

Global Economic Review and Outlook



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We believe that investors should look through near-term volatility for long-term opportunities.

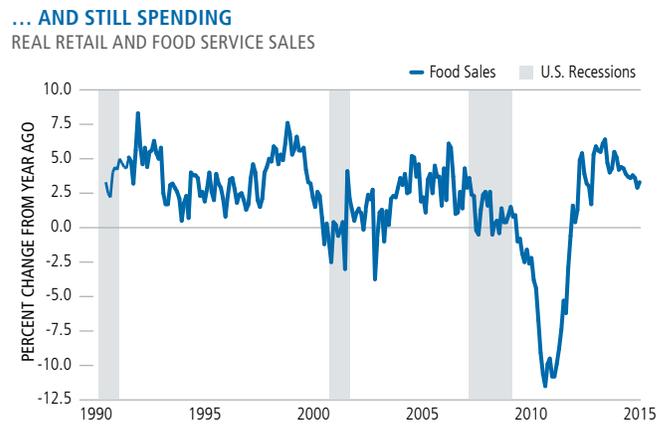
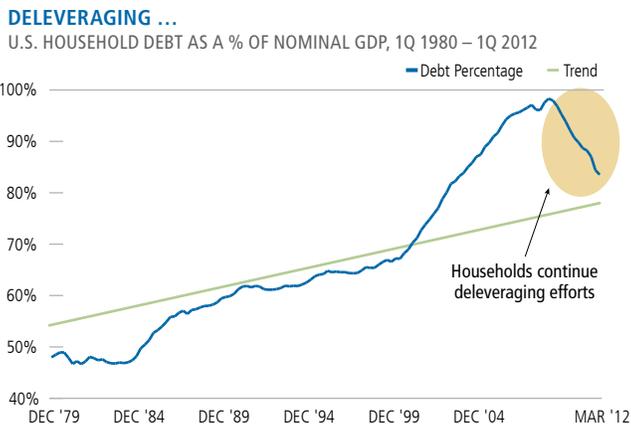
After a strong “risk on” first quarter, the pendulum swung back to “risk off” during the second. Falling commodity and equity prices around the world highlighted the fears of a synchronized global slowdown. In another sign of concern, the U.S. and German bond yields touched all-time lows during the quarter, indicating slow growth may be here to stay for an extended period.

Europe was the source of greatest anxiety, as highly contentious debates continued around an intractable knot of solvency and sovereignty issues. During the final weeks of the quarter, market sentiment brightened, buoyed by European policymakers’ decision to approve the direct recapitalizing of banks and the purchase of sovereign debt by the European Stability Mechanism. The news suggested that solvency was being addressed at a more fundamental level and not merely as a liquidity issue. Of course, much more needs to be done as details of the plan remain somewhat unclear, and the creation of a supervisory mechanism for tighter eurozone integration remains outstanding.

The U.S. continued on its mild recovery but market participants have grown anxious with the pace, particularly as the U.S. fell short of 2% growth. Job growth was particularly disappointing and the velocity of money continued to be tepid, a signal that stimulus policies have fallen short of their intended objectives.

Even so, the U.S. consumer remained resilient, with marginal personal spending increases reported in April and May. This was particularly encouraging as these gains occurred alongside continued household deleveraging (Figure 1). A decline in energy prices also

FIGURE 1. U.S. CONSUMERS ARE GETTING THEIR BALANCE SHEETS IN ORDER



GLOBAL OUTLOOK

- > **Political volatility stokes market volatility.** We expect politics, from eurozone negotiations to the U.S. presidential election to transition of leadership in China, to contribute to volatility throughout the global financial markets.
- > **Emerging markets continue to grow, albeit more slowly.** Emerging markets should continue to contribute to global GDP growth, even if at a slower pace than recent years. Secular trends relating to emerging markets, especially the growth and maturation of the emerging consumer, can continue to provide economic growth opportunities for companies around the world. Additionally, recent reports suggest that China may be in a transition to re-acceleration.
- > **U.S. stays on a slow-growth track.** Economic data continues to affirm our view that the U.S. would avoid a double-dip recession. Although employment data remains bleak, housing data has improved and consumers are doing the right things to support the economy—deleveraging and spending.
- > **The eurozone remains a source of volatility.** We've seen steps toward addressing the eurozone crisis as more than a liquidity issue. While this is encouraging, far more needs to be done and the road ahead is long, difficult and unclear.
- > **Ultimately, the pace of growth should correlate with fiscal restraint and expanding economic freedoms.** We expect uneven growth from country to country as some nations adapt more readily than others to evolving sovereign relationships. Sound fiscal policies and expanding economic freedoms, such as fair trade and reasonable regulations, can help countries capitalize on the opportunities of globalization.

