Economic Review and Outlook

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2014: Year of the Fundamental Investor

January 2014

Entering 2014, we expect a good year for global equity and convertible markets overall. The major global economies look positioned to show faster growth, although this positive global synchronization is occurring at varying rates and supported by diverging policies. Historically, the conditions we see today have benefited equities and convertibles, especially cyclical growth opportunities. More importantly, we are encouraged by the emergence of more fundamentally driven markets across asset classes and believe that our active approach is well suited to this environment.

In this Commentary:

Our global outlook continues to be cautiously optimistic.

We are seeing positive synchronization among major global economies, but growth rates will be uneven.

In the developed markets, the U.S. economic recovery looks well supported by consumer activity, healthy corporate balance sheets and low inflation, while positive trends in the euro zone and Japan remain tempered by structural hurdles.

There's more uncertainty in the emerging markets, but we don't expect a hard landing in China and are encouraged by reforms in a number of countries.

We believe the U.S. is in the midst of a secular bull market. U.S. equity valuations remain attractive in our view, especially those of cyclical growth stocks.

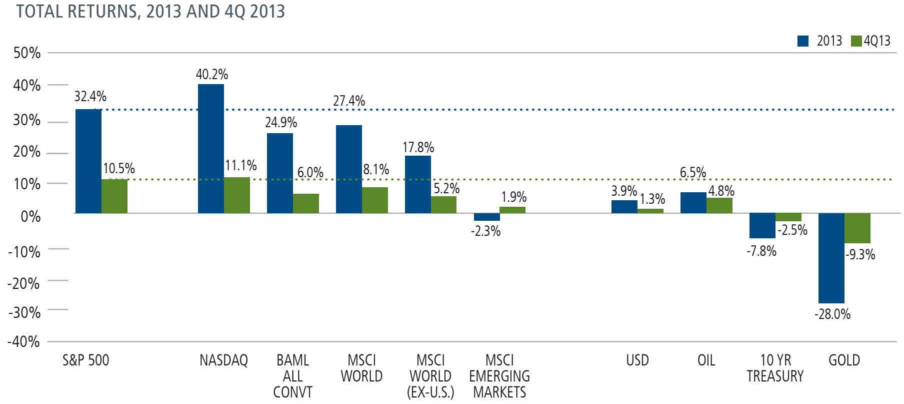
We prefer convertibles and select high-yield issues over investment-grade bonds.

I. Market Review

The S&P 500 Index rang out 2013 with a total return of 32%, its strongest year since 1997 (Figure 1). The Nasdaq Index soared even higher to a 40% gain for 2013, on the back of an increased appetite for risk assets, including smaller cap and technology names. Developed markets outside the U.S. also advanced briskly, supported by improved conditions in the euro zone and brightening sentiment on Japan.

FIGURE 1. U.S. EQUITIES SOAR, WHILE BONDS AND GOLD FALTER

TOTAL RETURNS, 2013 AND 4Q 2013



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

In terms of market performance, the emerging markets (EMs) did not enjoy similarly good fortunes, as market participants struggled with the potential deleterious impact of a U.S. taper on countries with weaker currencies and deficits; these anxieties were exacerbated by concerns of slowing growth. Talk of a potential credit bubble and slowing growth in China was a focal point of investor apprehension.

As is often the case, good news for U.S. stocks was bad news for much of the bond market, and the 10-year Treasury sank 8% for the year. Gold declined nearly 30% as inflation remained contained and equities extended their rally.

For the year (Figure 2), consumer discretionary led, as companies continued to reap the benefits of the wealth effect provided by rising equity markets and recovering home prices. Health care and financials rounded out the top performing sectors.

For the quarter, cyclical growth sectors performed best, led by industrials and technology. Utilities and telecom posted the most muted gains for the quarter and the year, as investors turned away from more defensive names.

