

Economic Review and Outlook

CALAMOS®

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IN THIS COMMENTARY

We explain why we believe:

- > A double-dip recession is unlikely in the near term; measured economic growth seems more probable in developed markets, with emerging markets positioned for stronger economic growth
- > Equities remain compelling when compared to other asset classes
- > Reflation and long-term secular themes create growth opportunities for companies all over the world
- > Businesses with global footprints maintain their appeal, as these have the flexibility to go where capital is treated best and to pursue global growth opportunities

Waiting on the World to Change

“Now we see everything that’s going wrong, with the world and those who lead it ... We keep on waiting, waiting on the world to change.”

- John Mayer, “Waiting on the World to Change,” 2006

Budget and debt ceiling negotiations, the Greek bailout, new lows in the housing market, another slowdown in job creation ... we are waiting on the world to change.

During the second quarter, investors grappled with the aftershocks of Japan’s devastating earthquake and the strains of food and energy price inflation. Equity and bond market responses seemed to imply a general consensus that global inflation and slowdown were the result of temporary dislocations—disruptions in the Middle East, weather and earthquakes—and not necessarily the precursor for future weakness.

We believe that the emerging economies should be close to completing their credit tightening cycles and should exhibit better growth going forward.

The U.S. government bond market rallied, with yields of 10-year bonds reaching a recent low of 2.80%. Equity markets rotated aggressively out of cyclical sectors toward more stable, less cyclical sectors, but the broad equity markets ended the quarter about flat. There was notable slowing in many of the key indicators that we watch closely, such as the ECRI Index (Figure 1) and the ISM Manufacturing Index (Figure 2). Anemic consumer spending over the past few months, persistently stubborn unemployment and bleak housing data suggested further challenges to the recovery in the United States.

Yet, we believe that a double-dip recession is unlikely in the near term. Historically, the rotation to lower risk assets in the equity markets has generally foretold a slowdown,

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Past performance is no guarantee of future results.

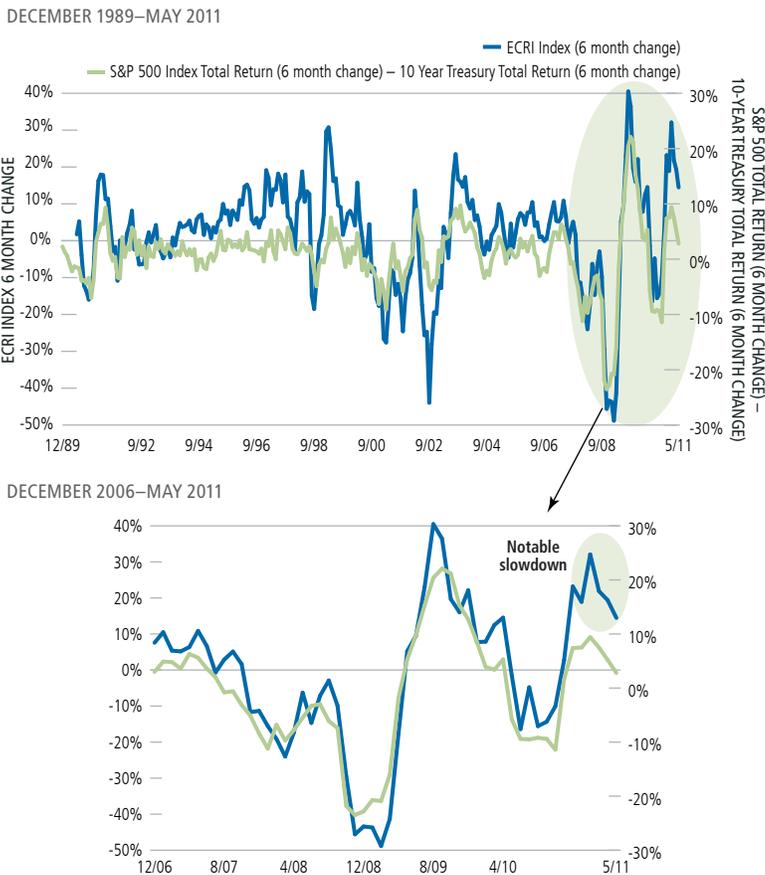
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but not a recession. While the correction in commodity prices underscores global growth slowdown risks, the fact that we did not see a collapse in commodities reinforces our view that a recession is less probable than a slowdown. The recent ease in oil prices has also helped reduce some pressure on consumers.

