

# Economic Review and Outlook

# CALAMOS®

## JOHN P. CALAMOS, SR.

Chairman, CEO & Co-CIO

## NICK P. CALAMOS, CFA

President of Investments & Co-CIO

### IN THIS COMMENTARY

- > We anticipate a slow, stop-and-go recovery.
- > We see encouraging signs of global rebalancing, with increased consumption and growth from emerging markets and increased exports and deleveraging from developed markets. These factors can be the foundation of the next secular bull market.
- > As experienced, active managers with long-term perspective and a focus on risk management, we believe we are well positioned to capitalize on the evolving market and economic landscape.
- > Valuations in growth equities are extremely attractive.
- > Convertible securities remain attractive as well. As low-volatility equities, they should be well positioned in an environment of ongoing volatility spikes.
- > Our long-term concerns center around the systemic implications of quantitative easing, government debt build up, and protectionist trade strategies.

During the third quarter, a series of weak economic data jolted the markets and led to concerns of a double-dip recession. The S&P 500 Index returned over 11%, but there was significant volatility behind this gain. The Index rallied nearly 5% in mid-June, declined 9% by early July, rallied another 10% into early August, only to drop more than 6% by the end of August. The quarter finished with one of the strongest Septembers on record with a rally of 9%.\* The U.S. government bond market also rallied. This positive correlation in bond and stock market returns has been out of “character” since the Great Recession started, and indicated an expectation that further quantitative easing (QE) by the Fed would drive Treasury purchases.

**As it has been for more than 30 years, our job is to capitalize on the reality of the markets and the economy—with a heavy emphasis on risk management.**

The Fed reaffirmed its dovish stance, and the U.S. dollar fell in value. Many investors saw this as a sign that U.S. export growth would likely pick up, with U.S. goods becoming more competitively priced (more on this later).

As we wrote last year, we believe the recovery will be slow. We expect there will be quarters that feel like the economy is on track and growing, followed by quarters that feel like we are still in a recession. We are in a stop-and-go economy and believe we will be for some time to come.

The ECRI Weekly Leading Index has been a relatively reliable indicator of economic growth, and it was one of the main factors that contributed to poor equity market performance in August. That said, there may be a sign for cautious optimism—although it is still in negative territory, it has recently stopped falling (see Figure 1).

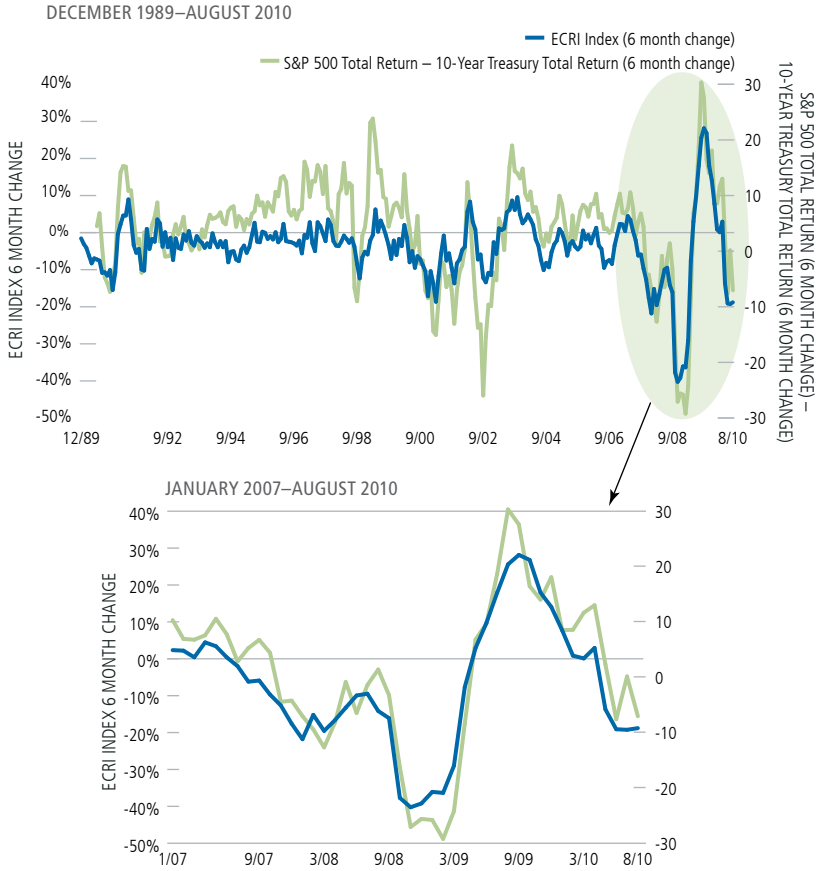
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**Past performance is no guarantee of future results.**

**NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE**

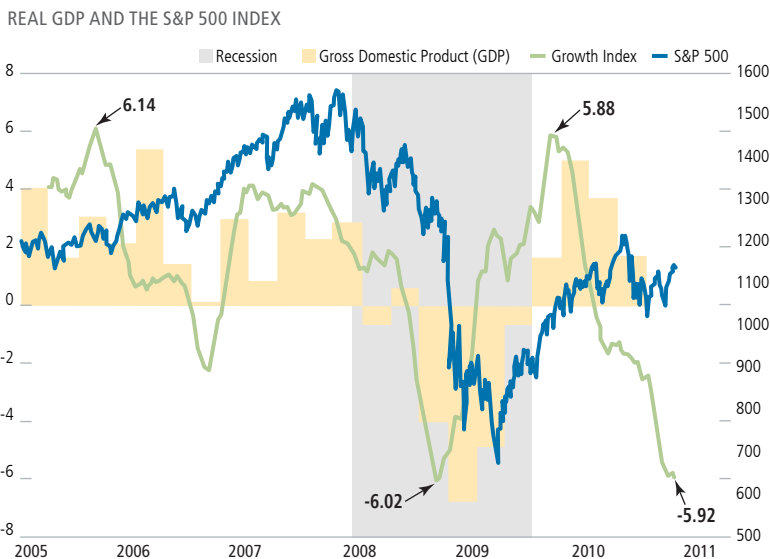
\*Source: Bloomberg

**FIGURE 1. S&P 500 INDEX (LESS 10-YR TREASURY) AND ECRI INDEX**



Source: Bloomberg. The S&P 500 Index is generally considered representative of the U.S. stock market. The ECRI Weekly Leading Index is a measure of leading economic indicators.

**FIGURE 2. CONSUMER METRICS INSTITUTE'S GROWTH INDEX**



Source: dshort.com. The Consumer Metrics Institute's Growth Index measures the growth or contraction in the economic impact and transaction size of consumer activities. (Source: www.consumerindexes.com)

Weakness in the Consumer Metrics Institute's Growth Index has also furthered fears of a double-dip recession. This index is a measure of consumer spending behavior in a broad range of categories. Although the index has a short history, it does provide a relevant context for analyzing the sustainability of GDP growth because consumption is still 70% of GDP. Figure 2 shows the pressure on consumer spending and, therefore, on GDP. The index is close to the lows reached during the Great Recession trough.

### QE 1.0, QE 1.5, QE 2.0 ...

As equity markets fell and signs of a weaker economy emerged, the Fed came to the rescue. It issued a statement that it would not let the old quantitative easing ("QE 1.0") stimulus roll off its balance sheet. Instead, it would reinvest the proceeds from maturing securities and all interest payments into new securities. This new stimulus strategy has been dubbed "QE 1.5" and sent a message that the Fed would continue to support the markets and economy—and is prepared to do so for quite a while. Since announcing QE 1.5, the Fed has indicated that high unemployment and slow growth remain of concern and that QE 2.0 is not out of the question.

The Fed is in uncharted waters. Interest-rate reductions are no longer a policy tool (rates are near zero). Faced with the challenge of stimulating economic growth, the Fed appears to be less concerned about the dollar's purchasing power than about the immediate problems at hand. The QE experiment is just that—no one can say with any certainty how much QE is needed for effective near-term stimulus. Also, down the

road, the Fed will also have to experiment with QE and hope to get the amount and timing of QE reduction correct.

The lag effect and longer-term economic impact are also uncertain. We remain concerned that interest rates are too low. Low rates will not fix the problems in the economy. The QE approach supports some asset values but may also create new problems in the near future. The risk in the Fed policy is that low rates distort the price mechanism in the marketplace. Near-zero nominal rates with negative real rates cause “mal-investment” and improper capital allocation. Bubbles generally occur as a result. (See sidebar at right for more.)

In our view, the Fed should be less concerned with the cost of money. Instead, we believe the Fed should be focused on advancing policy that defends the value of money and savings, which in turn will aid the recovery of asset values. Too much debt tied to weak asset values—not the cost of money—is the main issue. Thirty-year mortgage rates are at 60-year lows and housing sales are still suffering! The existing stock of housing remains highly levered. Eleven million homeowners—23% of all residential mortgage holders—have negative equity value in their property.\*

Of course, QE 1.0 targeted mortgage-backed assets, but it was not a complete solution. People need to be able to afford their mortgages, and this can only come from lower-priced homes or from more gainfully employed citizens with higher wages. QE and other government stimulus programs may stretch out the crisis by masking the “market rate,” but they don’t solve the problem.

The bursting of the debt-induced housing bubble left the economy with excessive debt on assets that are worth significantly less. Because of this, restoring asset values in the housing market will be essential to stabilizing the economy and stopping the debt deleveraging cycle from taking hold. There are encouraging signs on this front. New home sales and home prices may have stopped falling, as indicated in Figures 4a and 4b. So, at least the assets attempting to support the debt levels are providing a stable value from which to reduce leverage. The debt deflation cycle may not spiral downward from here.

### BUBBLES WAITING TO HAPPEN?

To us, likely areas for concern include the emerging economies, commodities and higher-yielding assets. Figure 3 shows the significant outperformance of high-yield bonds and emerging market equities over U.S. equities for the past 10 and 20 years. It is not too farfetched to expect these asset categories could develop into bubbles, given their smaller size and significant outperformance relative to the broad equity market. Even though they have not posted triple-digit gains during these periods, we believe the rise in commodities may make them bubble candidates, as well.