INVESTMENT OPPORTUNITIES

- > **Equities are highly compelling.** Equities remain the most attractive asset class in the current environment, particularly growth equities. Investors remain overly pessimistic about the prospects for growth companies, and we believe many equities are notably undervalued.
- > **Mid-grade corporate bonds remain attractive.** Even though inflation is low today, history has shown that it can rise rapidly and unexpectedly, a particularly detrimental scenario for holders of longer-term government bonds. Meanwhile, given a slower-growth environment, lower quality corporate bonds may not be providing appropriate compensation for risk. However, we continue to find attractive risk/reward among select mid-grade corporate credits.
- > **Global businesses provide access to secular growth.** Broadly speaking, global companies with geographically diversified revenues and healthy balance sheets may be best positioned to grow on the back of secular trends, especially those related to emerging markets. Moreover, these companies have the flexibility to go where capital is treated best.

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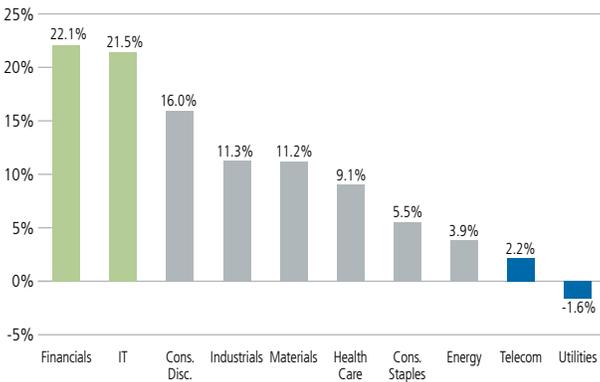
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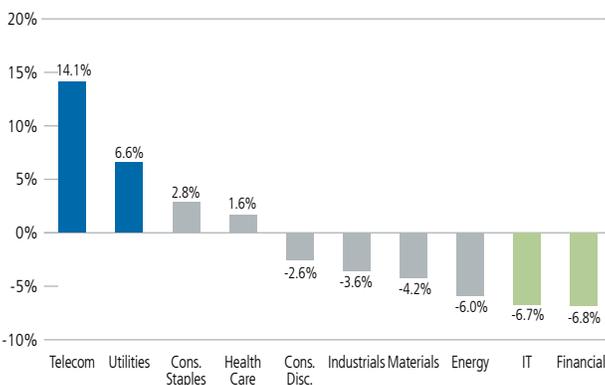
FIGURE 2. RISK ON, RISK OFF ...

Pronounced sector rotation between the first and second quarters

S&P 500 INDEX, 1Q 2012



S&P 500 INDEX, 2Q 2012



Past performance is no guarantee of future results.
 Source: Capital IQ. The S&P 500 Index is considered generally representative of the U.S. large-cap stock market.

provided relief, and inflation appears to be controlled—for now. Some of the most encouraging news came from the housing market, with reports that sales of new single family homes rose at their fastest pace in two years.

Emerging markets remained worrisome for investors. China’s most recent economic growth came in at 7.6%, still strong but below past levels. PMI data continued to show weaker sequential growth. However, inflation stayed on a downward trend, driven mostly by lower food prices, and

potentially providing for further policy flexibility. Over the past year, China has taken steps to align with the reflationary efforts of developed countries and has also taken action to spur consumption within its own borders.

Against these crosscurrents, equity markets sold off in the second quarter, with the MSCI World Index falling -4.86%. Europe declined most sharply, with the MSCI Europe Index returning -7.61%. The U.S. market held up better, as the S&P 500 Index posted a more modest decline of -2.75%. Economic worries took the greatest toll on companies with higher growth characteristics as well as more cyclical companies. Within the U.S. market, the financials, information technology and energy sectors fared worse, as investors gravitated toward more defensive areas of the market—telecommunications, utilities, consumer staples, and health care (Figure 2).

Meanwhile, fixed income securities gained in the risk-averse market environment. U.S. Treasurys performed strongly, as heightened economic uncertainty helped to push government bond yields down. Commodities remained volatile, with gold and oil prices sliding significantly, again iterating concerns regarding future growth.