Looking to the second half of the year, we expect moderate growth in the U.S., Europe and Japan. We believe that the

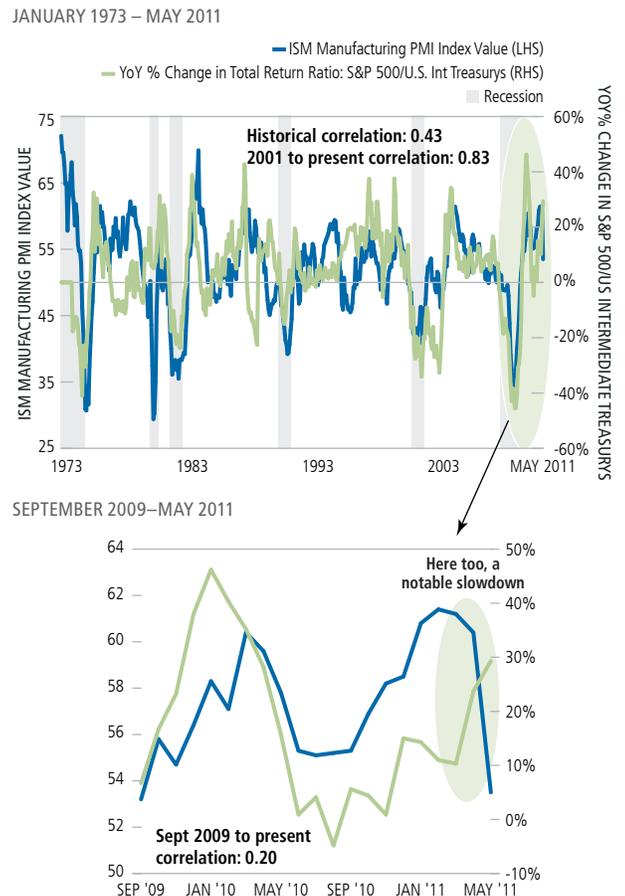
emerging economies should be close to completing their credit tightening cycles and should exhibit better growth going forward. China and the emerging markets will likely not sacrifice growth unless inflation heats back up again. The easing of energy and commodity prices, and especially food prices, has provided some breathing room for the emerging market economies, and we expect revived growth in late 2011 or in 2012.

FIGURE 1. S&P 500 INDEX TOTAL RETURN, LESS 10-YEAR TREASURY VS. 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. ISM MANUFACTURING VS. YOY% CHANGE IN S&P 500 INDEX/U.S. INTERMEDIATE TREASURYS RATIO



Source: Bloomberg. The PMI Composite Index is a seasonally adjusted index that includes measures for new orders, production, employment, supplier deliveries and inventories.

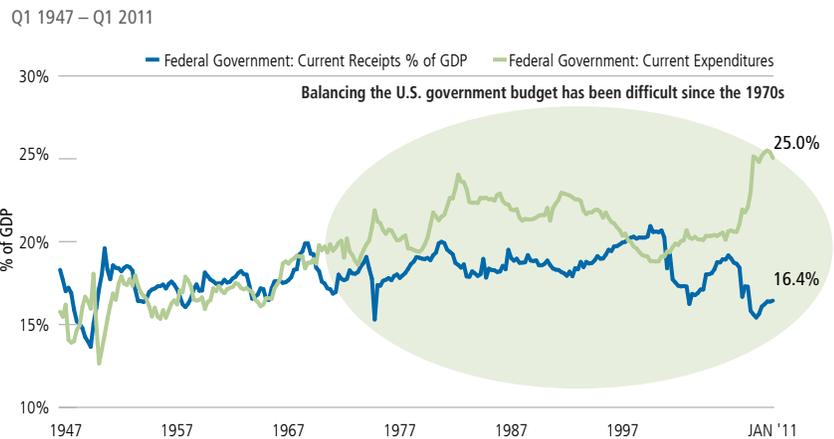
Waiting for change

We believe the next few months and quarters will reveal much about the state of the world’s economies and financial markets. We find ourselves watching and waiting intently for the world to change—or at least, for policies and evidence that change will come. Many of the current conditions in the global economy are neither healthy nor sustainable.