FIGURE 3: POTENTIAL BUBBLE AREAS

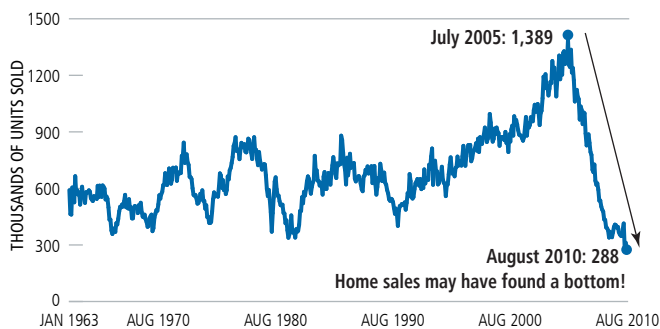
	20-YR CUMULATIVE PERFORMANCE 9.30.90 – 9.30.10	10-YR CUMULATIVE PERFORMANCE 9.30.00 – 9.30.10
MSCI Emerging Markets Index (USD)	798.67%	263.26%
Credit Suisse High Yield Index	569.41%	120.10%
RJ/CRB Commodity Index	19.94%	26.61%
S&P 500 Index	272.88%	-20.56%

Source: Bloomberg. The MSCI Emerging Markets Index is a measure of the performance of 21 equity markets. The Credit Suisse High Yield Index is a measure of high yield debt securities. The RJ/CRB Commodity Price Index is an arithmetic average of commodity future prices.

## FIGURE 4. SIGNS OF HOUSING STABILIZATION?

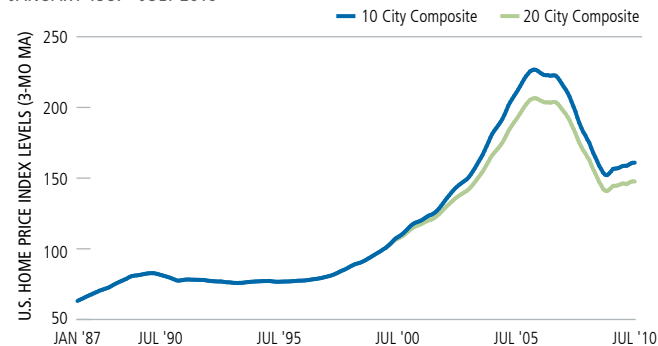
### 4A. U.S. NEW HOME SALES

JANUARY 1963 - AUGUST 2010 (SEASONALLY ADJUSTED)



### 4B. S&P/CASE-SCHILLER HOME PRICE INDEX

JANUARY 1987 - JULY 2010



Source: U.S. Census Bureau and Standard and Poor's. The S&P/Case Schiller Home Price Index measures changes in the value of residential real estate in the U.S.

We can always harbor hope that a more pro-growth fiscal agenda will emerge. But near term, the only politically viable government stimulus tool appears to be the monetary lever. Further fiscal spending is a non-starter—at least until the elections have passed, and potentially longer. Since QE is the only game in town, that leaves the questions of which assets the Fed will purchase and what effect those purchases will have. One thing seems sure: If GDP growth remains stubbornly low and unemployment high, then the Fed will pursue another round of QE. The output gap will support the non-inflationary story, at least for a while.

Champions of current QE strategy might present this argument: Should the dollar decline due to the Fed's actions, that's okay; there was no choice but to "save" the economy and treat the dollar as a secondary concern. In fact, the weak dollar has become negatively correlated with the equity markets since the start of the Great Recession. This indicates the U.S. growth story depends on export growth and that a weak dollar should help the U.S. competitive position. Figure 5 shows that the equity markets once again believe that a weak dollar is good for the economy (negative correlation

between stocks and the dollar) and that the liquidity provided by QE 2.0 will act as a safety net for equities.

However, while further QE can theoretically help drive higher exports as a result of a lower dollar value, this is a difficult means to prosperity. It's a strategy fraught with potential trade war responses and higher-than-intended inflation. We believe there is little doubt that the U.S. government will use the inflation tool to effectively default on debt and reduce debt burdens. The only question is when and how much. The fortitude to defend one's currency is tested when a significant percentage of government debt is held by non-voting foreign governments.

### Currency Wars Represent a Threat

The currency wars are heating up. Mixed floating-rate and fixed-rate regimes are doing battle. The U.S. and China are at the epicenter of the struggle. This past week, the U.S. House of Representatives voted 348 to 79 to impose tariffs on Chinese goods unless China revalues its currency. The other G3 countries are getting into the currency wars, too. Japan has intervened in the currency market in an attempt to halt

**FIGURE 5. CORRELATION OF U.S. DOLLAR INDEX AND S&P 500 INDEX**



Source: Bloomberg. The U.S. Dollar Index measures the value of the U.S. dollar relative to its most significant trading partners.

the appreciating yen, while European monetary authorities have made it clear that they will do what is necessary to defend the sovereign debt of the Euro countries at risk. The Eurozone commitment may be tested soon as sovereign spreads in Greece, Portugal and Ireland are all near crisis highs. So, in regard to currency value, the race to the bottom is on. The winner is expecting an export boom as investors continue to flock to gold as a solid currency alternative.

The currency war is a de facto trade war. All economies are concerned, and rightly so. We agree with the response of Brazil's finance minister, who declared in late September that "we're in the midst of an international currency war, a general weakening of currency. This threatens us because it takes away our competitiveness." Trade wars would likely weaken the forces of global rebalancing by hindering growth and consumption in emerging markets, as well as by slowing developed markets' export growth, debt deleveraging and savings.

Since the housing bubble burst, we have been concerned about the likelihood of G3 currency devaluations and their

trade implications. The need to reduce debt and export more provides the justification to devalue our currency, while inflation steals wealth and distorts the capital allocation process and free market economies. We have favored investing in sectors that benefit from this reflation, including information technology, materials, industrials, energy and emerging economies. We have also found opportunities in the equity and debt of hard currency countries. This may be a long trend with bumps along the way (as illustrated by the BP oil spill and its impact on energy stocks), but we believe the trend will persist over the next decade.

