other side of the U.S. economy is growing with expansion in the information technology, energy, health care and industrial sectors and some retail areas.
- > **Emerging markets, especially China, will continue to assert themselves on the global stage.** China still has plenty of ammunition and flexibility to manage its economic growth, including a soft landing in its real estate market. We expect an easy monetary stance this year from China as it responds to slower growth.
- > **Global politics are a potential game-changer.** 2012 is a pivotal year for global politics and leadership changes in the U.S., China, Europe and many countries in the developing world. This creates opportunity and risks.
- > **The debt bubble presents a persistent threat to growth and recovery.** Many developed nations are reaching a point of no return, where even slight increases in interest rates could have dire implications. Politicians and developed market governments must stop playing kick-the-can.
- > **High volatility will remain the norm.** We expect that global financial markets will remain very volatile and hypersensitive to both government policy initiatives and the unwinding of private and public sector debt.

Investment Opportunities:

- > **Equities provide the most attractive opportunities.** The equity markets should respond to a combination of monetary reflation and fiscal restraint as long as pro-growth fiscal policies are part of the mix. In our view, the equity markets provide the best way to access global growth opportunities, with far better risk/reward characteristics than most countries' government bonds.
- > **Strength in emerging markets.** While we believe a broad-based expansion in price-to-earnings multiples in the developed world is unlikely in 2012, we would not be surprised to see a rally in emerging market equities, including a strong advance in Chinese equities.
- > **Reflation, a catalyst for growth.** Greater coordination among central banks and global manufacturing data point to increased reflation activities. We intend to stay the course and only reduce our risk-asset and reflation-asset exposure into strength.
- > **Corporate bonds are also compelling, on a selective basis.** High-grade and mid-grade corporate bonds may still offer the most dependable source of low-risk-but-still-positive real return. Investors must balance credit risk and duration risk as global recession risk is likely once again higher than inflation risk.

that would improve their odds. Our hero, armed only with one can of bear spray, wasn't feeling quite as confident. That small can seemed rather insignificant against a huge, charging grizzly—and what if there were *more* than one?

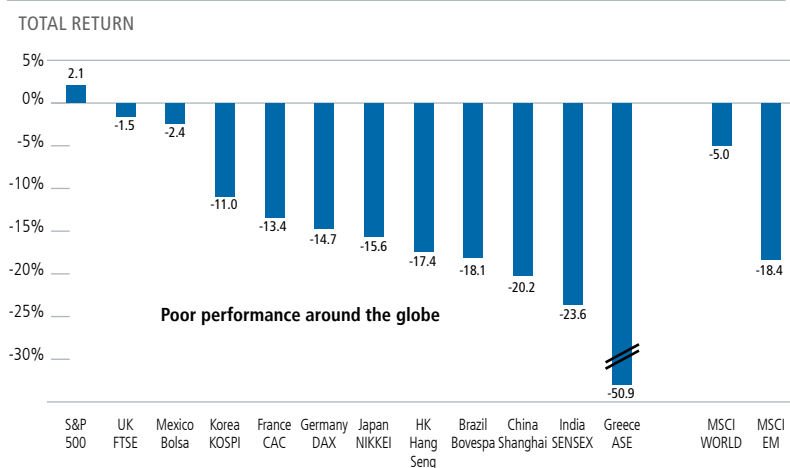
In 2011, the equity market felt like a year-long hike around Many Glacier Lake. Although the grizzlies left the scene, the uneasiness of the hike did not subside. At any moment, an attack could occur. After all, the bears were so close just minutes ago. Similarly, the memory of the 2008-2009 bear attack on the financial markets still lurks in investors' minds. Extreme nervous energy surfaces as volatility in the daily chaos of the financial markets. Why go into the forest (markets) after such a recent grizzly sighting (bear market)? Should we trust the professional ranger's (analyst/economist) opinion? The risk-rewards need to make sense, but what are they? Do we turn back to the safety of our car (cash and Treasuries)? Do we venture out and reap the rewards of experiencing the beauty of nature, even if it's at the risk of a mauling? These are the same questions that we

and many equity or "risk asset" investors have asked for the past three years.

2011 in Review: Risk-on, Risk-off!

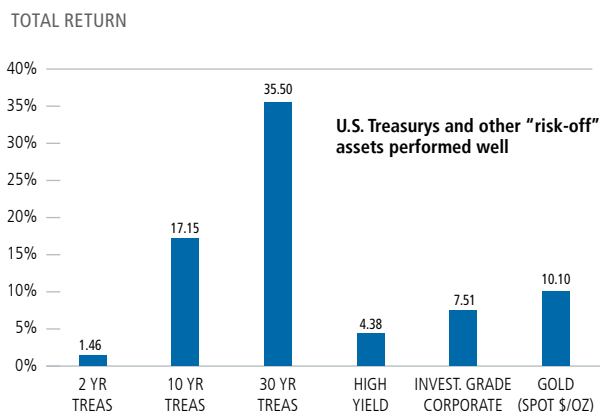
The investment climate in 2011 proved extremely volatile and unproductive for equity and "risk" assets. Investors saw extreme price swings, in what has lately been referred to as a "risk-on, risk-off" market. During the first four months of 2011, commodities, including gold and oil, and the S&P 500 Index gained 9% or more. The risk trades were on. Since May, however, the markets have gyrated wildly. The sovereign debt and economic growth problems in Europe sent markets into a tailspin, leading to a "risk-off" environment where risk assets were marked down sharply and rapidly. Equities performed poorly for the year (Figure 1), with the United States' modestly positive return making it one of the best performing equity markets in the world. Meanwhile, as "risk off" took hold, the U.S. dollar and U.S. Treasury securities provided excellent returns during the second half of the year (Figure 2), as investors fled to the

FIGURE 1. 2011 PERFORMANCE: GLOBAL EQUITY MARKETS



Source: Bloomberg. The S&P 500 Index is considered generally representative of the U.S. stock market. The MSCI World Index is composed of companies representative of the market structure of 21 developed market countries in North America, Europe and the Asia/Pacific Region. The MSCI Emerging Markets Index is considered generally representative of the performance of emerging market equities. Unmanaged index returns assume reinvestment of any of all distributions. They do not reflect fees, expenses or sales charges. Investors cannot invest directly in an index.