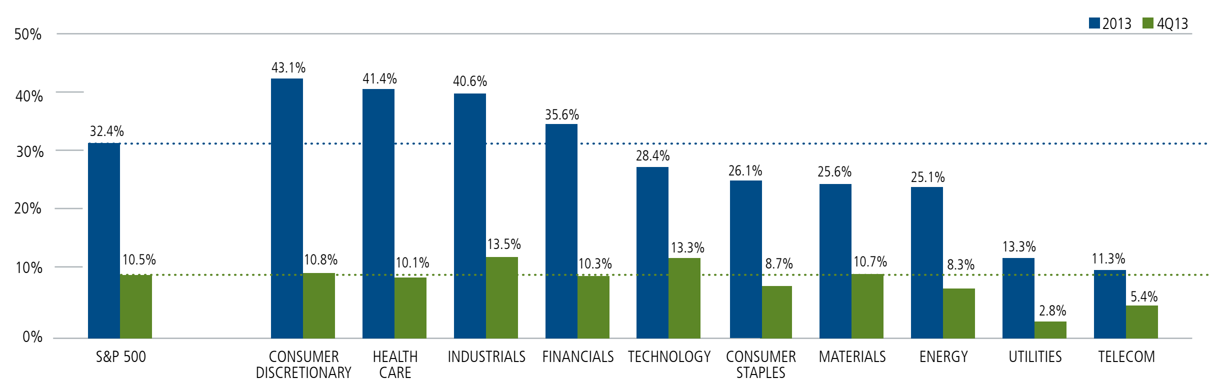
II. Global Outlook

While improved global economic growth in 2013 was led by the U.S., we are starting to see positive global synchronization among major economies. Europe is coming out of its recession, and Abenomics has promoted economic growth in Japan. China's growth has decelerated, but it is delivering solid growth nonetheless, as are a number of lesser-discussed EMs.

In the wake of the 2008 financial crisis and euro zone turmoil, accommodative policy was good for the global economy. Recovery efforts didn't take firm hold until the U.S., the European Central Bank (ECB) and China aligned in an accommodative direction. Now, with the worst in the rear-view mirror, countries are following different routes to move forward as they address local issues.

FIGURE 2. A STRONG SHOWING FOR CYCLICALS IN THE U.S. EQUITY MARKET

TOTAL RETURNS, 2013 AND 4Q 2013



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

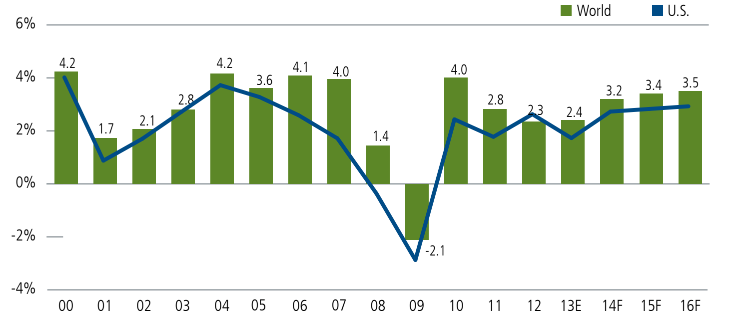
The U.S. is tapering; elsewhere in the developed markets, monetary policy remains highly accommodative and fiscal policy has become more stimulative. The ECB has indicated its willingness to inject more money into the euro zone, and Japan looks set to continue with its unprecedented stimulus measures. China and other emerging markets will likely be in varying levels of tightening as they work to avoid credit bubbles while keeping inflation in check. All in, we expect global growth slightly above 3.0% (Figure 3), with the U.S. and China making strong contributions. As the two largest economies in the world, their economic growth can offset the more modest expansion that we may see in the euro zone and in some EMs.

United States. The U.S. economy looks to be in a "not-too-hot, not-too-cold" period, supported by improving GDP growth and low inflation, upbeat consumers, good corporate balance sheets, strength in manufacturing and an improving trade balance. We expect U.S. GDP growth of 2.5 to 3.0% in 2014, with inflation holding at less than 2%. Against this backdrop, we anticipate that the Fed will withdraw QE stimulus by the end of 2014, while continuing accommodative policy through 2015.

Supported by a wealth effect of rising equity markets and home values (Figure 4), the U.S. consumer is feeling better and spending more, including on autos and other discretionary items (Figure 5). Net worth is higher than it was before the financial crisis, and the deleveraging cycle may have well have bottomed out (Figure 6). This willingness to spend and potentially take on debt should sustain economic growth over the long term.

FIGURE 3. GLOBAL AND U.S. GDP GROWTH

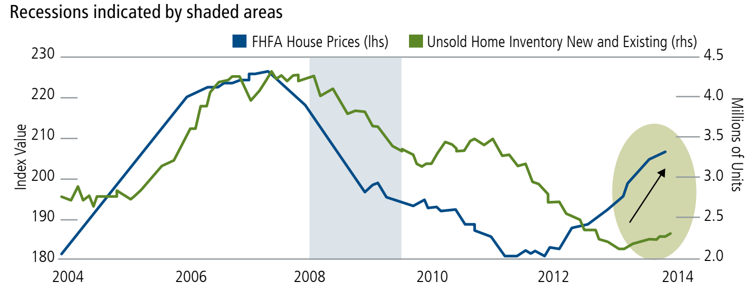
2000-2016, ANNUAL %



Source: World Bank. E indicates estimate; F indicates forecast.