In the near future, the trade wars can trigger the inflation we have been concerned about. Although deflation is the major concern in the marketplace—as reflected in low equity valuations and low bond yields—there is inflation in gold, agriculture and industrial commodities, collectibles, and possibly in emerging market assets. We are starting to see inflation move into the consumer goods market. Bloomberg reported on September 30, 2010, that "Wal-Mart Stores Inc.'s prices rose in September to the highest level in at least 21 months." That same week, FedEx also announced a six percent price increase, and we all know what has been happening to commodity prices. If trade wars intensify, expect more price hikes at the register.

### Charting a Course to Real Prosperity

The real road to lasting prosperity is to produce goods and services at competitive prices that businesses and consumers want. Productivity and quality improvements drive wealth creation, not government spending and redistribution of existing wealth.

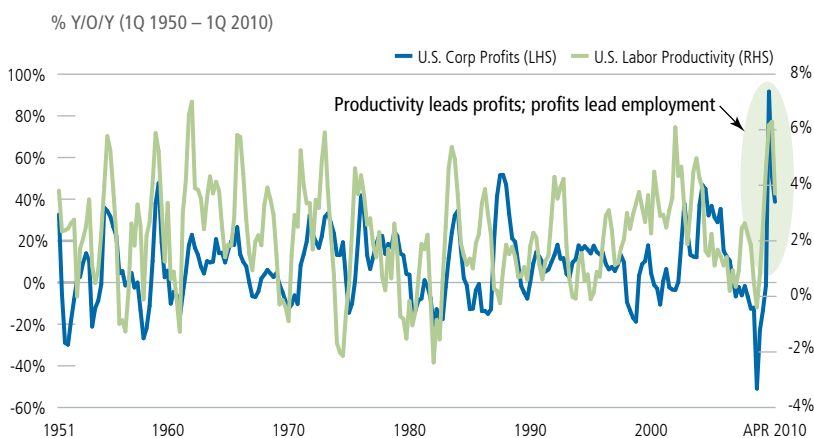
Labor and capital productivity drive corporate profits; growth and employment follow. (See Figure 6.) Real wages will rise on the heels of productivity. Wealth creation will follow in turn, driving asset values upward. This is how we will grow out of our debt. Therefore, it is imperative that the U.S. produces goods and services that the rest of the world demands, at prices they can afford. U.S. businesses must be at the leading edge of quality, creativity and productivity. The U.S. has only 5 percent of the world's potential customers,

so our future is dependent on providing goods and services for the rest of the world.

## The Paradox of Over-Regulation and Gray Areas

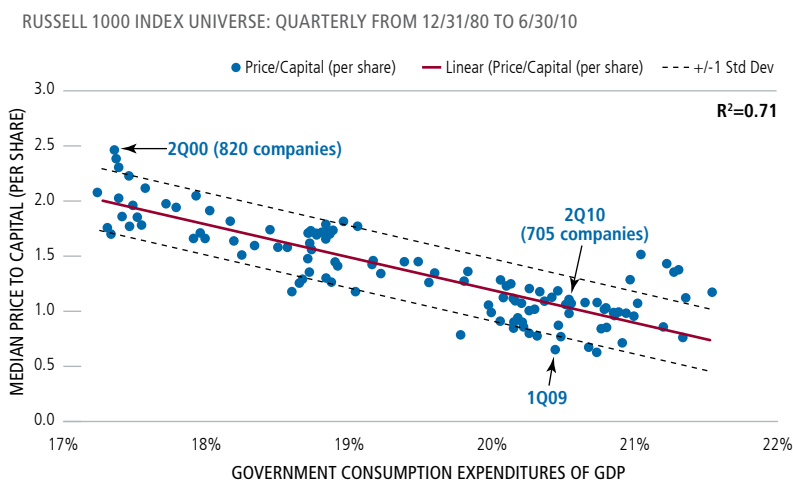
We think the current administration, while well intended, has not demonstrated an understanding of the complexities of growing competitive businesses globally. Layers of complex regulation, taxation and legal attacks are hardly the environment that allows competitive enterprises to thrive. In the U.S., executives and boards spend most of their time navigating these complex and very high-risk issues. Meanwhile, many global competitors can focus on creatively enhancing their market share and serving customers instead of the government or regulators. Many countries offer more balanced legal systems and much less complex tax and regulatory infrastructures. As the reach of the U.S. government is extended, we believe that a number of new regulations and tax code changes will further stifle American businesses' creativity and growth.

**FIGURE 6. U.S. CORPORATE PROFITS AND U.S. LABOR PRODUCTIVITY**



Source: Federal Reserve Bank of St Louis

**FIGURE 7. MEDIAN PRICE TO CAPITAL VS. FEDERAL PORTION OF GDP**



Source: Calamos, Model Station and Federal Bank of St Louis.

Figure 7 shows that as the U.S. government's portion of GDP grows, the value of each dollar of private capital declines—or better said, wealth declines. Of course, the opposite has also been true. Although many measures of equity valuation indicate that prices are inexpensive, this macro measure in Figure 7 indicates the market is fairly valued based on the government's large role in the economy.

The November elections should offer some real change. Even if they only produce a stalemate in Congress, this allows some time to digest and evaluate the thousands of pages of regulations and taxes the American public faces. The press and majority on Capitol Hill frames its side of the

debate as “everyone should pay their fair share, and the wealthy should pay more because they can afford it.” We won’t waste time expanding on the difference between the consumers of revenue (governments) and the producers (working Americans). The real debate should be how to live within our means and what tax rate maximizes wealth creation and living standards, not what tax rate allows government to grow larger and keep their spending ways. Less government intrusion produces a better environment for wealth creation and employment opportunities.