FIGURE 2. 2011 PERFORMANCE: U.S. NON-EQUITY ASSET CLASSES



Source: Bloomberg. High-yield bonds are represented by the BofA ML High Yield Master II Index. Investment grade corporate bonds are represented by the BofA ML U.S. Corporate Master Index.

perceived safety of U.S.-backed assets, unfazed by Standard and Poor's credit rating downgrade of U.S. debt. (Head for your cars in case of a grizzly sighting, everyone!)

At this time last year, we were concerned about the emerging markets' pursuit of tighter monetary and credit paths in response to commodity market inflation, hot money flows and credit expansion. Our thought was to reduce exposure to these economies until policies reversed. Europe was also pursuing a tight monetary policy and even raised rates into the middle of 2011.

Mid-year, we wrote that that the markets were "waiting on the world to change." We were looking for the U.S. Congress to change—specifically, to act courageously and put in place a permanent solution to manage the deficit and debt spiral. We were looking for Europe to handle the euro crisis as more than just a liquidity event and either support its sovereign paper directly or resolve the fiscal union impasse. We were looking for changes in emerging markets' monetary policy with a move toward a more expansionary phase. We were looking for global leadership to emerge.

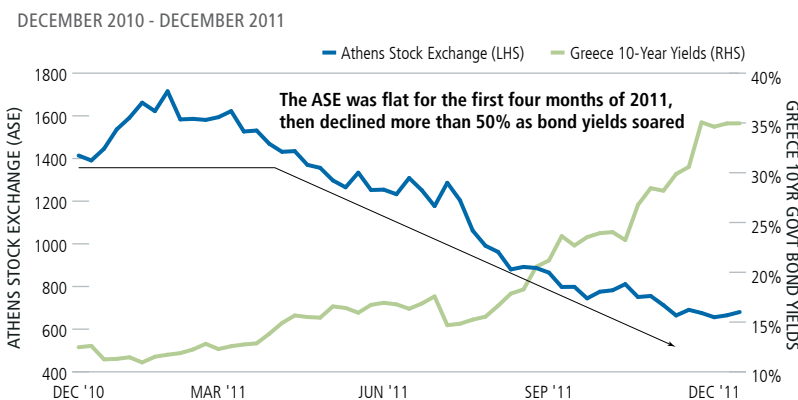
We did get some changes, but virtually none of them provided real, long-term solutions; and the global markets became tumultuous. In a debt deleveraging process, credit and debt contraction and the likelihood of a high level of loan defaults hinder growth. The result is many years of below normal growth in GDP, higher unemployment and lower real asset prices.

We believe that the reflation scenario remains the most likely one for the Fed and global monetary chiefs in the near future.

We have been uncomfortable with the lack of progress in the unwinding of the developed world debt cycle. In 2011, we believed that we would see an active Fed and ECB undertake coordinated reflation efforts. We also expected fiscal stalemate across the U.S. and Europe within the context of a secular bear market. We came into the year concerned about emerging market inflation and viewed the tightening credit and monetary stances as unlikely to help the global economy during the first half of the year. As a result, we reduced our exposure to emerging market equities. As we set our sights on finding growth globally, it seemed to us that assets which traditionally benefit from global monetary reflation should be overweighted.

However, by mid-year the ECB had raised rates twice and clearly was not in the reflationary camp until the Greek debt market spiraled out of control. The Greek equity market was flat for the first four months of the year (the "risk-on" period) but has declined more than 50% since (Figure 3).

FIGURE 3. GREEK EQUITY MARKET AND 10-YEAR YIELDS



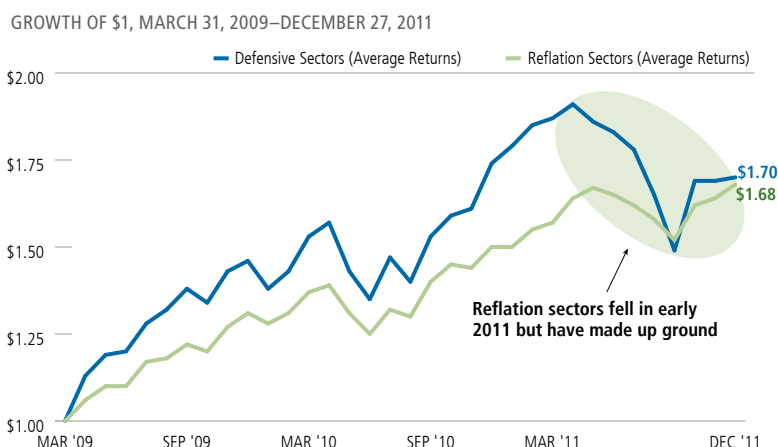
Source: Bloomberg

Meanwhile, yields of the Greek 10-year government bond exploded to more than 35%, and the yield of the two-year bond soared to more than 100%! Italian debt next surfaced as a problem, and all risk assets were caught up in the ensuing turmoil. The implications of these developments were impossible to ignore. The ECB is now firmly into the reflation cycle and has increased its balance sheet to \$3.55 trillion with loans to bad banks chocked full of sovereign debt and real estate loans.

We also expected a more aggressive Fed reflation effort, such as another round of quantitative easing (QE3) that involved mortgage paper purchases and continued Treasury purchases. Instead, we saw a weaker form of support in Operation Twist, although it did help bring down the long end of the Treasury curve. In the last month, we've seen increased involvement from the Fed as it provided dollar swaps (loans) to the ECB in excess of \$50 billion to support efforts to end the European crisis and to limit the perception that the ECB is in an all-out monetization mode.