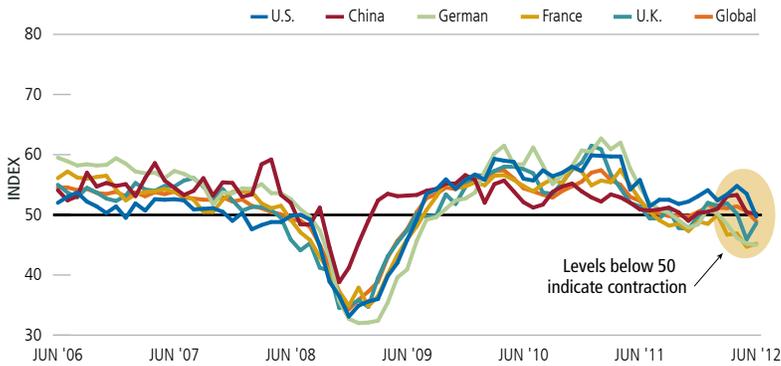
Outlook: Political Volatility Continues to Create Market Volatility

We expect more of the sideways-trending market with volatile swings. Globally, political volatility is stoking market volatility around the world. We expect this to continue in the run up to major elections in developed and emerging markets. The secular low for global economic growth was likely reached in 2009, but the fear is that on a real basis, we may experience lows near that level again. Global PMI data

FIGURE 3. SIGNS OF SLOWDOWN IN THE GLOBAL ECONOMY

PMI LEVELS: MAJOR COUNTRIES

JUNE 2006 - JUNE 2012



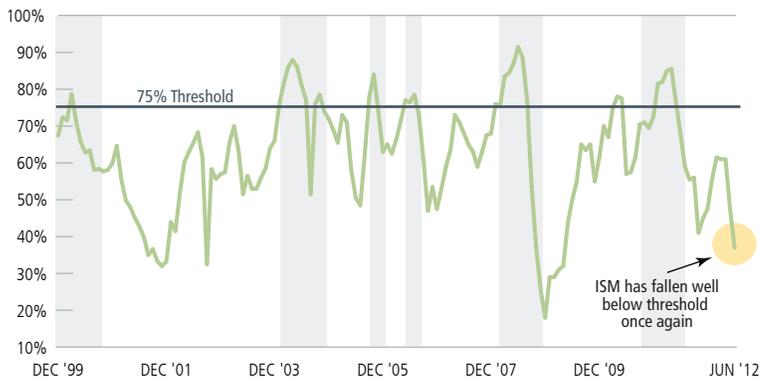
ECRI INDEX VS. S&P 500 INDEX TOTAL RETURN, LESS 10-YEAR TREASURY TOTAL RETURN

SEPTEMBER 2005 – JUNE 22, 2012



ISM MANUFACTURING PRICES PAID INDEX

DECEMBER 1999–JUNE 2012



Source: Bloomberg. The ECRI Weekly Leading Index is a measure of leading economic indicators. ISM Manufacturing Prices Paid Index tracks business sentiment regarding future inflation. A higher figure indicates increased inflation expectations.

and leading indicators paint a picture of a slowing global business environment (Figure 3).

The European crisis is still in the early stages, while the U.S. will be dealing with messy debates about the potential “fiscal cliff” and rationalizing spending and tax rates. The emerging economies are now firmly into the deflation camp and China has reduced interest rates twice in the last month. Stimulating growth via monetary policy is popular around the globe, but only a few countries are fiscally sound and utilizing fiscal policies. The downside of the credit/debt cycle will have to play out. The current approach around the world is to spread the cycle out to reduce the shock, but that means muted growth and social stress in the developed world for the foreseeable future.

Equity markets are grappling with uncertainties associated with high levels of debt in developed nations and slower global economic growth. Although markets have advanced for the year-to-date, these gains have been earned against a backdrop of volatility (Figure 4). The downside in the market is still significant as we move through this deleveraging cycle in a challenging global political environment. An upside surprise could come from a resurgence of emerging economies’ growth, change in fiscal policy, European union solution, or a more pro-business climate in Washington.

While the issues facing the global economy are real—and many—we believe that investors are overly skeptical about the long-term opportunities in the markets, particularly those offered by global growth equities, as we will discuss at greater length. Secular trends, particularly those related to the rise of the emerging

market consumer, may provide a powerful wind in the sails for companies in a variety of sectors.

