> **In this commentary, we discuss why we believe:**
>
> » The U.S. should maintain a slow growth path while volatility persists in the global financial markets.
>
> » An environment that encourages business investment and hiring leads to individual and national prosperity.
>
> » Governments should clearly identify and support their countries' comparative advantages.
>
> » Secular growth opportunities remain compelling against a backdrop of a rapidly growing middle class in emerging markets, a focus on productivity-enhancement, and increased longevity.

# Prescriptions for U.S. Economic Growth

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BY JOHN P. CALAMOS, SR.
CEO AND GLOBAL CO-CIO

With the election behind us and the fiscal cliff coming closer every day, many investors are wondering what the implications will be for the U.S. economy, the markets and their portfolios. We believe that market volatility will remain high in this politically charged climate, but see opportunities for investors who can look through the short-term uncertainties. The political volatility around the world makes this an especially perilous environment for market timing, so stay focused on fundamentals.

**We maintain our outlook for slow growth and believe a double-dip recession can be avoided.** We are cautiously optimistic that the fiscal cliff can be resolved before year end. There's a low probability that the U.S. slips over the cliff for a short period of time. Even if this were to occur, we still think a recession can be avoided.

President Obama has a stronger mandate going into his second term, and there have been signs here and there of potential compromises across the aisle. Still, it's clear that we'll see contentious political wrangling through the end of the year. We can only hope that partisan politics ultimately will be put aside in favor of policies that support collective good and future prosperity of the country.

What would this look like in practice? We believe that a strong global economy requires fiscal responsibility at the government level, an appropriate level of regulation, and policies that support economic freedoms, thereby incentivizing businesses to grow. The U.S. must also clearly identify and capitalize on its comparative advantages—that is, what it does best and better than other countries. From this, we would expect wider employment, greater personal wealth and more tax revenues.

With the right long-term approach, we can pursue individual prosperity, corporate prosperity and national prosperity at the same time.

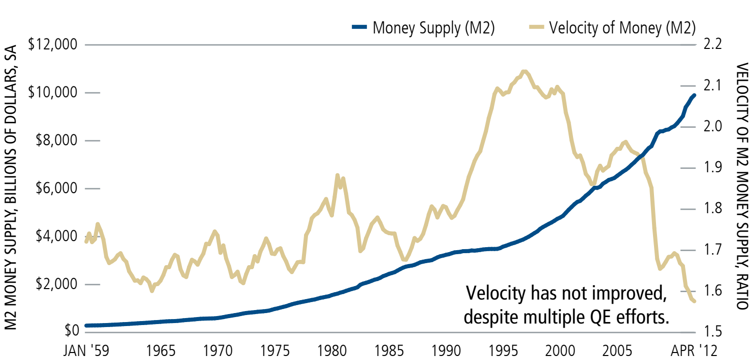
## Short-term solutions have yielded incomplete results

In developed markets, spending and intervention have been the most popular solutions. In the U.S., we've had bailouts and Federal Reserve interventions … QE1, QE2, Operation Twist and QE3. In the euro zone, the European Central Bank has taken unprecedented action with an unlimited debt buy-back plan for some of its most debt-burdened members. Meanwhile, China and other emerging markets have eased monetary policy to stimulate growth.

Monetary easing and similar policies are designed to give a quick shot in the arm to flagging economies by putting more cash into circulation. The idea is that more cash in the system will lead to more spending. This increase in movement of cash, referred to as velocity, would then stimulate economic growth. However, data suggests that this strategy isn't generating the desired results (Figure 1).

**FIGURE 1. MONEY IS STUCK ON THE SIDELINES**

JANUARY 1959 – APRIL 2012




Source: Bloomberg. Federal Reserve Bank of St. Louis

The Federal Reserve controls money supply, and they've opened the spigots full force. However, the Fed can't control the speed that money moves through the economy. The velocity of money is in the hands of banks, businesses and individuals. Velocity depends on banks' willingness to lend, businesses' willingness to risk capital through hiring and expansion, and consumers' willingness to spend. As we wrote in our October Global Economic Review and Outlook, money is not getting where it needs to go to stimulate economic growth and wealth creation. Instead, banks and large companies are choosing to sit on massive amounts of cash rather than loan or spend. (A recent *Wall Street Journal* article estimated that upwards of a trillion dollars is on the balance sheets of nonfinancial companies in the United States.*)

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## How do we fix this?