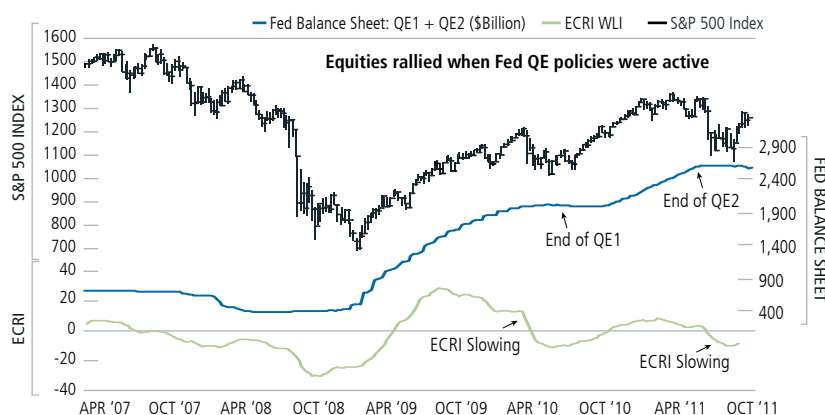
In 2011, we were early with the reflation call (the same as being wrong), but in the last few months the U.S., ECB and emerging markets have been sitting on the same side of the table. Figure 4 shows the headwinds that reflation assets faced as the global reflation efforts stalled in 2011, as well as their stronger performance more recently. Reflation sectors have come back, with returns in line with the more defensive sectors of the economy since the market bottom in March of 2009. (Here, we considered reflation asset sectors to include energy, materials, financials, consumer cyclicals, capital goods and information technology. Defensive sectors include health care, utilities and consumer staples.) With some signs of economic life from the emerging markets,

FIGURE 4. REFLATION CYCLE OF RUSSELL 1000 INDEX SECTORS



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 5. EQUITY MARKET SENSITIVITY TO FED INTERVENTION

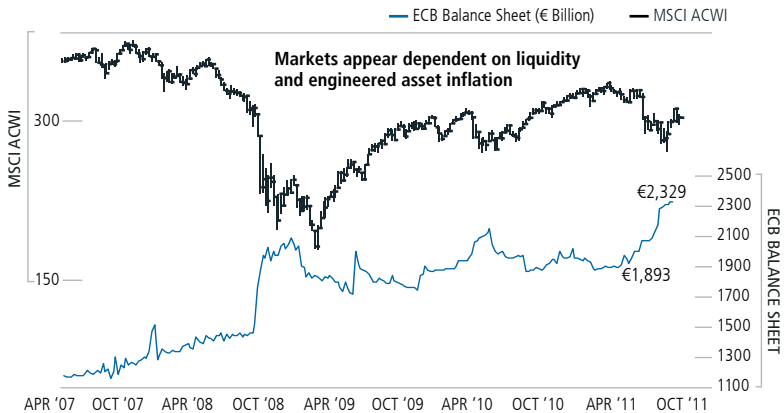


Source: Jurrien Timmer, Pyramis Advisors, "Will the Roller Coaster Ride Ever End?," November 2011, using information from FAM (GAAD). S&P 500 Index and Fed balance sheet are as of November 9, 2011. The ECRI Weekly Leading Index is as of November 2, 2011. The ECRI Weekly Leading Index is a measure of leading economic indicators.

we should see "risk-on" for a few quarters and a rally in reflation assets.

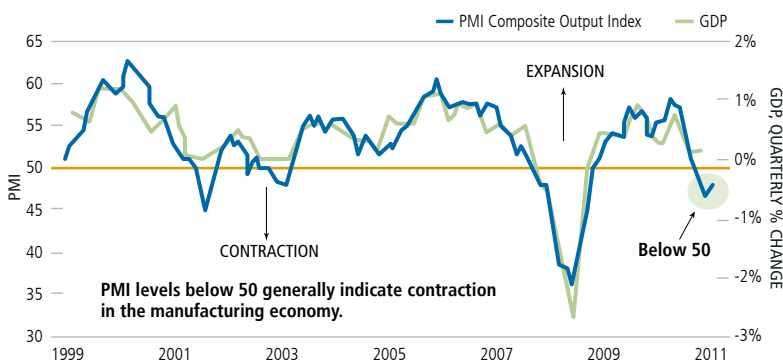
Figure 5 shows the market's sensitivity to Fed reflation efforts (quantitative easing). Equities rallied when Fed QE policies were active, fell after the end of QE1, and turned up again with talk of QE2 and eventual Fed action. In 2011, the equity market decline corresponded with the end of QE2.

FIGURE 6. ECB BALANCE SHEET EXPANSION AND GLOBAL EQUITY MARKET PERFORMANCE



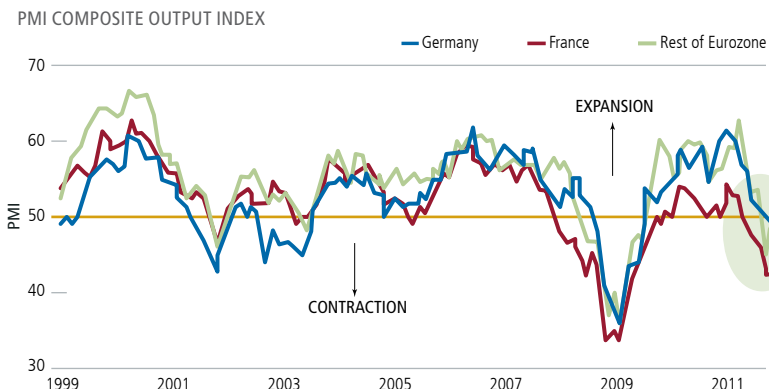
Source: Jurrien Timmer, Pyramis Advisors, "Will the Roller Coaster Ride Ever End?," November 2011, using information from Have Analytics and FAM (GAAD). The MSCI All Country World Index measures the performance of equities from developed and developing markets.

FIGURE 7. MARKIT (FLASH) EUROZONE PMI AND GDP



Source: Markit Economics Limited, News Release, December 15, 2011, "Markit Flash Eurozone PMI."

FIGURE 8. EUROZONE CORE VS. PERIPHERY PMI OUTPUT INDEX



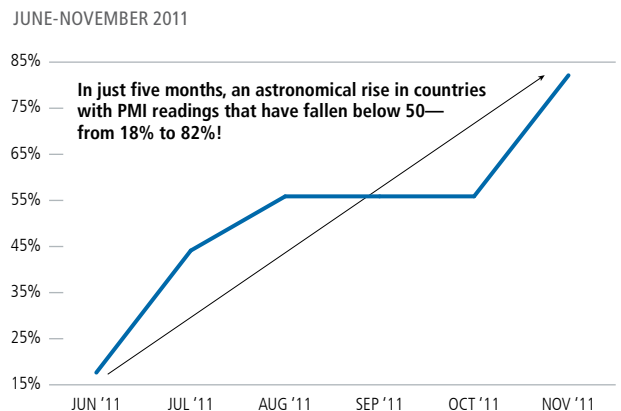
Source: Markit Economics Limited, News Release, December 15, 2011, "Markit Flash Eurozone PMI."