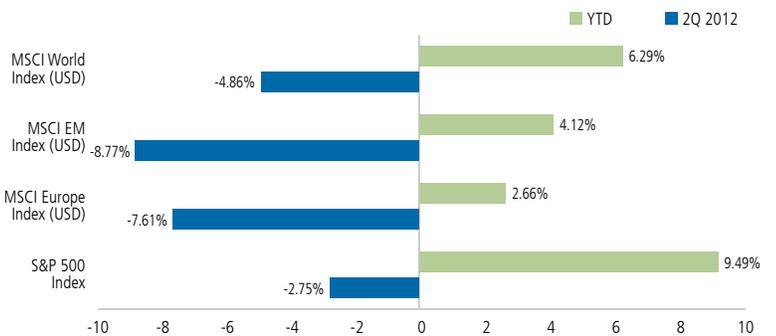
A good deal of money is on the sidelines, and could move back into the market. Such a move, along with slow-but-positive growth and attractive equity market valuations, could set the stage for a more prolonged rally. If the debt mountains and fiscal policies in developed markets can make a significant directional change, then we believe equity markets can rally. The false choice between fiscal austerity and growth is a Keynesian policy trap. We believe that long term, fiscal responsibility and the encouragement and incentivizing of private industry is the correct policy.

The combination of more pro-growth economic freedoms and fiscal austerity should eventually help move the world into a sustained wealth creation phase. Investors need to be patient, as this process may likely take years. Indeed, while we believe we have a good idea of the conditions that would be required to set a positive market in motion, it is impossible to predict exactly when the turn will come. History has taught us time and again that markets can shift quickly and unpredictably. The best course is to maintain long-term perspective and invest ahead of the turns.

The Known, the Unknown and the Road Ahead

Europe. Eurozone problems are chronic issues that will likely cause considerable global financial market volatility for the foreseeable future. The road ahead for Europe is long and difficult, with many unknowns. Recessionary pressures are building in the eurozone and the PIIGS are near insolvency. The dysfunction in the monetary union is well known. So, the markets see the problems but struggle to handicap the

FIGURE 4. YTD RETURNS MASK A VOLATILE 2Q FOR EQUITIES



Past performance is no guarantee of future results.
 Source: Bloomberg. The MSCI World Index is a market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America, Europe and Asia Pacific regions. The MSCI Europe Index is a market capitalization weighted index composed of companies representative of the market structure of Europe. The MSCI Emerging Markets Index is a free float adjusted market capitalization index cited as a measure of the performance of emerging market equities.

most likely outcome. The optimist feels that a fiscal union will somehow come about and that the wealthy European nations will ultimately pay for the fiscal profligacy of their neighbors, giving up sovereignty to save the eurozone. If that happens, we could likely see a strong rally in equity markets and risk assets, but also further currency debasement and rising tensions as some countries vie for larger pieces of the spending pie, for which their more solvent neighbors are obligated to pay.

On the other hand, the move to protect independent solvency and sovereignty could result in a sharp sell-off in risk assets, especially those of deeply indebted countries, such as Greece. The Greek debt and equity prices imply that it is very likely that Greece will have to deal with its fiscal mess on their own. But Spain and Italy still have a de-facto ECB backing implied in their debt and equity prices, possibly a result of the "too big to fail" implications for the union as a whole. Overall, the equity and bond markets are pricing in the expectations that the ECB continues to fight the battle

via quantitative easing and financial repression, harboring hopes that growth on the European continent picks up.

Meanwhile, France has moved into the socialist camp again. It will be interesting to see how that country taxes and spends its way to prosperity if the youth unemployment rate remains over 25% for another decade. The ECB and rolling Long-Term Refinancing Operation (LTRO) programs may be able to continue for a while, but even if Spain can be kept on

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life support it is not likely that France can. In a few years, this could be the straw that breaks the back of the euro union.

United States. As we discussed in our April commentary (“All Debt Gets Paid Back with Someone’s Equity”), the U.S. is much further along in dealing with its debt deleveraging cycle, although it has yet to turn the corner in regard to reducing Federal debt. We expect volatility to persist on the back of policy uncertainty and in the run-up to the November elections.

There’s a good amount of data supporting our view of a continued recovery, albeit a slower one. The declining cost of energy in the U.S. offers consumers and businesses a bit of relief (Figure 5). As we noted, consumers continue to both spend and deleverage. Housing markets across the country show signs of life and consumer prices have been very tame in general. We also see improvements in the

financial pictures of many state and local governments. The downsizing in a number of states is essentially complete. Unfortunately, other states, such as California and Illinois, have a long way to go to address their fiscal spending and debt burdens.