### For U.S. Businesses, a Difficult Playing Field

Why aren’t businesses investing more in growth? Why is business capital spending so low relative to the cash on balance sheets and corporate profitability? The reason is that business leaders have low confidence, unclear rules, taxes and costs to deal with, thanks in large measure to vague government mandates and regulations. Imagine playing a competitive football game. A 10,000-page rule book gets expanded by a few thousand pages. (U.S. regulations and tax codes well exceed this!) Each team is left to interpret how the rules will apply. “Just play the game,” say the referees (government regulators), and we will let you know if it appears that an infraction has occurred. After the game, the referees will watch game films and impose additional penalties for other infractions. Oh yeah, infractions can also be brought up by referee helpers (lawyers) who are paid in windfall amounts (33%) of any approved finding. The payment is a forfeit of the team’s revenue and even potential revenues. Teams can even be threatened with lifetime expulsion.

The refs will fund another group to ensure that the game does not result in the violation of environmental or labor concerns that have been implicitly or explicitly communicated in the voluminous guide. If a team is too successful, it may be subject to open criticism from reporters and referees for

**The real road to lasting prosperity is to produce goods and services at competitive prices that businesses and consumers want.**

overpaying talent. The team can be penalized for rewarding athletic talent, because only altruistic intentions should be well rewarded. At the end of the season, new rules and regulations may be introduced, with the goal of ensuring the “equitable” distribution of points (taxes).

Okay, Team, focus on creating a winning game plan and beating the competition!

### Bull Case, Revisited

We are seeing signs that a global bull market case may be slowly developing, with a widening divergence between emerging and developed economies. Emerging economies continue to emerge and capital is flowing in their direction. Most emerging economies are growing in excess of 8% per year, with many growing by double-digit rates. On the other hand, the growth rates of Japan and the European economies are anemic. The U.S. growth rate is marginally higher. The emerging economies are growing three to four times faster than the G3!

The shift in wealth and living standards is accelerating and financial markets have noticed (see Figure 8). The risk premium for emerging market sovereign debt relative to developed market sovereign debt has evaporated. Equity market risk premiums have also converged, as better growth prospects, balance sheets and policy options make the emerging economies less risky in most investors' eyes.

Increasing consumption in emerging economies should provide a catalyst for G3 export growth, helping to rectify imbalances in world trade and savings (Figure 9). U.S. consumers are saving more and debt deleveraging continues while bank balance sheets have become significantly stronger. Although housing sales are still struggling, home prices look to have bottomed, indicating a near-term stabilization.

Corporate profits are driven by strong productivity; better employment numbers should follow.

While we see encouraging signs supporting the bull case, fiscal headwinds and sovereign debt burdens lessen the likelihood that a new secular bull market will occur soon. Further rebalancing of global consumption and savings must occur, along with a reduction in G3 government debt addictions. Most developed countries have significant deficit and debt issues—the result of unsustainable spending habits. Even with aggressive actions, it would likely take at least five years to correct these issues.

**FIGURE 8. PERFORMANCE OF U.S. AND EMERGING MARKET EQUITIES**

CUMULATIVE TOTAL RETURNS	YTD PERFORMANCE THROUGH 9/30/10	1/1/00–9/30/10
MSCI Emerging Markets Index (USD)	11.02%	190.42%
S&P 500 Index	3.89%	-5.55%

Source: Bloomberg

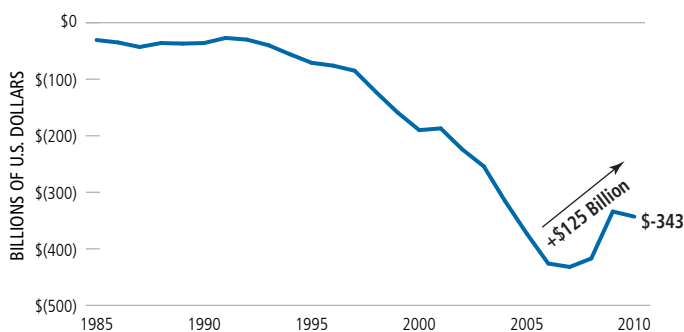
## The Opportunity We See

Against this backdrop, we expect sideways markets over the next few years, with growth and unemployment remaining the prevalent concerns. But all is not lost for equity investors. We believe valuations present good return opportunities, and global economic growth can be pulled along by dynamic developing economies. The equity markets can continue to make headway because

**FIGURE 9. CHANGING TRADE RELATIONSHIPS, BENEFITS FOR ALL**

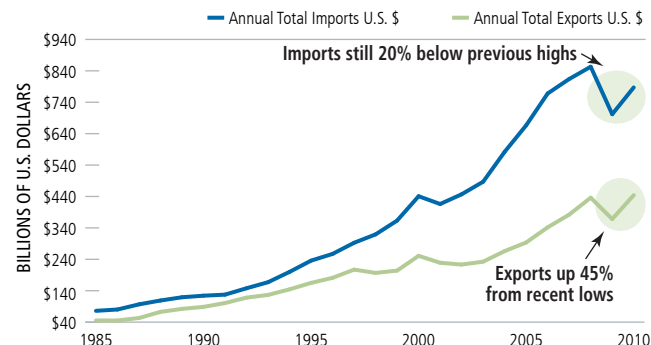
### 9A. U.S.–EMERGING MARKETS TRADE BALANCE

ANNUAL SUM OF MONTHLY NET EXPORTS  
1985 THROUGH MAY 2010 (ANNUALIZED)



### 9B. U.S. EXPORTS AND IMPORTS WITH EMERGING WORLD ECONOMIES

1985 THROUGH MAY 2010 (ANNUALIZED)



Source: U.S. Department of Commerce, Bureau of the Census, Foreign Trade. Emerging markets are represented by the countries in the MSCI Emerging Markets Index.

globalization gives investors more choices to employ their capital in countries with growing economies.