With no significant QE3 planned, investors were troubled in the face of Europe's worsening debt crisis and slowing global growth. The equity markets are looking for more help from the Fed. We thought the most likely scenario was that this intervention would come throughout the second half of 2011, and we positioned our portfolios accordingly. Although we were wrong about reflation during the second half of 2011, we believe the reflation scenario remains the most likely one for the Fed and global monetary chiefs in the near future.

Figure 6 illustrates the ECB's balance sheet expansion and effort to re-inflate. With some additional help from the Fed and China, we expect risk assets to rally off of the liquidity injections. Unfortunately, these charts also show the markets are dependent on liquidity and engineered asset inflation, not productivity growth and corporate cash flow.

Additionally, we believe global manufacturing data supports our thesis that global reflation efforts will ramp up in 2012. Purchasing Managers Index (PMI) readings of below 50 are generally associated with economic contraction. Figures 7 and 8 show the slowdown in Europe, while Figure 9

FIGURE 9. PERCENTAGE OF COUNTRIES WITH PMI READINGS BELOW 50



Source: Deutsche Bank Securities, Inc.

indicates more than 80 percent of the world economies are contracting now. To us (and many central bankers), these are clear signals to step up monetary reflation.

Looking Ahead to 2012

In past commentaries we've stated we expect alternating periods that feel like we're moving forward, only to move back. We believe it will be more of the same in 2012 and 2013, with quarters that feel like recovery followed by quarters that feel like slowdown. The IMF estimates global economic growth of 5.1% in 2011 and 4.0% in 2012, as the U.S. muddles along and China's economy slows. Europe is already in a mild recession which could easily slide into a deep recession if policy choices do not improve quickly. We believe the economies going through debt deleveraging cycles will continue to bounce around zero growth, maybe plus or minus 2%, until a reasonable amount of debt clears. This debt clearing will take years, not months. Real GDP growth is also dependent upon accurate estimates of inflation. If the inflation rate is underestimated, the actual growth rate is even slower and will show up in higher unemployment and stubborn asset valuations.

Although the debt problems are well known and at least partially discounted in equity and debt market valuations, the equity markets are betting on further reflation and mild growth. If this does not occur, then the markets will suffer in 2012. Overall, the equity markets reflect confusion and skittishness, and near-zero interest rate government debt captures more capital as investors seek comfort in a lower volatility, presumed-safe asset.

In our interconnected economy, investors cannot forget about the global backdrop. Global markets are highly

correlated and dependent on government action. As a result, more investing decisions have become as much a *political anticipation* contest as a search for excellent assets and businesses. Unfortunately, even excellent assets must be analyzed within the context of their business and economic environment, so it is important to get the macro and political factors correct. Even the best beachfront property in Venezuela is not worth a fraction of beachfront in Miami.

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The developed world's debt bubble is at the front and center of the global economy's challenges. Governments around the world are attempting to manage the deflation of the debt bubble by offsetting it with monetary schemes and credit enticements. The fiat money experiment, with its combination of floating, fixed and managed pegs, is under extreme stress as the emerging economies take a more significant role on the world's stage. Of course, the great seduction of the fiat currency system is that the political class can create wealth without an increase in productive output or a massive wealth discovery. The combination of "free money" and the use of government debt to offer all things to all people has created welfare state economies in the developed world that are at or nearing structural insolvency as politicians search for one more magic bullet to get them past the near-term crisis.

The fallacy of stimulus with debt financing for current consumption is best explained by James M. Buchanan, a Nobel laureate in economic sciences: "By financing current

public outlay by debt, we are, in effect, chopping up the apple trees for firewood, thereby reducing the yield of the orchard forever.” The excessive use of debt has been more politically acceptable than attempting to raise taxes to pay for government expansion. But using high levels of debt for non-productive capital investment, such as current consumption, is not sustainable. It steals from the next generation. *Hey kids, your mom and I took out a million-dollar interest-free balloon loan due in 25 years to contribute to our favorite charity. Oh yeah, the loan cannot be forgiven from our family heirs upon our death. Good luck.*

Let’s not forget the private sector’s role in the current crises. Banks and many other financial institutions are private/public partnerships and therefore demand a unique policy approach. The reason the private/public partnership exists is that when (not if) trouble comes knocking at the leveraged financial institutions’ door, the public becomes a partner of last resort, even if it’s unaware of this relationship. The *en masse* collapse of banks, insurance companies and government-sponsored agencies (Fannie Mae, Freddie Mac) devastates an economy, and as a result, the public provides the rescue funds to keep the system alive. **In effect, these institutions have a utility-like function within society but with a severely asymmetric risk-reward profile that is favorable for the institution and some stakeholders (senior bond holders and management) and unfavorable to the public.** We believe that the chase to reduce risk in the financial system and better align stakeholder rewards will continue but slowly lose steam until the next crisis. (In other words, the cycle repeats.)

We Are All Reflationists Now: Europe, Stage 1; Japan, Stage 2; U.S., Stage 2.5

The developed world’s love affair with Keynesian economics is coming to an end. The politicians who decide national economic policies don’t necessarily pursue the altruistic path but rather one that leads to power and security—their job security. Keynesian economics makes sense on the surface—save as a government (run surpluses) during economic expansions and spend some of the savings or run deficits during recessions. This is in fact how a rational family household budget works: “*save now for a rainy day.*”

One of many problems with Keynesian economics is that it ignores the point that **politicians are spending other people’s money and they can spend it to buy votes** and guarantee re-election. (Have you seen the probability of reelection to the U.S. Congress?) We believe that the U.S. Congress plays an active role in holding down and manipulating the cost of government debt by encouraging Fed policies such as fixing short-term interest rates, purchasing massive amounts of government debt in the open market (QE) or attempting to manage the long end of the curve (Operation Twist.) When these sorts of tactics are used, the public does not feel the costs of excessive debt until the nation’s credit quality is severely impacted by either inflation, the debt spiral trap or the inability to continue to refinance the ever-growing debt mountain.