FIGURE 4. U.S. HOME PRICES RISE, HELPED BY LOW INVENTORY

Recessions indicated by shaded areas

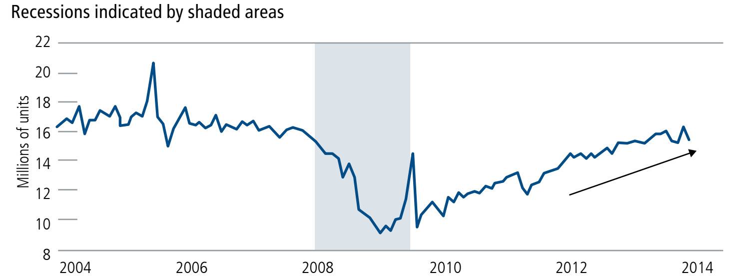


Source: ISI Group

FIGURE 5. U.S. AUTO SALES ON THE RISE

MOTOR VEHICLE SALES

Recessions indicated by shaded areas

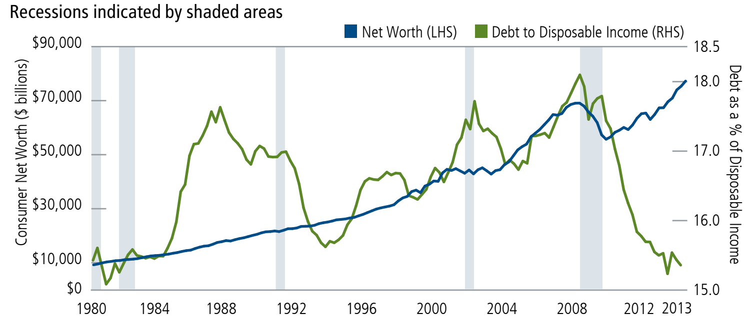


Source: ISI Group

FIGURE 6. U.S. CONSUMER NET WORTH CLIMBS AS DEBT BURDENS PLUMMET

HOUSEHOLD FINANCIAL OBLIGATIONS AS A % OF DISPOSABLE INCOME (RATIO)
HOUSEHOLD NET WORTH (BILLIONS)

Recessions indicated by shaded areas

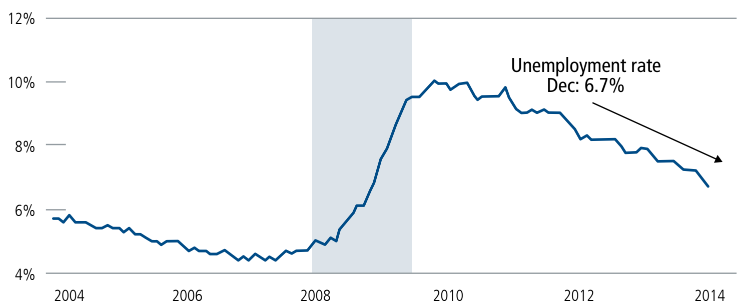


Source: Federal Reserve Bank of St. Louis

The U.S. Labor Department's report that only 74,000 jobs were added in December fell far short of economists' expectations (Figure 7), but we expect the number to be revised upward next month. The calendar was compressed with Thanksgiving coming late; the weather was bad; and if one considers November data (revised up to 241,000 jobs) along with December's data, the average monthly job growth has been respectable at about 160,000. The December numbers are also inconsistent with the other stronger economic data we've seen over the past few weeks, including new unemployment claims and ADP's private sector job growth report.

FIGURE 7. U.S. UNEMPLOYMENT DECLINING

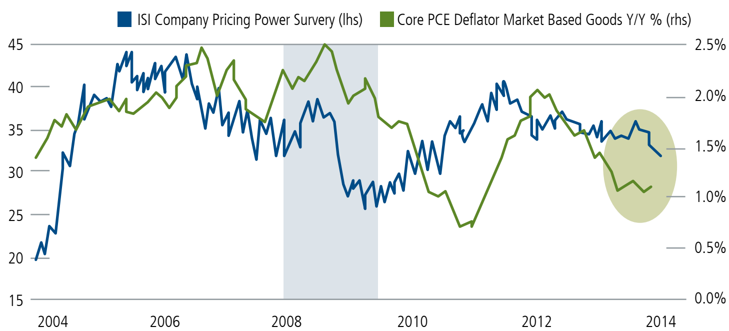
UNEMPLOYMENT RATE %
Recessions indicated by shaded areas