Some may say that the case for equities is predicated on GDP growth. But the short-term relationship between GDP growth and equity market returns is not clear-cut. As Figure 10 shows, equity markets can provide good returns even in periods of slower GDP growth. In fact, no correlation is apparent unless GDP growth is very high. The long term is quite another story; from a secular standpoint, GDP growth and equity market performance have a very high correlation. We see opportunity today that looks cyclical—and we hope it becomes secular in the near term.

We believe that the valuation opportunities are particularly compelling among U.S. large-cap growth stocks. Figure 11 shows the cash flow yield (net operating profit) for U.S. growth stocks, represented by the Russell 1000 Growth Index, divided by the Baa bond yield (a three-year rolling average). As you can see, stocks have not been this cheap since at least the early 1980s.

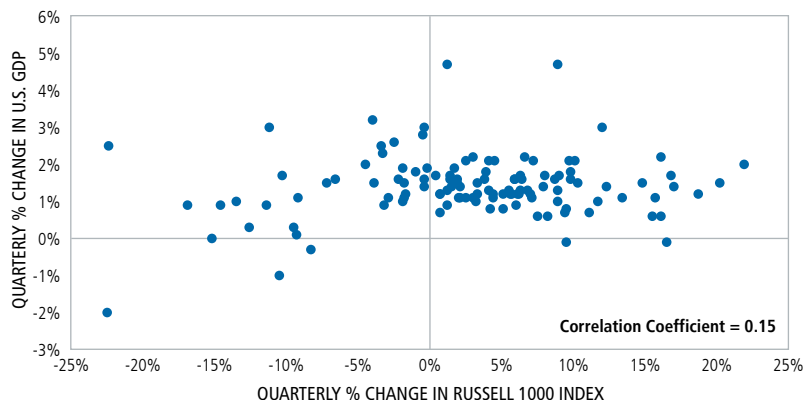
At Calamos, we utilize discounted free cash flow valuation to determine a stock's value. We separate out the growth in free cash flow from a no-growth scenario. Figure 12 shows how much growth is priced into a stock—or in this case the median stock—today as compared to the last 25-plus years. Once again, stock valuations relative to past growth expectations are very attractively priced.

In the U.S. and Japan, the bond markets' low yields look and feel bubble-like. Eurozone nations don't look to be far behind. It's not a good sign when so much U.S. government debt is purchased by the U.S. government. The ability to

**FIGURE 10. GDP GROWTH AND EQUITY MARKET PERFORMANCE**

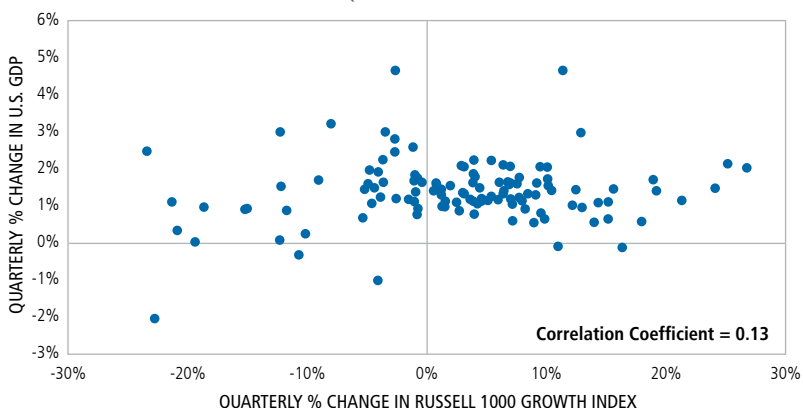
**10A. GDP QUARTERLY % CHANGES RELATIVE TO THE PERFORMANCE OF THE U.S. EQUITY MARKET**

RUSSELL 1000 INDEX UNIVERSE: QUARTERLY FROM 12/31/80–6/30/10



**10B. GDP QUARTERLY % CHANGES RELATIVE TO THE PERFORMANCE OF GROWTH COMPANIES**

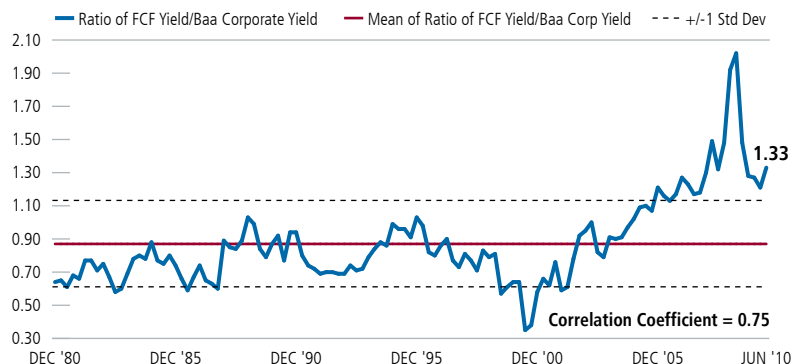
RUSSELL 1000 GROWTH INDEX UNIVERSE: QUARTERLY FROM 12/31/80–6/30/10