The permanence of government debt can be seen all across the developed world. “Borrow and spend” is politically more acceptable than “tax and spend” because people will revolt against increasing taxes but apparently not against increases in debt until it’s too late. The unwillingness to deal with the long-term reality of excess debt is best illustrated by the so-

called political “third rail” of Social Security. Any attempt to fix (change) the unfunded system is guaranteed political suicide. Everyone knows it must change, as must Medicare, but no career-loving politician will seriously tackle these huge and rising liabilities so we leave them for another generation. But, the fiscal endpoint seems to be near as fiscal austerity and spending reduction impasses may finally render Keynesian deficit stimulus spending dead in the face of debt cycle unwinding. Either through gridlock, new leadership, the IMF, German insistence or bond market panic, many borrow-and-spend politicians may find their jobs at stake. The monetary lever is still available (currency is fiat). We believe that a few indebted developed economies may be able to use this lever, along with pro-growth fiscal packages, to generate some short-term growth and longer-term solutions.

The Fed and the ECB are once again aligned in their monetary policy direction, as are most of the emerging markets, including China. We are in the early stages of a global reflation endeavor as countries move to prevent further deflationary pressure from the European sovereign debt crises and the U.S. debt bubble contraction. Japan is also well into what might be the final stages of its great debt expansion and likely implosion, which would unleash further damage to the global financial markets and economy. So, as the weight of the developed world’s long-term debt cycle implodes, the fiat money printing and financial repression accelerates, and the hope of a wealth effect and reflation in assets remains.

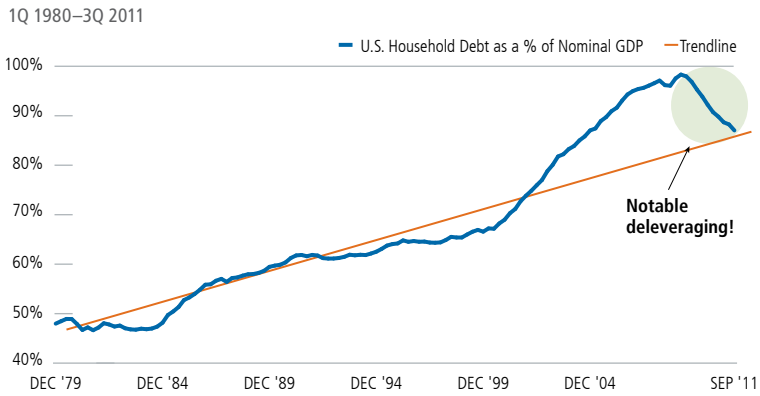
The emerging markets, especially the BRIC nations and most especially China, may be part of the answer to the global malaise. But, the United States’ role in the global healing will also be critical this coming year. Europe and

Japan will not likely contribute much to growth, leaving the world dependent on China’s continued growth and the U.S. not falling into a recession. The developed economies are at a crossroads and neither path is easy politically or as a population to embrace. We have a choice to pursue a smaller government and pro-growth policies while we learn to live within our means (some short-term pain for long-term gain). The other path is more-of-the-same debt and deficit spending and unending government expansion. The end result of this path would be to wind up like Greece—a society with few options, significant struggles, and a devastating collapse in wealth and living standards (short-term gain with long-term pain).

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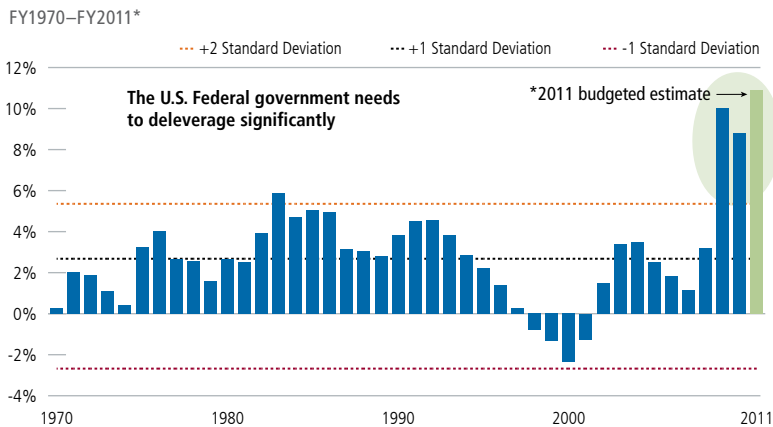
The major economies are at different stages of dealing with their debt crises. Historically, debt nationalization has often been the first strategy for dealing with the aftermath of banking/real estate-leveraged implosions. The U.S. and Japan have accomplished this to a large degree. The eurozone is trying to figure out what nationalizing the debt of varied countries means and who pays. The recent banking bailouts in Europe are the first few steps in the nationalization of the debt. On the whole, Europe’s debt picture is similar to that of the U.S, but without a true fiscal union, Europe faces a much more difficult resolution process. Thus far, most of the

FIGURE 10. U.S. HOUSEHOLD DEBT AS A % OF NOMINAL GDP



Source: Bloomberg. Data subject to a one-quarter lag.

FIGURE 11. U.S. FEDERAL DEFICIT, AS A % OF GDP



Sources: U.S. Treasury and Bureau of Economic Analysis

efforts have been aimed at ensuring liquidity to banks and stressed countries in the European Union, but solvency issues need to be addressed soon. The trick will be to nationalize the debt and then monetize it. As renowned hedge fund manager Kyle Bass recently said about fiscal consolidation in Europe, “Which of your relatives would you go into joint and several liabilities with?” Most likely, none.

Some have suggested that the huge debt-fueled bubble amounts to the failure of capitalism. History has not demonstrated that capitalism can be held accountable for

the world’s woes. Did the Soviet Union not experience a huge misallocation of capital, low living standards and collapse? Have socialist governments allocated capital better and provided higher living standards? Capitalism did not fail. Instead, the excess debt levels that accumulated during boom times did not allow for a margin of safety in the economies (Latin America debt crisis and U.S. banks in the 1980s, savings and loans failed in the 1990s, banks failed again in the 2000s). Welfare state models are failing; sectors subject to heavy government influence, such as K-12 education, are failing; and the heavily subsidized areas of health care and banking are failing. Capitalism in a developed economy is about “creative destruction” as new technology, distribution channels and better business models quickly render non-competitive businesses obsolete. Government interference in the above-mentioned sectors prevents growth, creativity and solutions. Until the debt burden and government growth are arrested, the developed economies will find themselves stifled.