Unfortunately, the U.S.’s known issues also include a gridlocked government. The entire blame for an anemic economy cannot be laid at the foot of the current Congress and president; but directionally, we are still employing the same type of policies and thinking that got us into this mess, with many of the same players. Real change will be needed lest we follow Japan’s path into a sluggish decade. We don’t believe that making a broken government larger is the way out. Our reading of history does not suggest that larger, more centrally controlled governments will be fair and more caring. The debt burden in the U.S. is known but the tipping point on this debt is not. The direction of fiscal policy is unknown and the monetary policy manipulation endpoint is also not known.

FIGURE 5. RELIEF AT THE PUMP



Past performance is no guarantee of future results.

Source: Michael P. Ryan, CFA, UBS, “Global Economic Review and Outlook,” June 2012, using data from Bloomberg and UBS WMR.

Emerging Markets. We believe that emerging markets will remain an important driver within the global economy, even if we see a continued moderation of economic growth from the levels of recent years. Although we have yet to see a real impact from the accommodative monetary policy that began in the second half of 2011, we believe the odds are that China can sustain its relative growth and navigate a soft landing. There have also been indications that the country may be transitioning to a re-acceleration of growth. And, more broadly, the secular trends relating to the emerging markets remain extremely compelling for investors.

Of course, exactly how the emerging market growth story plays out over the near-term remains to be seen. The issues that could influence the trajectory of emerging market growth include a further slowdown in China, as well as the deflating of China's credit-induced real estate and infrastructure bubbles. A large credit bubble in an economy growing at 7 to 10% is easier to deflate than in an economy growing at 2%. Additionally, China, like many other emerging markets, is in the midst of a shift from infrastructure build-out to a consumption and service driven economy. This landscape provides a different context for analyzing data relating to manufacturing and industrial production.

Many unknowns relate to the role of government and the political evolution of emerging markets, such as the potential risk coming from a rise of state capitalism. As we noted in our recent whitepaper, *Evolving Emerging Market Strategies* (June 2012), "economies are evolving rapidly, but often against the backdrop of significant political and social conflict. There are many possible routes to take—free market, controlled economy or something in between. The

course each country chooses sets the stage for different risks and growth outcomes."

Another unknown is the impact that developed market debt burdens could have on the emerging markets. Although many emerging markets have come into their own over the past decades, they cannot go it alone in a global economy. We will be watching carefully to see how emerging markets, particularly China, respond to their increasingly central roles—and responsibilities—within the global economy, specifically as they relate to currency pegs and trade policies.

We believe that emerging markets will remain an important driver within the global economy, even if we see a moderation of economic growth from the levels of recent years.

The rise of the middle class in emerging markets over recent years is perhaps the most exciting "known" for the global economy. We expect the growing purchasing power of China's consumers to provide an economic engine for the Asia region and other emerging markets, in turn fueling the growth of a middle class elsewhere. This demographic shift has opened the doors to significant growth potential for companies all over the world—in both developed and emerging markets. New markets for technology innovations, consumer products, health care and educational services are growing, as are opportunities for certain companies in cyclical industries. Also, as we noted, many emerging markets are in the midst of rapid shifts from infrastructure building

to consumerism, which we believe can create different investment opportunities over time.

Economic Growth is About Economic Freedom

As we have written in the past, in an increasingly globalized economy, relationships and outcomes are intertwined and evolving. These changes may be uncomfortable, and may even feel unfair, but they can also provide economic growth for countries and governments that look forward, not back. These opportunities are far from guaranteed, however, and will wither without a global backdrop of economic freedoms. Protectionist trading policies, retaliatory threats against trading partners and currency manipulation are poor strategies for developed and developing economies alike. They upend the growth potential of globalization.