Source: Mellon Analytical Solutions LLC and Federal Reserve Bank of St. Louis. (Price return shown for Russell indexes.) The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. The Russell 1000 Growth Index includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

**FIGURE 11. CALAMOS ECONOMIC PROFIT MODEL**

MEDIAN FREE CASH FLOW YIELD/BAA CORPORATE YIELD (3-YEAR ROLLING AVERAGE)  
RUSSELL 1000 GROWTH INDEX UNIVERSE: QUARTERLY FROM 12/31/80 TO 6/30/10



Source: Calamos Advisors LLC, Model Station and the Federal Reserve Bank of St. Louis.

print money and purchase government debt or QE are good for the bond markets over the short term because yields are driven down. However, a tipping point will occur and no one is sure where that point is, not even Fed Chairman Ben Bernanke. At the margin, QE may be okay. At the extremes, it may sow the seeds for more difficult inflation issues in the future. Besides concerns about government intervention in the bond markets, bond yields are also indicating slower GDP growth ahead and the potential for deflation.

Equity market valuations also indicate concerns about slower growth and deflation, as shown in Figure 13. Figure 13 shows the expected inverse relationship between the market price for capital and interest rates. But it also shows that at low nominal interest rates (below 4%), the inverse relationship flips to show a positive correlation. We can best explain this as a reflection of deflationary concerns and the corrosive impact deflation could have on the economy and growth.

## Positioning

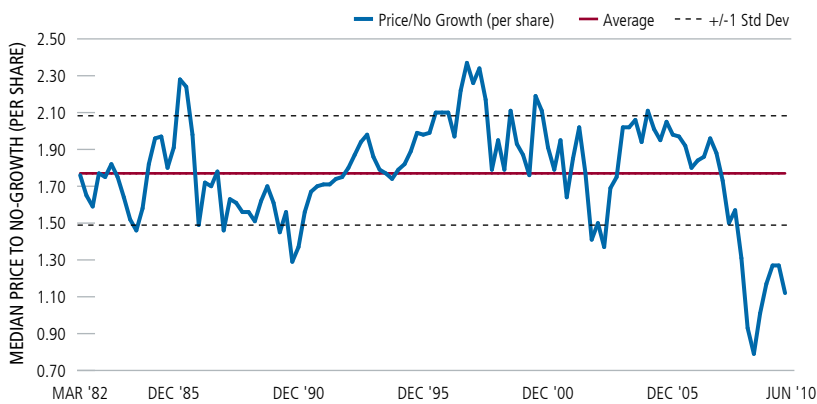
As we have noted, we believe there are many opportunities in the equity markets. Equities are still pricing in slow growth and deflation concerns. At current valuations, many offer good risk/reward characteristics. We believe that the opportunities are particularly compelling among growth equities, specifically large-cap multinationals with geographically diversified revenues, global business strategies, and strong balance sheets. With regard to the multinationals, U.S. and European equities are equally attractive on the whole. However, we believe that U.S. domestic companies look more attractive than European companies operating in Europe.

Emerging market stocks have caught momentum and are priced for continued success. They offer better growth potential within economies with better balance sheets. That said, we remain cautious. Although emerging market equities do not represent a bubble at this time, they do have a more aggressive risk/reward profile.

We also continue to find opportunities in convertibles, particularly those issued by companies with higher-quality balance sheets. As low-volatility equity securities, convertibles offer equity market upside with potential

**FIGURE 12. MEDIAN PRICE TO NO-GROWTH VALUATION**

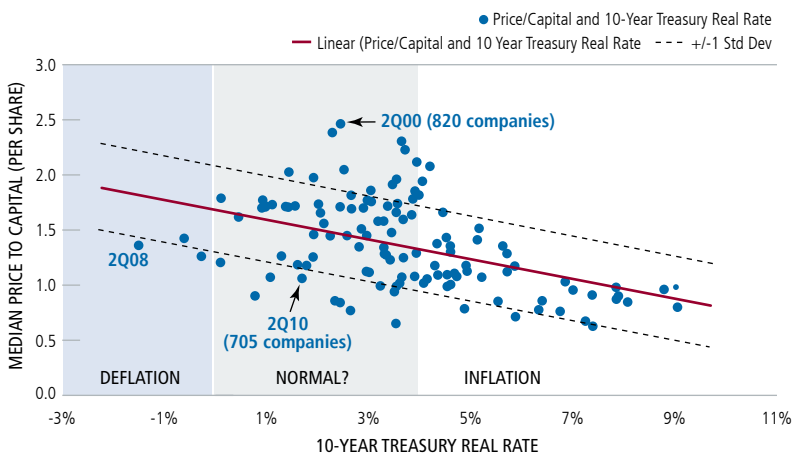
RUSSELL 1000 INDEX UNIVERSE: QUARTERLY FROM 3/31/82 TO 6/30/10



Source: Calamos Advisors LLC, Model Station and the Federal Reserve Bank of St. Louis.

**FIGURE 13. MEDIAN PRICE TO CAPITAL VS. 10-YEAR U.S. TREASURY REAL RATE**

RUSSELL 1000 INDEX UNIVERSE: QUARTERLY FROM 12/31/80-6/30/10



Source: Calamos Advisors LLC, Model Station and the Federal Reserve Bank of St. Louis.

downside protection; we believe these attributes will remain compelling in an environment of ongoing volatility spikes.