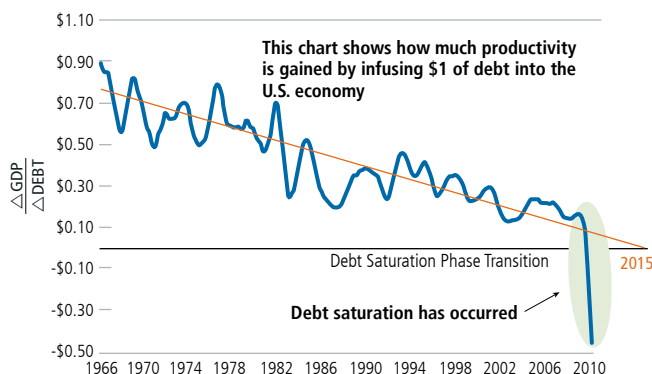
After debt nationalization, the next stage of digging out of debt-fueled crisis has often been financial repression and debt monetization. The U.S. is well into this stage, with QE1, QE2 as well as Operation Twist helping to hold rates down. Japan has had the savings to finance its massive government debt internally, but this is changing and we expect Japan will begin a more aggressive move into this next stage very soon. The final stage should be private sector and public sector debt deleveraging and the U.S. is also moving along on this front. U.S. state and local governments, along with the household sector (Figure 10), have been deleveraging for more than a year. Only the federal government has remained stubborn about coming to grips with fiscal reality (Figure 11).

The developed world is now dependent upon central bank balance sheet expansions and ultimately additional QE (unsterilized asset purchases). The effectiveness of debt-levered GDP has collapsed, as Figure 12 indicates. In 1970, approximately every dollar of debt produced 70 cents in GDP. This debt payoff has been on a long slide since then. Prior to the current global crises, a dollar in debt only produced 10 cents in GDP growth! Today, the payoff is negative—which should be a strong signal that the debt bubble is rolling over on the developed markets. The next time you hear a politician or economist argue for another debt-financed stimulus spending program, show them this chart!

The world is in a mildly synchronized monetary reflation as it attempts a fiat-money-driven expansion and a wealth effect to support huge balance sheet liabilities within banks and indebted sovereign nations, while also adding a welcome devaluation of the face value of debt through inflation. The global issue is too much debt and inflexible exchange rates. Adding to the debt is unbelievably irresponsible and exacerbates the problem! **The debt will be addressed as it always has been—with wealth transfers from creditors to debtors in the form of inflation, government interest rates well below market rates, currency devaluation and default.** We can only hope that a healthy dose of growth will also accompany the debt reduction. This would make the process bearable for citizens as well as reduce the absolute amount of debt that needs to be addressed.

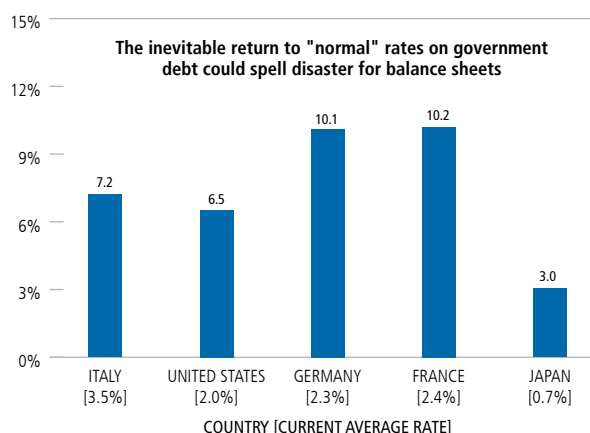
The debt build-up in the developed markets has left those economies extremely vulnerable to rising interest rates. If U.S. interest rates go up to 6.5% on five-year Treasury debt, then 20% of all government revenue will be required to pay interest on the debt. Moreover, because the U.S. economic

FIGURE 12. DIMINISHING MARGINAL PRODUCTIVITY OF DEBT IN U.S. ECONOMY



Source: www.EconomicEdge.blogspot.com. Chart produced by Christopher Rupe and Nathan Martin, data from the U.S. Treasury Z1 Report, March 11, 2011.

FIGURE 13. RATE AT WHICH GOVERNMENT INTEREST EXPENSES WILL CONSUME ONE-FIFTH OF REVENUES

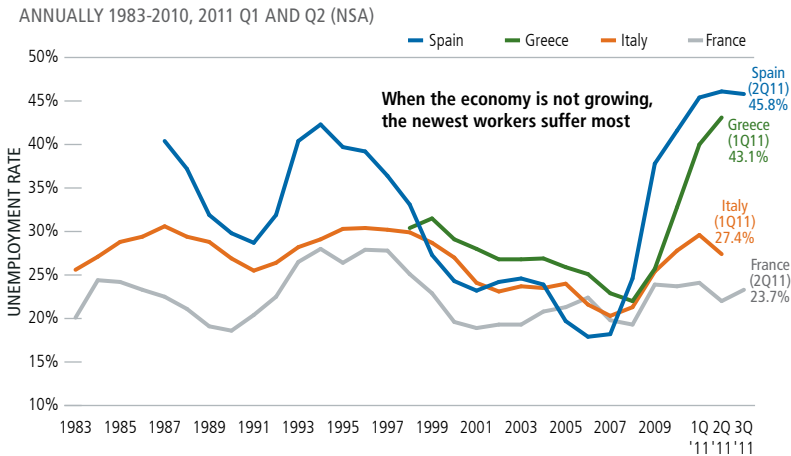


Sources: OECD and Bloomberg.

growth rate is below 6%, the debt level will continue to climb. We have seen the warning signs from Italy as debt rates went above 6%. Figure 13 indicates the depth of the debt crisis and the potential for a government funding collapse if interest rates near the “normal” ranges of the past.