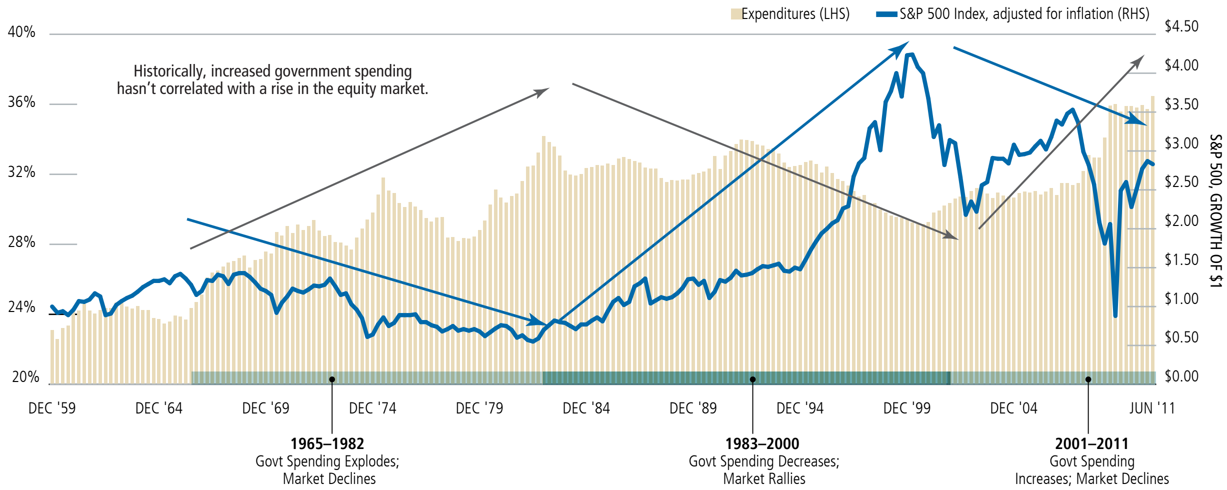
So, if monetary easing and lower interest rates aren't the silver bullet, then what do we think the second-term Obama administration and Congress should do? In large measure, quantitative easing has come up short because of political and regulatory unknowns and other disincentives for taking capital risks.

Job growth comes from small businesses, but regulation concerns discourage banks from extending small business loans. Similarly, mortgage rates may be at

*The Wall Street Journal, "The Business Plan for American Revival," Lloyd Blankfein, November 14, 2012.

**FIGURE 2. FEDERAL GOVERNMENT EXPENDITURES AS A PERCENT OF GDP**

FIRST QUARTER 1960 - THIRD QUARTER 2011




Source: Bureau of Economic Analysis (Federal government expenditures), Bureau of Labor Statistics (CPI), Bloomberg (GDP and S&P 500 Index).

historic lows, but many consumers find that banks have created high hurdles to access. Meanwhile, without clarity about taxes and the fiscal cliff, large U.S. companies are choosing to sit on cash rather than spend, hire and grow.

We believe the solution lies in a greater commitment to pro-business policies and a more reasonable level of government intervention. This summer, I traveled to Greece as a member of the Hellenic Initiative, a group of businesspeople formed to provide economic counsel to the Greek government. Prime Minister Antonis Samaras expressed the need for Greece to "switch from being a country of red tape to one of a red carpet for investors." This approach can empower economic growth in Greece, the U.S. and Europe. In short, we believe the most reliable route to better wages, increased tax revenues and national prosperity begins with a strong private sector.

In contrast, as we noted in our global outlook commentary, rising government debt without rising personal income is a roadmap to economic stagnation and a hurdle to wealth creation. In Figure 2, we show the historical relationship between U.S. federal government expenditures and stock market performance. Increased spending has not been a catalyst for strong market performance.

## Maintaining a competitive advantage in the global economy

There is a popular saying, "capital goes to the place where it is treated best." We will be closely watching policymakers, in the hopes that they can make the U.S. a friendlier destination for businesses. We are concerned that high taxes and complex regulations are disincentives for U.S. businesses to stay and for global businesses to expand operations here (Figure 3, page 4). We've become all too familiar with the wrenching stories of the towns that fold up when a large business leaves. Similarly, new businesses can transform a community, providing jobs as well as opportunities for other companies to meet the needs of workers and their families.

**FIGURE 3. CAPITAL IS TREATED BETTER IN SOME PLACES THAN OTHERS**

FIGURE 3A. COMBINED CENTRAL AND LOCAL GOVERNMENT STATUTORY CORPORATE TAX RATES (%)