Source: ISI Group

FIGURE 8. INFLATION REMAINS CONTAINED

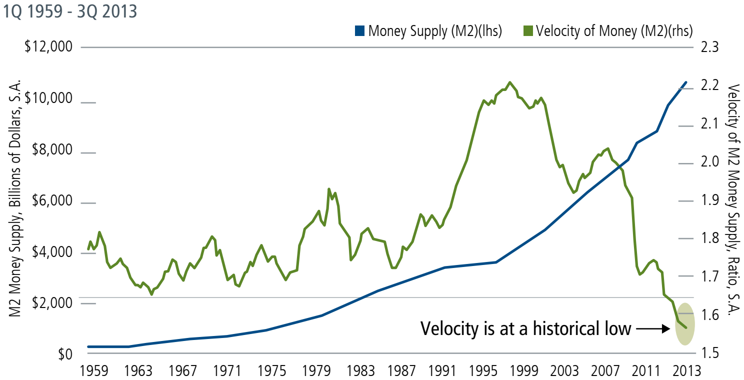
Recessions indicated by shaded areas



Source: ISI Group

FIGURE 9. STALLED VELOCITY OF MONEY SUPPORTS LOW INFLATION OUTLOOK

1Q 1959 - 3Q 2013



Source: Federal Reserve Bank of St. Louis

Businesses are also doing well. Capital spending has begun its long-anticipated recovery, with total expenditures at record highs. Corporate cash growth and high cash balances suggest that this recovery can be sustained over an extended period. Operating earnings of S&P 500 companies continue to rise. Small businesses are adding jobs and benefiting from increased access to credit. As earnings season starts again, we believe most sectors are likely to do better versus reduced expectations. Retail and restaurants may be an exception; like the employment numbers, these sectors were similarly affected by the compressed calendar and weather.

What could derail this recovery? We believe the most significant threat to U.S. economic growth is inflation, which would cause long-term rates to spike. At this point, we believe the threat of this is low. Wage inflation is not a problem, as unemployment is still relatively high. At 1.5%, core inflation is well contained today and looks to be so for the foreseeable future, while the velocity of money, a primary driver of asset inflation, remains subdued (Figures 8 and 9).

We also view government policy as a potential impediment to a more robust recovery. We'd like to see more favorable fiscal policy for business, which in turn could stimulate job growth and GDP growth. It's our hope that Congress will focus on this in 2014.

Euro zone. We believe GDP growth is likely to turn positive in 2014, led by stronger growth in Germany and more stimulative fiscal policy. Stronger U.S. growth should also benefit the region by creating demand for European exports. While we expect regional expansion, the growth will be uneven by country. Germany has continued along the recovery trajectory. Spain, Ireland and Greece have gone through painful austerity programs and appear headed to brighter prospects.

Countries that have not undertaken reform may remain or become potential problems. In France, manufacturing has fallen significantly, public debt has soared to more than 90% of GDP, and President Hollande's aggressive tax agenda has discouraged private enterprise and investment. Due to its size, even a relatively small stumble from France could cause a large impact.

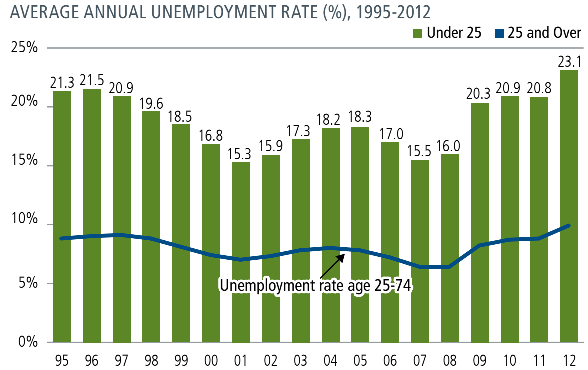
More broadly, structural issues across the euro zone continue to create considerable headwinds to more robust growth: money growth is slow, bank loans have declined, and unemployment remains at more than 10% for the region, with youth unemployment even higher at 23% (Figure 10).

So, while the Fed is ready to start weaning its patient from its meds, the European Central Bank likely has more to administer. While the exact prescriptions are to be determined, the ECB has alluded to providing liquidity exclusively to banks that commit to extending those funds to businesses. In this case, attaching conditions to banks' ability to access additional capital would be a positive because we believe stimulating business is the long-term route to economic growth.