We are waiting and hoping for changes in exchange rate policies, changes that would free the developed markets and peripheral European debtors from the chains of inflexible policies. The normal corrective measures in a free trade global marketplace are floating exchange rates. Countries with trade deficits and current account deficits should experience a decline in currency values relative to those with surpluses. Until such changes occur, we will see further stresses on the global trade and financial markets.

We are waiting to see if the U.S. can address its imbalances and put itself on a road to lasting growth. The most recent surge of deficit spending, combined on top of a generation of spending beyond our means, has left the U.S. with the malaise of mediocre economic growth and a fragile banking system. The end of QE2 will test the resiliency of the economy, and maybe more so the strength of the wealth effect on equity and bond market valuations. As the U.S. Congress and president try to work out a deal to raise the debt ceiling again, we—and the world—await signs that the U.S. can actually govern for the long-term health of the country. Will policymakers address the debt and deficit with a reduction in spending, or will they once again take the

FIGURE 3. FEDERAL GOVERNMENT RECEIPTS/ EXPENDITURES AS A % OF GDP



Source: Federal Reserve Bank of St. Louis

easy route and avoid spending cuts, raise taxes and hope some future Congress will make the tough choices?

As Figure 3 shows, the U.S. federal government has not been able to manage a budget since the early 1970s. Government tax receipts have been pretty stable—around 18% of GDP, despite vastly different tax rates. The problem is that spending has outpaced receipts and has grown from 18% to around 22% on average since the early 1970s. The 1970s brought the end of the gold standard and the introduction of a global fiat money system, or “political money” as economist Frank Fetter warned to the world. Along with the arrival of political money, the U.S. also took away the president’s power to manage the budget and gave it to Congress. We have all paid the price ever since.

We are also waiting for a recovery in the U.S. housing market, especially as that market appears to have slipped into a double-dip recession or at least a double bottom. Housing starts have fallen to levels of 1963, even though

the population has doubled since then. Housing prices are also making new lows again in a majority of the nation's major markets.

Globally, we await the next stages of the Greek bailout, the likely model for debt resolution in a fixed exchange rate regime. Although the first part of an austerity package for Greece passed, much is left to accomplish and the heavy lifting for the Greek citizens is just beginning. Greece is only the first round of Europe's sovereign crisis, but the European Central Bank's (ECB's) response and the European community's support will send an important message to Spain, Ireland, Portugal and Italy.

Historically, the rotation to lower risk assets in the equity markets has generally foretold a slowdown, but not a recession.

If debt restructuring just seeks to address the liquidity of the bond market without addressing the solvency and sustainability of the package, the flash point doesn't go away. It just moves further into the future. However, it's also important to avoid default. A Greek debt restructuring that triggers a default would in turn trigger credit default swap contracts and likely another round of bank crises. Real success will ultimately be dependent upon fiscal policy consolidation in Europe, something we believe has virtually zero probability of happening in the current environment. The euro is an experiment that seemed doomed from the beginning. While the euro is not "damaged" yet, as evidenced by its high relative value versus the dollar, we believe it is likely to become a much smaller currency bloc

in the future as the fiscal policies of nations clash with the monetary policies of the ECB. The PIIGS' sovereign crisis is the likely breaking point.

We are waiting to see where inflation goes in the emerging markets, hoping that the peak has occurred and that inflation will be contained in the economies that have been the world's growth engine for most of the past decade. We await a shift from policies that focus on slowing credit growth and hot money flows, and maintaining a currency advantage to policies that encourage economic growth that is driven by consumption, not just exports. Although at this stage, any growth with contained inflation will do the job.

We are waiting for the changes that new global leaders may bring. Upcoming elections in the U.S. and a new president in China could have significant implications for the global economy. The Arab Spring has led to the removal of once-entrenched dictators, with the potential for more to fall. In Latin America, we are encouraged by signs that oppressive regimes could give way to greater levels of freedom in countries such as Venezuela and Cuba.