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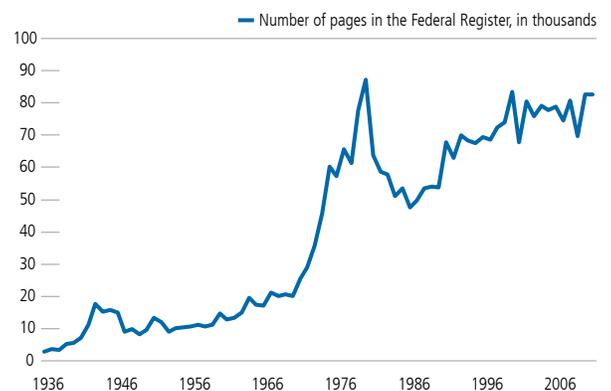
Investing during a debt deflation cycle is painful. So too is the discipline required to implement corrective policies over the long term. Wealth creation is nearly non-existent and debt reduction, defaults and forgiveness wipe out equity on the other side of the ledger. Often, governments heavily manipulate currencies and interest rates, as well as targeted assets and subsidized businesses. This manipulation can work its way into many aspects of the capital markets and personal freedoms in the name of fairness, better regulation or because capitalism supposedly failed. Capitalism works precisely because of its ability to motivate self interest,

personal freedom, and fairness, while it eliminates inept, uncompetitive or corrupt businesses. Unfortunately, many politicians seem to have little appetite for this type of change and competitive destruction.

As the U.S. government has stepped into certain sectors (recent examples being financials and health care sectors), the mechanisms of capitalism are impeded. This can come with a high price: a collapse in economic freedoms, wealth creation and risk taking as return on investment falls to levels that are not commensurate with their risk.

A growing business sector cannot benefit from confusing regulations (Figure 6) and the threat of higher taxes. The expectation that higher taxes will be the reward for risk taking and success is a powerful disincentive for businesses to hire and grow. So, too, are uncertainties regarding future health care costs, inflation, regulatory costs and income and payroll taxes. Additionally, when governments decide which businesses fail and which survive, crony capitalism replaces fairness.

FIGURE 6. U.S. BUSINESSES ARE SLOGGING THROUGH PAPERWORK



Source: Michael P. Ryan, CFA, UBS, "Global Economic Review and Outlook," June 2012, using data from Law Librarian's Society of Washington, DC, UBS WMR

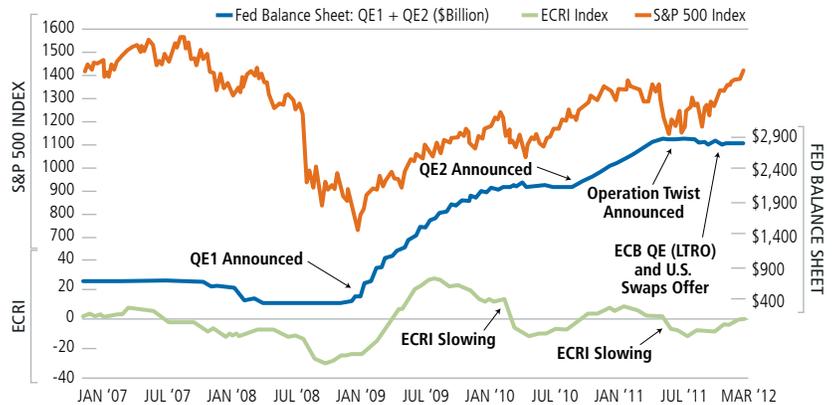
We believe that central banks can also undertake actions which run counter to promoting economic freedoms. Although over the short term, this may provide welcomed breathing room, deferring the moment of reckoning doesn't make the pain go away. Often, it makes it worse. The abuse of the monetary system—by which we mean an extended period wherein the cost of money is excessively low—leads to a huge misallocation of credit and capital. As we saw during years leading up to the housing bubble in the U.S, a monetary and credit induced bubble can usher in further erosion of economic freedoms and an anemic economic environment. The bursting of the bubble and asset prices, and the failing of banks, pension funds and businesses, leads to a cry for government help that opens the door for monetary value debasement, unfunded spending, and further regulatory overreach.

Fool Me Once ...

The financial markets are getting smart in regard to the asset reflation game that the developed world's central banks are playing. The magnitude and duration of asset rallies in response to quantitative easing (QE) phases have lessened (Figure 7). In the end, the net effect of monetary asset reflation should be no significant change in real economic wealth but an illusion of recovery and health. The next QE from the Fed or the ECB will likely fool even fewer investors, but could still cause a short-term rally in targeted assets, if only from the reality of supply and demand. The markets are now looking for real sustainable solutions and a real clearing of excess debt.