Japan. Markets have loudly cheered Abenomics, with the MSCI Japan Index (local) rising 55%. With the printing presses working overtime, Japan has doubled its money supply, and the yen is down 20% since the outset of Abenomics. Economic growth was strong during the first half of the year, but slowed

FIGURE 10. HIGH UNEMPLOYMENT POINTS TO STRUCTURAL PROBLEMS IN THE EURO ZONE

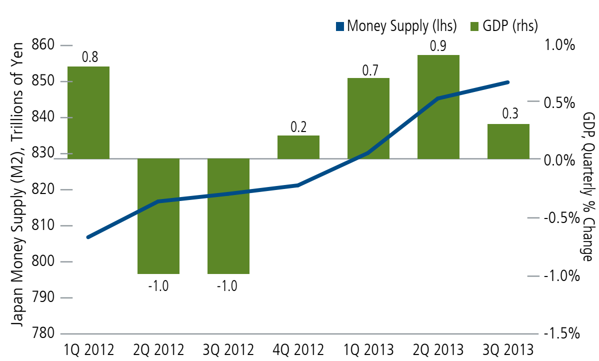
AVERAGE ANNUAL UNEMPLOYMENT RATE (%), 1995-2012



Source: Eurostat

FIGURE 11. WILL BOJ EFFORTS BE ENOUGH TO SPUR GROWTH?

JAPAN M2 MONEY SUPPLY AND GDP, 1Q 2012 - 3Q 2013



Source: Federal Reserve Bank of St. Louis more recently (Figure 11). The trade balance remains problematic, hindered by tepid exports. Ebbing domestic consumer demand provides further cause for concern.

In our view, the Japanese equity market may have gotten ahead of itself in 2013, especially as the sustainability of the recovery is contingent on meaningful structural reform. Persistent overcapacity issues and stagnant wage growth create significant hurdles to more sustainable economic growth. We expect consumers to pull spending forward before the introduction of the value-added tax this spring; this could lead to a near-term boost to economic growth, but it's too soon to gauge the longer-term impact of the tax.

Emerging markets. While we expect broad global economic synchronization overall, the expansion will be uneven. Most broadly, the secular growth trend of the emerging market middle class consumer remains intact. On a country level, we are seeing encouraging reforms in China, Mexico, the Philippines, and South Korea—reforms that have the potential to improve longer-term economic growth prospects, including stimulating foreign direct investment.

In regard to China, we are not anticipating either a hard landing nor a significant acceleration of growth. Rather, we believe the economy will slow to a still-healthy 6% range for the medium term. We are prepared for bumps along the way, as the influence of state-owned enterprises (SOEs) decreases and the role of private enterprises expands.

In Mexico, President Nieto's "Pact for Mexico" has unified opposition parties to implement structural reforms. In the Philippines, economic prospects have been bolstered by President Aquino's government's successful strides against corruption, helping to level the playing field and encourage foreign investment and private enterprise. Moreover, since Typhoon Haiyan, the Philippine government has also shown greater momentum in moving forward public-private partnerships to build infrastructure and promote private enterprise. (For more on Mexico and the Philippines, read blog posts by Co-Portfolio Manager Nick Niziolek, CFA, at www.calamos.com/viewpoints.)

However, the upcoming taper in the U.S. and the aggressive monetary accommodation in Japan give many emerging markets less room to navigate as they attempt to forestall inflation without curtailing economic growth. Saddled with a fiscal deficit and a current account deficit ("twin deficits"), Brazil is in a difficult spot as it seeks to combat slowing growth and high inflation, a challenge made more difficult given our expectation of softer commodity demand and rising real interest rates in that country. For many similar reasons, we're cautious on India's growth prospects, as the government struggles with economic deceleration, rising inflation, a twin deficit, the shadow of a potential ratings downgrade of its debt, as well as a fractious political environment.

Moreover, India and Brazil are two of the five major EM twin-deficit economies with national elections scheduled in 2014; the group is rounded out by Indonesia, South Africa and Turkey. The outcomes will likely lead to structural changes, but whether positive or negative remains to be seen. We should be prepared for more volatility along the way.

III. Opportunities in Global Equities

We see considerable upside in the equity markets in 2014, but at the same time, there could be significant divergence between the winners and losers.