Financial asset valuations: a bipolar world?

Government bond market yield curves are pricing in a slow growth decade with the risks of deflation in the midst. The low yields on 10-year and longer government debt reflect the economic growth rate expectations for developed market economies. Historically, the 10-year yield approximates the nominal growth rate of an economy. Figure 4 illustrates what the U.S. economy is up against. We believe bond market pessimism reflects the fact that the U.S. and Europe

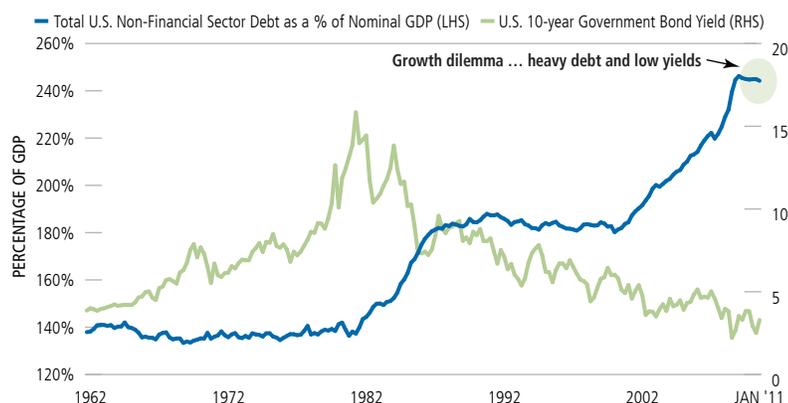
find themselves in a very difficult growth dilemma, hindered by heavy debt burdens from years of fiscal profligacy and a recent burden from a banking crisis quickly supported by nationalizing private debt. Poor demographics are a further weight to growth in these “pay-as-you-go” welfare state models. Unless some changes are made, the U.S. and Europe look to be travelling down the same road that Japan has struggled along for 20 years—a path well-paved by sovereign crises, stagnant wealth creation and/or inflation with slow GDP growth.

We believe U.S. equity markets are pricing in a more normal environment, at first glance. Price-to-earnings ratios (P/E) are near their long-term averages, and profit margins are near 20-year highs. In our view, the normal P/E is likely a conglomeration of many non-normal factors that the market is considering when it prices stocks. Although the U.S., Japan and Europe look to be stuck in a slow-growth scenario for many years to come, many emerging economies offer strong growth prospects.

Many U.S. companies are moving quickly to emphasize opportunities outside of their borders. Today more than 50% of the revenues of the S&P 500 Index constituents come from outside the U.S., and the profitability of these revenues is higher than the homegrown type. The better margins and more diversified revenue streams would indicate that at least one half of the market’s P/E should be above average, while the U.S. portion of the P/E with less growth, more regulation and the prospects for higher taxes and healthcare costs would place downward pressures on the P/E. Of course, strong corporate balance sheets and cheap debt capital also

FIGURE 4. TOTAL U.S. DEBT TO NOMINAL GDP VS. 10-YEAR BOND YIELD

1Q 1962 – 4Q 2010



Source: Bloomberg and Federal Reserve Bank of St. Louis.

help support higher P/E ratios. All in, we believe P/E ratios and overall U.S. equity market valuations are reasonable and offer investors the best opportunity to generate real returns on their wealth in the near future.

We see similar opportunities in the Japanese and developed European equity markets, but believe the emerging markets offer the best overall combined risk-reward prospects, supported by high growth potential and the fiscal and monetary flexibility to fend off weakness. The abnormally low interest rates in the developed world do not look to be discounted in equity values. For example, the old Fed model discounted the market earnings at the inverse of the 10-year Treasury bond rate (Figure 5). Today, that would mean earnings would trade at a multiple above 30, more than twice today’s level. The equity market is discounting a 10-year Treasury bond rate near 6% or slower earnings-per-share growth and a rate near 5%. Either way, the equity markets have priced in a different environment and provide a

better risk-reward than fixed income or commodity indexes, at this point.