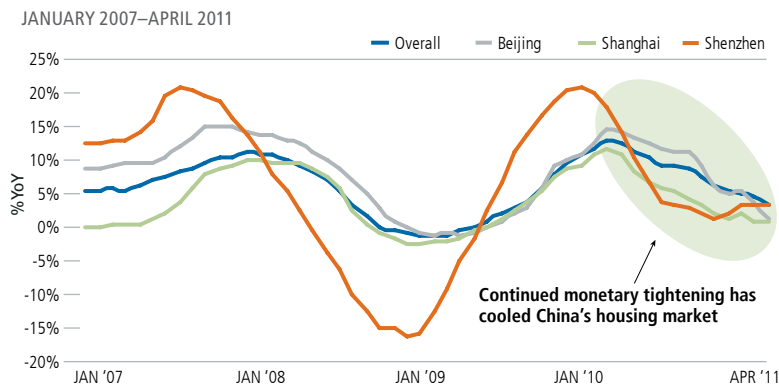
Debt levels in some major economies are closing in on points of no return. Interest rates above sustainable GDP growth rates are problematic for economies approaching 100% debt to GDP. In addition to a potential government funding

FIGURE 14. YOUTH UNEMPLOYMENT BY COUNTRY



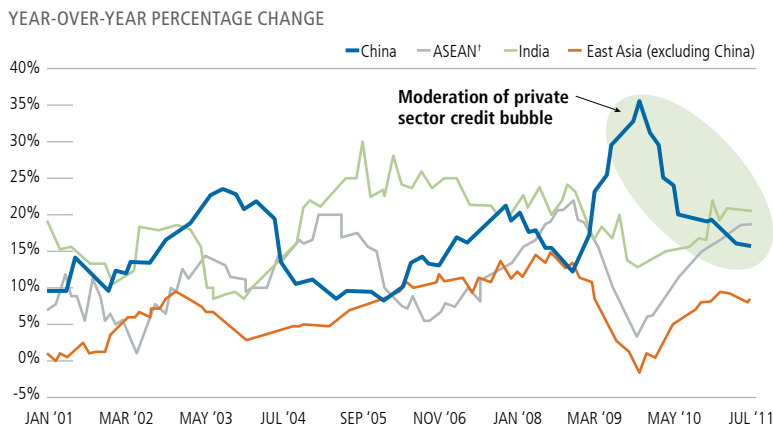
Source: Eurostat

FIGURE 15. THE RISE AND FALL OF PROPERTY PRICES IN CHINA



Source: BBVA Research, "China Real Estate Outlook," July 11, 2011, using data from NBS, CEIC and BBVA Research.

FIGURE 16. CHINA: NOMINAL CREDIT TO PRIVATE SECTOR



Source: Global Macro Monitor, "China's Credit Bubble," macromon.wordpress.com/2011/11/20/chinas-credit-bubble, using data from CEIC Data Company Ltd., Haver Analytics and IMF staff calculations.

† ASEAN includes Indonesia, Malaysia, the Philippines and Thailand.

collapse if interest rates rise, heavy debt burdens will further stifle economic growth and fuel out-of-control debt spirals. Along with excess debt output drag, a growing government sector adds to the weight of the economy and impedes growth further as evidenced by the weak growth in much of Europe over the last 20 years. The U.S. is following the European model with a growing public sector and chronic youth unemployment due to structurally slower growth.

Figure 14 shows the youth unemployment rate (ages 18-25) in France, Spain, Italy and Greece over the past 25 years. Each of these welfare state economies has averaged more than 20% unemployment for this group. When the economy is not growing, the newest workers suffer most, especially when it's difficult to fire employees. These economies are fast reaching a time when the government subsidies will have to be significantly reduced and then they will be dealing with hungry and angry youth! It's time to try pro-growth stimulus with fiscal reality.

China's Influence in 2012?

The health of the Chinese banking and real estate markets are very difficult to ascertain. No doubt bad loans are escalating and the real-estate bubble is deflating. This may be a normal cyclical slowdown. But, it is very difficult to take the Chinese government's economic statistics at face value, so other means of analysis are necessary. It does seem likely that China has the ammunition and flexibility to engineer a soft landing in its real estate market (Figure 15).

China also has enough growth and inflation to paper over bad loans, as it did with its banking crisis early in the last decade. The private sector credit bubble appears to be

moderating (Figure 16). The economic slowdown indicated by manufacturing data (Figure 17), combined with Europe's slowdown, caused the Chinese government to respond with lower reserve requirements, even with inflation running above targets (Figure 18). We believe it is likely that China stays in its easing monetary stance this year. This should be good news for other Asian economies and maybe even for commodity-sensitive countries in Latin America and for Canada. A U.S. with reasonable economic growth and an expanding China offer a ray of hope for risk assets in 2012, provided we also have a healthy dose of monetary reflation. Additionally, China's equity market was under severe pressure last year. With the change in monetary policy and signs that they have controlled the credit and real estate bubble, we expect a strong rally in Chinese equities in 2012 and in emerging market equities overall.

Financial Markets in 2012

Do we stay biased toward the reflation sectors and assets in 2012? We have been debating this over the past few months. As the evidence has presented itself over the past few weeks, we believe we stay the course and only reduce our risk-asset and reflation-asset exposure into strength. Let's hope the global central banks act in a manner we expect and as they have in the past, and reflation assets should rebound.

We expect a continuation of a two-tiered U.S. economy, with more deleveraging and deflating at the state government, local government and household levels. We anticipate muted growth or continued contraction in the financials, housing and construction industries on the whole. However, we are focused particularly closely on the