But, let's consider what could happen if Fed intervention ceases. Deflation could take hold, with a decline in consumer

FIGURE 7. EQUITY MARKET SENSITIVITY TO FED INTERVENTION



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

prices. Businesses may feel a profit margin crunch but would also get creative and find ways to drive productivity. Furthermore, asset deflation in the housing, bad mortgage and sovereign debt market could find a clearing level, thereby providing investors and consumers cheaper homes and higher-yielding paper. The feared deflation could very well normalize market prices in line with economic reality, while ending currency debasement and interest rate repression. A real recovery could come more quickly.

Opportunities We See Today

From an asset class standpoint, we believe that equities provide the best opportunities for long-term investors, on the basis of relative risk/reward, valuations, and the potential for inflation. In particular, we are favoring global businesses with geographically diversified revenue streams that have demonstrated the ability to generate cash flows in more challenging economic environments. Although the slowdown in the global economy has recently had an impact on companies with global revenues, we believe many of these multinationals are best in class and may be able to

better ride out slower economic growth. These companies are capitalizing on long-term secular trends, such as the rise of the emerging market consumer. Because of their global presence, multinationals also have the flexibility to move their capital where it will be treated best. This is a key advantage, given the uneven economic environment and different business climates around the world. Figure 8, for example, shows the wide disparities in tax rates among countries.

The most compelling fixed-income opportunities may exist within the mid-grade credit tiers, where we've found many issues offering favorable risk-reward characteristics.

As we have discussed, there are many uncertainties, but we believe that market participants need to think longer term and look beyond near-term volatility. This shorter-term focus has taken a particular toll on growth companies, where valuations are largely predicated on future cash flow generation. Negative sentiment has driven the valuations of many global growth equities to levels that we believe are attractive, based on cash flow as well as other more traditional valuation metrics. In our view, the merits of these growth companies will be more fully recognized as investors take a longer-term perspective.

Within the fixed income market, investors should be cautious. Although inflation remains low and we expect central banks will maintain a high level of intervention to keep the global economy afloat, history has taught that interest rates can move quickly and unexpectedly. A rapid

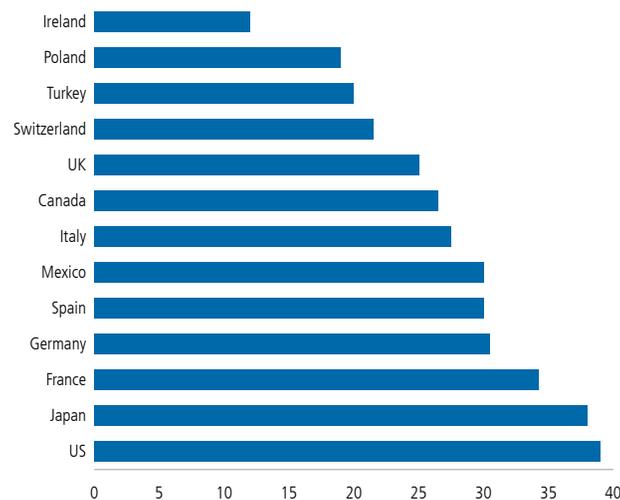
run up in rates would have significant implications for fixed-income investors, especially those favoring government issues at the long end of the curve. Additionally, in a low rate environment, many market participants are reaching far down into lower-quality credit tiers in pursuit of income. They may not be appropriately compensated for the risks they are taking, given our expectation for an extended slow-growth period. Reflecting these influences, the most compelling fixed-income opportunities may exist within the mid-grade credit tiers, where we've found many issues offering favorable risk/reward characteristics.

Conclusion

We expect that the eurozone will remain volatile, as political volatility makes the road forward harder to discern. From the standpoint of secular trends, emerging markets remain an important driver in the global economy, even as GDP

FIGURE 8. CAPITAL IS TREATED BETTER IN SOME PLACES THAN OTHERS

COMBINED CENTRAL AND LOCAL GOVERNMENT STATUTORY CORPORATE TAX RATES (%)



Source: Michael P. Ryan, CFA, UBS, "Global Economic Review and Outlook," June 2012, using data from the OECD Tax Database, UBS WMR.

growth slows. And although the U.S. is not growing as rapidly as some may have hoped, there has been progress in deleveraging. Corporate balance sheets are healthy on the whole, and capital has become more mobile, globally.

We continue to carefully monitor these influences, looking beyond the noise and maintaining a global perspective. We have found many global companies that we believe are doing the same. These businesses are adapting to the rapidly evolving global economy with innovation and entrepreneurial spirit, and we believe that they demonstrate that opportunity exists in all market environments.

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