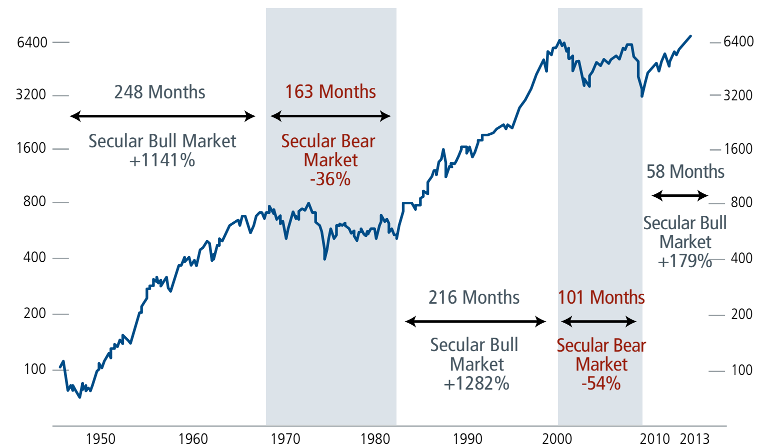
Developed market equities. As the U.S. equity market has rallied, talk about a potential market top has increased. However, steady 2 to 3 percent GDP growth, low inflation and short-term rates, and rising long-term rates have historically supported stocks. We don't see much evidence of a bubble in the U.S. stock market today. Instead, we believe we are in the mid-phase of a secular bull market (Figure 12).

By many of our favored measures, U.S. equity valuations are reasonable. If we consider the earnings yield of stocks relative to 10-year Treasury yields, on the basis of trailing earnings, the S&P 500 equity return premium is 250 basis points over the Treasury (Figure 13). When we consider forward earnings, equities look even more attractive. Equity earnings yields of 6.3% (inverse of a forward P/E estimate of 16.0x for the S&P 500 for 2014 and earnings per share of $115) provide a 340-basis point advantage relative to 10-year Treasury yields at about 2.9%. The return advantage offered by equities over bonds thus ranks at one of its most attractive levels over the past 60 years.

We believe growth equities are especially attractive and cheap versus value (Figure 14). We have found opportunities in technology companies that are benefiting from secular shifts to mobile, the cloud, and internet and social media; consumer discretionary names tied to housing and autos; industrials benefiting from innovations in the U.S. energy sector (the "energy renaissance") and infrastructure spending; and financials that may benefit from the upward slope in the yield curve, increased lending and stronger

FIGURE 12. ROOM FOR THE BULLS TO RUN

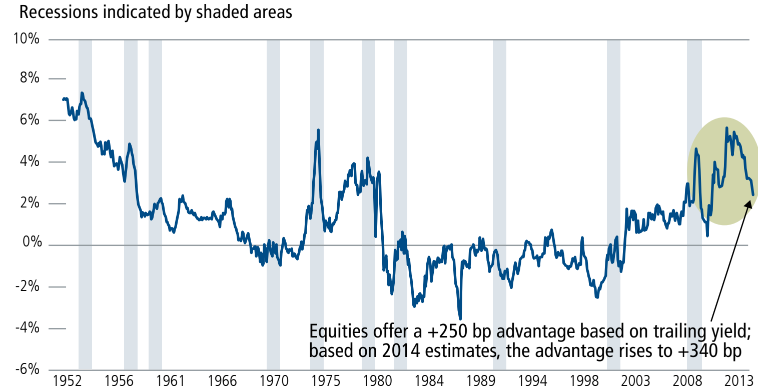
SECULAR PHASES OF THE U.S. EQUITY MARKET
S&P 500 REAL TOTAL RETURN INDEX (JAN 1946=100, LOG SCALE), 1946-2013
Recessions indicated by shaded areas



Past performance is no guarantee of future results.
Source: BCA Weekly Report, "A Secular Bull Market?" Feburary 11, 2013, Updated as of December 31, 2013

FIGURE 13. EQUITIES ARE ATTRACTIVE RELATIVE TO BONDS

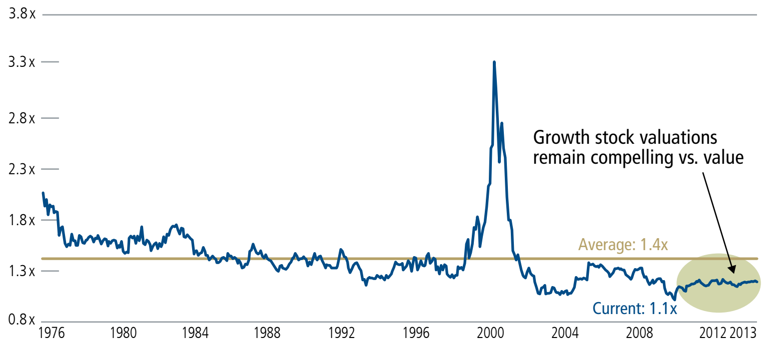
S&P 500[1] TRAILING EARNINGS YIELD LESS THE 10-YEAR BOND YIELD
1952 THROUGH 2013
Recessions indicated by shaded areas



Past performance is no guarantee of future results.
Source: Robert Shiller, National Bureau of Economic Research, Federal Reserve Board, Standard and Poor's, Corporate Reports, Empirical Research Partners Analysis. [1]Capitalization-weighted data.