As we have discussed, within our equity and convertible positions, we are emphasizing companies that are positioned to benefit from long-term secular trends, including reflation coming out of QE. In “Sector Outlook and Positioning,” (see page 12), we provide additional commentary on our sector views.

**The case for multinational growth equities is extremely compelling. We see encouraging signs that the global economy is moving toward a more balanced savings and consumption scenario.**

Turning to the fixed-income markets, we believe G3 government bonds offer very poor risk/reward characteristics and poor absolute returns. Opportunities among emerging market sovereign debt may also be more limited than in the past. Yields are near historic lows and risk premiums relative to developed nations’ sovereign debt are gone. But the currency advantage may still make emerging market debt worthwhile on a selective basis. Higher-quality U.S. corporate bonds are still relatively attractive, but capital gains opportunities are limited and absolute yields are not overly compelling.

Looking to the future, we expect growth in emerging economies to lead to growth in their corporate, high-yield and convertible debt markets. This is an exciting trend that we will be watching closely.

The U.S. high-yield market has continued to attract much capital. The search for yield has helped push much of the market into a mediocre risk/reward profile. The good news is that just about anybody who needed to refinance has been able to do so. This has reduced the near-term default risk in the marketplace, but a considerable relaxation of debt covenants has come along with this refinancing frenzy. That said, we are continuing to find select opportunities through rigorous bottom-up research. We maintain a bias toward the higher-quality tiers of the high-yield universe and are largely avoiding the most speculative grade credits.

## Conclusion

The economic landscape is never perfect. But, as experienced, active managers with long-term focus, we don’t need it to be. We also don’t believe we need a bull market to generate compelling results. As it has been for more than 30 years, ***our job is to capitalize on the reality of the markets and the economy—with a heavy emphasis on risk management.***

We believe there are many real opportunities and positive trends. As we have discussed, the case for multinational growth equities is extremely compelling. We see encouraging signs that the global economy is moving toward a more balanced savings and consumption scenario. There’s a greater emphasis on fiscal austerity in many parts of the world (the U.S and Greece among the exceptions). The growth and progress coming out of emerging markets represent a significant opportunity for companies, countries and investors all over the world. We believe we are well positioned to participate.

# Economic Review and Outlook

## SECTOR OUTLOOK AND POSITIONING

In the chart below, we've summarized our broad sector positioning.

SECTOR	POSITIONING*	KEY CONSIDERATIONS
Financials	Equal weight / Underweight	Banks will be under pressure to pay for the FDIC's huge insurance liability, while new regulations, lower ROEs and ROAs continue to make the banking sector less attractive. REITs' prices reflect yield chasing, not value. Asset managers and insurers look reasonable from valuation- and business-model perspectives while offering better balance sheets and equity risk/reward.
Technology	Significant Overweight	Capital spending as a percentage of GDP is near a 40-year low, and we expect that this trend will reverse. Technology companies are positioned well for a rebound in the capital spending cycle and are very used to competing in a deflationary environment. Businesses' needs for productivity enhancements and cost controls should encourage technology spending. The sector will benefit from global infrastructure stimulus spending. The sector may be re-establishing its leadership position in the equity market for the first time since last decade's collapse.
Consumer Staples	Equal weight / Underweight	We favor low-cost producers with global reach and brand focus.
Industrials	Equal weight / Overweight	Valuations again imply a weak economic cycle for the next decade. 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.
Materials	Equal weight	With QE 2.0 and Euro QE likely, still-strong demand out of Asia, and China fiscal tightening coming to an end, materials should benefit. Further U.S. dollar devaluation and global stimulus spending should help boost commodity prices over the long term.
Energy	Equal weight	U.S. dollar devaluation should help support energy prices over the long term. Mid-East turmoil adds to the attractiveness of this sector as it can hedge unforeseen energy price spikes. BP oil spill and global slowdown have devastated stock prices in the sector. As heavy liability risks and global slowdown weigh on valuations, we are looking to selectively add.
Consumer Discretionary	Underweight	Stocks offer significant discrepancies in values and opportunities, with a widening divide between winners and losers. High-end and trendy products still selling well.
Health Care	Equal weight	This sector may be undergoing some significant changes with the government taking on a more activist approach, and becoming a major player and insurer. It is important to follow government actions and adjust accordingly. Valuations in most industry groups reflect utility-like pricing environment so the risk/reward is reasonable.

\* 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.

Unmanaged index performance does not reflect fees, expenses or sales charges. Investors cannot invest directly in an index.

Example company name mentioned in the discussion of emerging market consumption has been chosen solely to illustrate macroeconomic concepts. Use of this name does not constitute a recommendation to buy or sell any security or product. The purchasing of put options does not guarantee against a loss within a portfolio. The purchasing of put options may not reduce the portfolio volatility to the extent desired. A reduction in holdings of put options could result in an increased exposure to a market decline. A strategy risks losing all or part of the cash paid for purchasing put options.

The information in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in any account's portfolio at the time you receive this report. The securities discussed do not represent any account's entire portfolio and in the aggregate may represent only a small percentage of any account's portfolio holdings. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

**CALAMOS**<sup>®</sup>

Calamos Advisors LLC  
2020 Calamos Court  
Naperville, IL 60563-2787  
800.582.6959  
www.calamos.com

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