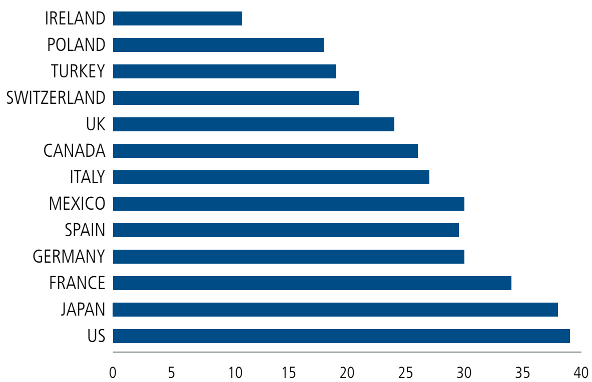
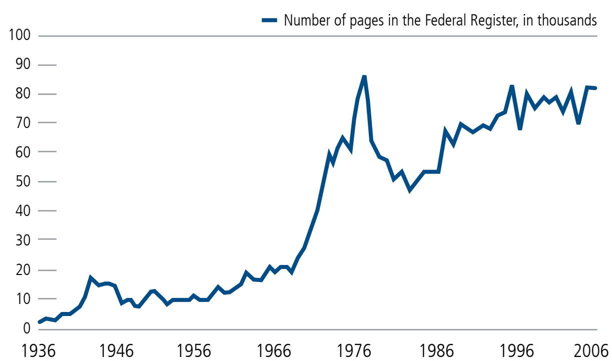



FIGURE 3B. U.S. BUSINESS FACE MASSIVE PAPERWORK




Source: Michael P. Ryan, CFA, UBS Wealth Management Research, Global Economic Review and Outlook, June 2012.

## Identify and support comparative advantages

**We also believe that the U.S. will be most successful if corporations and the government think globally and work together to identify our national comparative advantages.** China's prosperity has been built in large measure by positioning itself as an export powerhouse to the U.S. and other parts of the world. Greece, meanwhile, could be well served by a back-to-basics approach, which could include a rekindled and concentrated focus on its tourist and hospitality industries.

**Returning to the U.S., our comparative advantages are built on innovation and creativity.** We're not the best at producing cheap semiconductors or microchips—and we shouldn't try to be. Instead, American businesses are exceptional at developing revolutionary products, in industries such as personal and business technologies. Entire global product eco-systems can develop around these innovations.

> We see the U.S. also taking a leading role in the rapidly growing field of biosciences, another highly innovative industry.

For example, tablet computers have transformed the way individuals access information and entertainment and connect with each other. The breakthrough technology has come from the U.S., but draws upon a global network of raw materials, from plastics to rare earth metals, as well as component manufacturers, software providers and customer service support. The U.S. government doesn't need to intervene to support these global corporate eco-systems, but should instead focus on removing barriers, such as tariffs. We need to work with trade partners to encourage appropriate currency relationships as well. The government can also support our competitive edge—creativity—by finding ways to enhance the quality of education and access to it.

We see the U.S. also taking a leading role in the rapidly growing field of biosciences, another highly innovative industry. Several demographic trends support biosciences as a secular growth theme: Longevity is increasing worldwide, populations are aging in developed markets, and the emerging market middle class has more resources to devote to health.

The U.S. government can help bioscience companies capitalize on the country's comparative advantages companies by revisiting regulations here as well. As the Milken Institute noted in its recent paper, "Accelerating Innovation in the Bioscience Revolution," revisiting the structure, training and procedures of the FDA could provide benefits not only for bioscience innovators but also for patients depending on the innovations.

## How Should Investors Respond to Election Results?

With the election now in the rear-view mirror and the fiscal cliff dead ahead, many investors are wondering if they should make adjustments to asset allocations. We believe the best course is to maintain a deliberate strategy and avoid reactive changes in the face of near-term market moves. Market timing is always ill-advised, and especially so in a period of politically-driven market volatility.

We ourselves are not making significant tactical shifts as the result of the election. The re-election of President Obama has removed one unknown, but that means other unknowns stay "status quo," at least until the fiscal cliff deadline.

As we noted, we are cautiously optimistic that there will be a resolution to the fiscal cliff before year end. We are prepared for a high level of market volatility through year end, and continue to seek ways to capitalize on volatility when market participants seem to be losing sight of long-term opportunities.

We continue to think globally and long-term, and encourage investors to do so as well. **The fiscal cliff is front and center, but we must not lose sight of the other crosscurrents affecting the financial markets.** In the U.S., we have seen improvements in the housing market and access to mortgages, and this can help boost companies in the financials sector. A better housing market can also support companies in the consumer discretionary sector as consumers become more confident about their financial well being (the "wealth effect"). In an environment of slow growth and against a backdrop of continued reflation, we expect companies in select cyclical industries to benefit as well. With near-term threats to the Affordable Care Act mitigated, hospitals now have a tailwind, while insurance companies face new headwinds.

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Although the damage estimates are far from finalized, we will be closely analyzing the impact that Hurricane Sandy will have on the economy as well as on individual companies. GDP growth in the fourth quarter will likely reflect a dip in consumer activity but longer term, there could be a boost coming out of rebuilding efforts.