FIGURE 14. VALUATIONS SUPPORT THE CASE FOR GROWTH

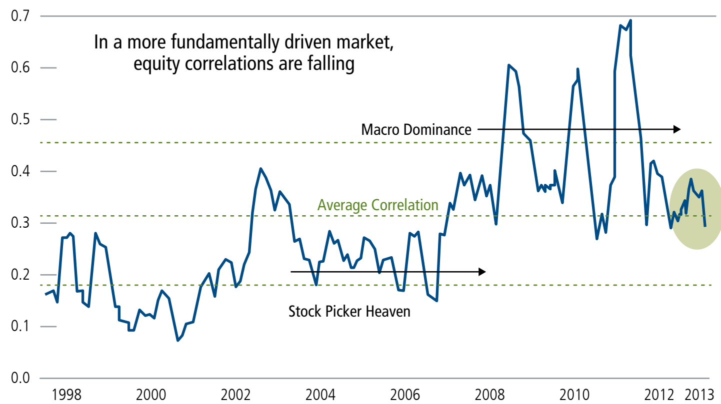
LARGE-CAPITALIZATION GROWTH STOCKS RELATIVE TO NON-GROWTH STOCKS, RELATIVE FORWARD-P/E RATIOS, 1976 THROUGH 2013



Past performance is no guarantee of future results.
Source: Corporate Reports, Empirical Research Partners Analysis.
Capitalization-weighted data.

FIGURE 15. FUNDAMENTALS MATTER MORE

S&P 500 INDEX, AVERAGE PAIR CORRELATION CALCULATED USING 100 DAILY RATE OF CHANGE DATA, SMOOTHED OVER 20 DAYS



Past performance is no guarantee of future results.
Source: GaveKal Research, January 7, 2014.

equity markets. These types of pro-cyclical investments have tended to perform well in similar environments, such as 1994, when long-term interest rates rose, but short-term rates did not in a low-inflation climate. We are more cautious about the prospects for materials, utilities and defensive staples.

As we noted, macro factors have become a less significant determinant of U.S. stock prices (Figure 15). We believe as the taper commences and investors become confident in the economic recovery, this focus on bottom-up factors will continue.

While we're most constructive on the U.S., our team is indentifying increased opportunities within the euro zone. On the basis of valuations alone, euro zone equities look attractive. Still, structural uncertainties in the region remain far-reaching. This has led us to take a selective approach favoring luxury brands, staples with strong EM presence, and consumer-facing technology.

As noted above, Japanese equities soared in 2013, and valuations for many companies are higher than we like. And similar to the euro zone, the uncertainties surrounding the implementation of structural reforms heighten our caution. While we are underweighted to Japan, we have found pockets of opportunity in companies that would benefit from increases in consumer spending.

Emerging market equities. Fundamentals are also carrying more weight in the EMs. Correlations among emerging market country indexes have declined, with individual country and company fundamentals having a greater impact on performance. We believe we are well positioned for this environment.

From a regional standpoint, we are finding attractive prospects in emerging Asia. While we have tended to underweight China versus the broad market, our team is identifying more opportunities, particularly in industries unfettered by SOE competition—such as internet, gaming and consumer spending. We've been more wary of the financial sector, given bank participation in funding SOEs. In Taiwan and South Korea, we emphasize companies that export to both developed and other emerging economies. We're adding exposure to the Philippines, favoring consumer opportunities as well as companies positioned to benefit from infrastructure projects.

In regard to Latin America, we are cautious about Brazil, reflecting the macro outlook discussed above. We're more optimistic about Mexico. Because of its close ties to the United States, Mexico is positioned to benefit from U.S. economic growth versus those countries that are instead more vulnerable to the tapering. We have also diversified our Latin American exposure to include growth opportunities in the Andean region beyond Brazil.