FIGURE 17. CHINA MANUFACTURING INDEX

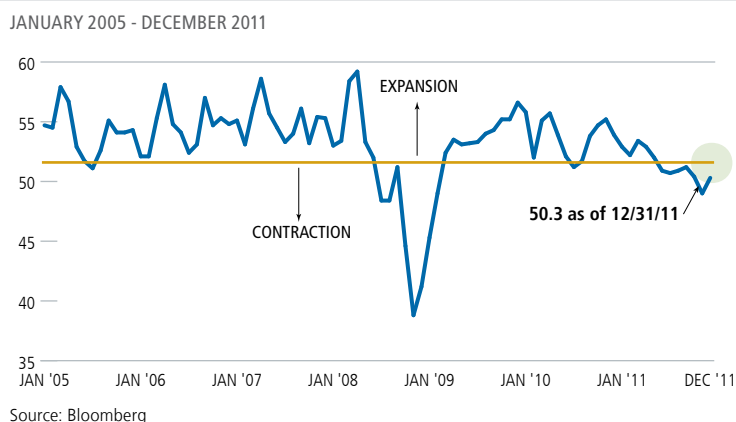
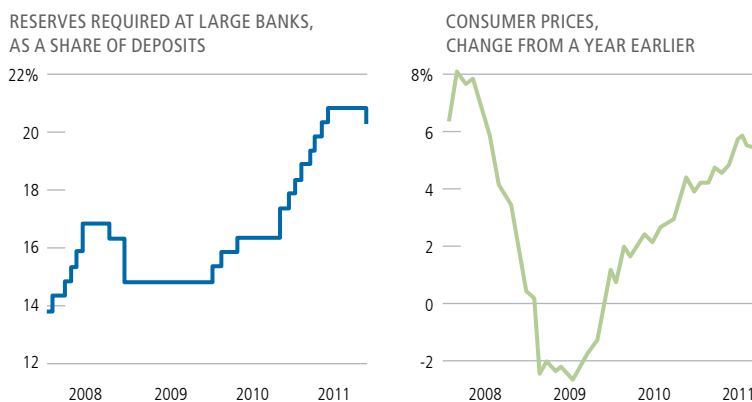


FIGURE 18. CHINESE BANK RESERVE REQUIREMENTS AND CONSUMER PRICES

Concerns about inflation seem to be taking a back seat to economic growth considerations.



housing market, as it appears to be stabilizing and perhaps even showing signs of a little life. Meanwhile, the other side of the U.S. economy is growing with expansion in the information technology, energy, health care and industrial sectors and some retail areas.

The U.S. is still in a wealth destruction stage, via inflation in fees and taxes. As deflation in risk assets persists and

volatility rises, investors are more inclined to sell into the downside phase. Finally, repressed interest rates steal from those on fixed incomes and U.S. pension plans while higher regulations and tax burdens discourage businesses from taking risks or making decisions. These problems are mirrored in many other developed markets. We won't be in a secular bull market until these things change and debt deleveraging runs much deeper.

We believe it is likely that China stays in its easing monetary stance this year. This should be good news for other Asian economies and maybe even for commodity-sensitive countries in Latin America and for Canada.

Globally, we expect that financial markets will remain very volatile and hypersensitive to government policy initiatives and the unwinding of private and public sector debt. We expect investors will keep their time horizons short and further rein in durations on risk assets. The only long-duration assets that did well in 2011 were U.S. government bonds and gold—the ultimate safe havens (at least in theory). In many investors' eyes, gold is the real store of value and its appeal directly correlates to the demise of fiat money and the banking system. Government bonds appeal to the "risk-off" crowd that still believes U.S. government debt can provide a store of value and preserve wealth, at least in the near term. We have yet to find anyone who believes they will generate a real positive return on Treasury securities held

long term (10 years or longer). Instead, many investors seem to be holding Treasuries as a ready-to-trade-asset, with the expectation of exiting at the first sign of credit or inflation problems. Because of this, we expect that Treasuries will continue to be extremely volatile.

High-grade and mid-grade corporate bonds may still offer the most dependable source of low-risk-but-still-positive real return. Investors must balance credit risk and duration risk as the global recession risk is likely once again higher than inflation risk. We believe that developed market government bonds offer an exceptionally poor risk-reward as the bubble in government debt expands, but timing the eventual correction is very difficult.

In our view, a broad-based expansion in price-to-earnings multiples in the developed world is unlikely in 2012, given political uncertainty and global banking and debt problems. Equities are subject to the risk that a global recession or slowdown puts pressure on profit margins and at the same time P/E multiples contract as uncertainty about the path to economic sustainability remains unclear.

Emerging markets may provide an area of opportunity, although they are still reliant on developed economies to fuel their growth. As we noted, risk and risk awareness are high and time horizons for investors are short. It is no different at the corporate level, as uncertainty about the global economy, taxes, regulations and lack of political will all shorten the duration of businesses' outlooks. Therefore, large capital projects and long-term growth initiatives are few. Business people and investors alike are limiting the risks

of long-term capital investments in this volatile and fragile global business climate.

But 2012 is a pivotal year in regard to global politics and there could be significant impacts on the global markets. The U.S., China, Europe and many countries in the developing world are undergoing leadership changes, which create opportunity and risks.

High inflation and poor global economic conditions have fueled significant rebellions and leadership changes in Argentina, Libya, and Egypt. Unfortunately, these changes did not open a clear path toward freedom and democracy, although the world looks on with hope. There are continued challenges from Iran, a less stable Iraq, a new leader in North Korea, protests in Syria and likely leadership changes in Saudi Arabia. The world has not become a safer place. As the U.S. and Europe deal with the debt crisis, many of the fanatical regimes have stayed focused on their plans to destabilize the world's political and economic order.

Although we highly doubt the onset of a new secular bull market in 2012, the opportunity to build a stronger foundation of financial sanity, global leadership and fiscal recovery is in the realm of possibility. **We also believe the equity markets will respond to a combination of monetary reflation and fiscal restraint as long as pro-growth fiscal policies are part of the offering.** In our previous outlook, we demonstrated that the unwinding of massive debt has corresponded in the past with equity bull markets and bond market malaise. The only difference this

time is that the developed world economies have promised the populace welfare in excess of the ability to provide it.

Conclusion

We began this commentary facing the bears on the hiking trail. Ultimately, we decided that the right decision was to go on the hike. We feel the same about the markets today. Indeed, even as we anticipate high volatility in the markets, we see significant growth potential in the global economy driven by secular themes related to emerging market consumers, infrastructure build-out and rebuilding, and technology innovation. We believe the equity markets provide the best way to access global growth opportunities, and with far better risk/reward characteristics than most countries' government bonds. Our team continues to find what we believe are great businesses at good valuations, particularly among multinational companies.

Of course, while we're going on the hike, we're not being reckless. We've got bear spray in hand, and lots of it. In this case, it's vigilance to the changing macroeconomic landscape, good research and common sense. Experience has taught us that we can't always see what's around every corner, but the view at the end is well worth it.

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