Looking overseas, we believe that the secular growth opportunities related to the expansion of a middle class in China remain intact and highly compelling, even as economic growth becomes more measured (though still

### GLOBAL SECULAR THEMES AND LONG-TERM OPPORTUNITY

An important element of our portfolio construction process is the identification of global secular growth trends that transcend the ups and downs of short-term volatility. Companies positioned to capitalize on secular trends may have better prospects through periods of slower economic growth and full market cycles. These are some of the most important themes we see:

- A rapidly evolving middle class in emerging markets creates growth opportunities for companies across market sectors—staples, luxury goods, education, health care, telecommunications
- Technology companies remain compelling given demand for devices and services that provide connectivity and information
- Bioscience innovators are positioned to capitalize on longevity trends and individuals' desire to stay healthy
- Global infrastructure build-out in developing and developed nations can support demand for industrial and materials companies

high, both in absolute terms and relative to the global economy). We will be closely following how the Chinese government approaches economic freedoms going forward, such as currency and trade policies. As new leaders take the helm in China, we'll be watching for policies that can stimulate stronger consumer demand in that country, creating a more balanced economy as exports slows.

> We maintain conviction in the attractiveness of equities.

We are staying highly attuned to risks associated with the euro zone and its continued list of woes. Spain is sinking deeper into recession; the European Central Bank President Mario Draghi has warned that the long-term weakness in the union is now adversely influencing Germany's economic growth; and the UK raised concerns about its future membership in light of the union's budget plans.

## Opportunities in the Global Markets

Because of the uneven economic prospects we see around the world, we believe it makes most sense to maintain a focus on global companies, as they have more access to the areas where secular growth trends are most compelling. They can also go where capital is treated best.

**Equities.** On an asset class level, we maintain conviction in the attractiveness of equities, based on our assessment of the markets as well as individual opportunities. We expect that a low-rate environment will continue, and with it a weaker dollar, which supports the case for equities. Additionally, the spread between average earnings yield of companies in the S&P 500 Index and the 10-year U.S. Treasury yield remains highly attractive relative to levels of the past 60 years. By this measure, equities do not appear overvalued.

**Convertible securities.** We believe that convertible securities remain a compelling choice for investors who wish to participate in the equity markets, but who remain concerned about equity market volatility. Because they blend the opportunity for equity market participation with the potential for resilience in down markets, convertibles can be thought of as lower-volatility equity securities. A convertible strategy can be actively managed to pursue an asymmetrical risk profile, seeking to capture a greater portion of equity market upside than downside over full market cycles.

In our experience, convertible securities can be particularly attractive in periods of volatile, upwardly rising equity markets. Additionally, many convertibles are issued by growth oriented companies. As we discussed, we believe that growth equities are attractively valued; and we view convertible securities as a way to access this well-priced growth. We continue to find a number of convertible securities that offer a good balance of equity and fixed income characteristics.

Over recent years, issuance in the convertible market has declined, due in large measure to an extended period of prevailing low interest rates—an environment that encouraged corporations to issue "straight" rather than convertible debt. However, convertible issuance can be influenced by a number of factors, including economic growth. As the U.S. economy continues its recovery, companies are finding that they have more choices for accessing the capital markets, including through the issuance of convertibles. The improved performance of equities in 2012 can also contribute to a more favorable issuance environment.

**Fixed Income.** In regard to fixed income asset allocation, we believe the mid-grade sector of the corporate bond market offers appealing risk/reward characteristics for income-oriented investors, including competitive income and the potential for capital appreciation in a slow-growth environment. Treasurys, meanwhile, should be approached with caution—especially long-dated issues. Yields have plummeted in a global low-rate environment and are extremely vulnerable to rising inflation.

With interest rates at historic lows and the Fed stating its intention to suppress them for the foreseeable future, inflation may not appear to be a threat. However, when the Fed and other central banks reverse policies, rates could rise sharply and with little warning, as they have in the past. Long-term investors, particularly more conservative ones, should address this possibility before it happens.

## Conclusion

We believe that the U.S. economy is likely to maintain its slow-growth path and avoid a recession. Although the partisan political environment is highly discouraging, we expect that a precipitous fall from the fiscal cliff can be averted. We maintain hope that the U.S. will take steps to become a better home for capital and for businesses. This can set the stage for job growth and increased prosperity for more individuals. Yet, we are not dependant on these outcomes coming to pass. As active, fundamental investors, we must be ready to invest through many different environments, always considering the risks and opportunities of multiple economic scenarios. We are prepared to adapt to the evolving environment as we maintain our long-standing investment processes.

CALAMOS®

**Calamos Investments LLC**
2020 Calamos Court | Naperville, IL 60563-2787
800.582.6959 | calamos.com | caminfo@calamos.com

**Calamos Investments LLP**
No. 1 Cornhill | London, EC3V 3ND, UK
Tel: +44 (0) 20 3178 8838 | calamos.com/global



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