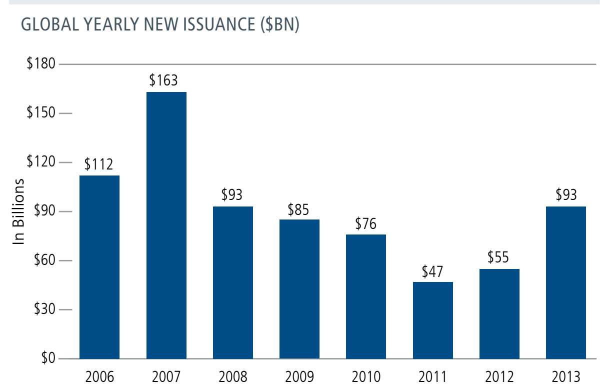
IV. Addressing the Risks in Bonds

As the taper approaches, the risk in U.S. investment-grade bonds and Treasurys has increased. The "safe haven" U.S. Treasury returned -3% for the quarter and -8% for the 2013.

Convertible securities. For investors who seek alternatives to bonds and those who are reluctant to allocate more to equities, the case for convertible securities remains compelling. As equity-linked securities, convertibles are generally less sensitive to interest rates, while providing the opportunity for upside equity participation with potential downside protection if equities decline. We believe these attributes may be particularly beneficial as long-term rates increase and given our expectation that after recent momentum, the equity markets may experience periods of volatility even as they rise.

As discussed in our past commentaries, global new issuance trends remain encouraging. In 2013, new convertible issuance of $93 billion (USD) reached its highest level since 2008 (Figure 16), more than offsetting redemptions. In 2014, we expect continued global economic recovery and rising rates in the U.S. to build upon this trend, while redemption activity is expected to moderately taper.

FIGURE 16. GLOBAL CONVERTIBLE NEW ISSUANCE REBOUNDS



Source: BofA Merrill Lynch

Fundamental research will be essential to identify the best ideas in the convertible market. For example, investment-grade issuance has declined significantly as a percentage of total issuance; in our view, this does not point to a reduction in overall opportunity, but rather the need for rigorous research. Often, convertible issuers with respectable fundamentals choose not to have their securities rated, which does not disadvantage us, because we rely on our proprietary comprehensive research. Moreover, the improving global macro environment allows us to consider a broader spectrum of credit qualities among the rated universe.

High-yield bonds. Although returns in the high-yield market may fall below long-term averages, there are still sufficient pockets of bottom-up opportunity. Supported by strong issuer fundamentals and an improving economic environment, default rates will likely remain low. However, valuations are stretched, especially with spreads below long-term averages. While we expect coupon income to largely offset the impact of rising interest rates, volatility caused by the taper will likely spill into the high-yield market at some point during the year. In this environment, our team believes the most compelling opportunities exist within the middle-credit quality tiers where we are focusing on upgrade candidates and those with enough spread to absorb a back-up in interest rates. The most speculative issues (those rated CCC and below) and those with the highest interest rate sensitivity continue to warrant caution.

V. Conclusion

As active, research-driven investors, we are encouraged by the more fundamentally driven markets that have emerged over recent months—a market climate that we expect will continue through 2014 against the backdrop of global economic recovery. We see compelling upside potential in equities, especially in a U.S. equity market that looks to be in the mid-phase of a secular bull market. However, although conditions look set to improve across much of the global economy, we do not see a rising tide lifting all boats from an investment standpoint.

In an environment with the potential for highly divergent returns, we believe our ongoing commitment to specialized fundamental research will serve us well. In 2013, we strengthened our team through internal promotions as well as by adding individuals to our investment organization, including 12 senior investment professionals (co-portfolio managers, global sector heads, risk management) and five analysts. We are pleased that these efforts are bearing fruit, and together our team looks forward to capitalizing on the opportunities of the global markets in the years to come.

The **S&P 500 Index** is considered generally representative of the U.S. equity market. The **MSCI World Index** is considered generally representative of the market for developed market equities. The **MSCI World ex-U.S. Index** is a market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America (excluding the U.S.), Europe and Asia Pacific regions. The **MSCI Emerging Markets Index** is a free float adjusted market capitalization index cited as a measure of the performance of emerging market equities. The **Russell 1000 Growth Index** is considered generally representative of the U.S. large-cap growth stock market. The **Russell 1000 Value Index** is considered generally representative of the U.S. large-cap value stock market. The **Russell 2000 Index** is considered generally representative of the U.S. small-cap stock market. The **BofA Merrill Lynch VXA0 Index** is considered generally representative of the U.S. convertible market.

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