We believe that high yield bonds warrant a particularly selective approach. High yield bonds today have less credit risk and more interest rate risk in the spread premium than normal. Many of the credit risks have been refinanced and pushed out a few more years. The spread above Treasury bonds reflects a normal risk, but the added risk is a back-up

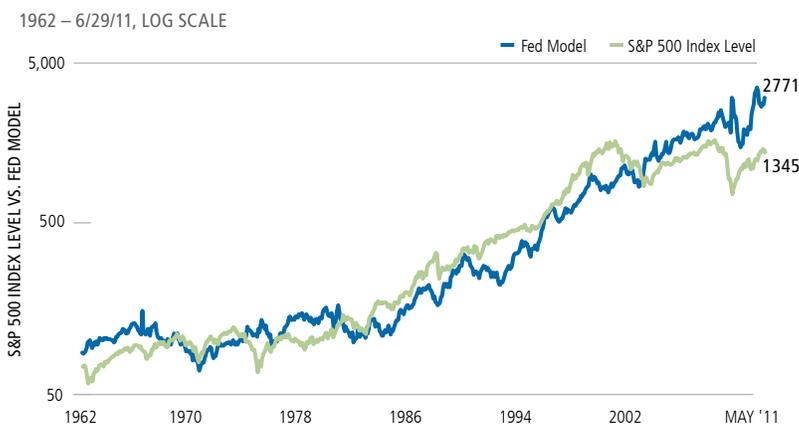
in Treasury yields. So, while the short-term risk in high yield bonds appears low on the whole, we see poor risk-reward characteristics in the asset class.

Productivity of labor and capital: A closer look

The world has changed considerably in the past decade, due in large measure to the technology and telecomm bubble. The bubble helped accelerate changes in business technology, communication, productivity and a host of business and consumer competitive forces that are disruptive but unstoppable because of the efficiency and conveniences they offer. These changes unleashed a healthy deflationary environment. This deflation, along with the bursting of the bubble, offset some of the Federal Reserve's actions that made the last decade difficult at best. Anxious to avoid Japan-style deflation, the Fed misread healthy pricing pressures—that is, those resulting from rapid changes in products, game-changing innovations and disruptive technological advancement. These were normal competitive pricing pressures that we see every day in a well-functioning industry. But as these pressures became more widespread and the technology stock bubble burst, the Fed had seen enough and did what it does best. It created a “put” to support the financial markets and economy through a flood of cheap money.

The T-bill rate compared to the smoothed GDP growth rate provides a quick measure of the excess monetary and credit stimulus created by cheap capital. By this measure, when the T-bill rate is below the GDP trend, the costs of money and credit are too low. As Figure 6 indicates, from

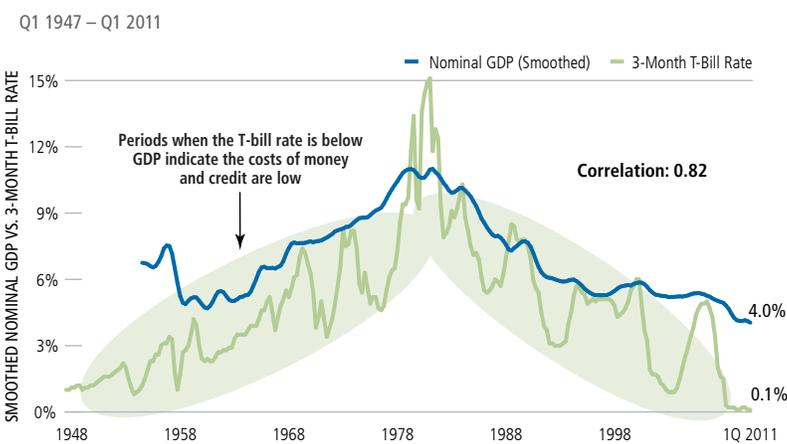
FIGURE 5. FED MODEL* VS. THE ACTUAL S&P 500 INDEX LEVEL



Source: Calamos, Bloomberg and Federal Reserve Bank of St. Louis.

* The Fed Model is the S&P 500 Index's earnings per share, multiplied by the inverse of the 10-Year Treasury rate.

FIGURE 6. NOMINAL GDP (SMOOTHED) VS. 3-MONTH T-BILL RATE



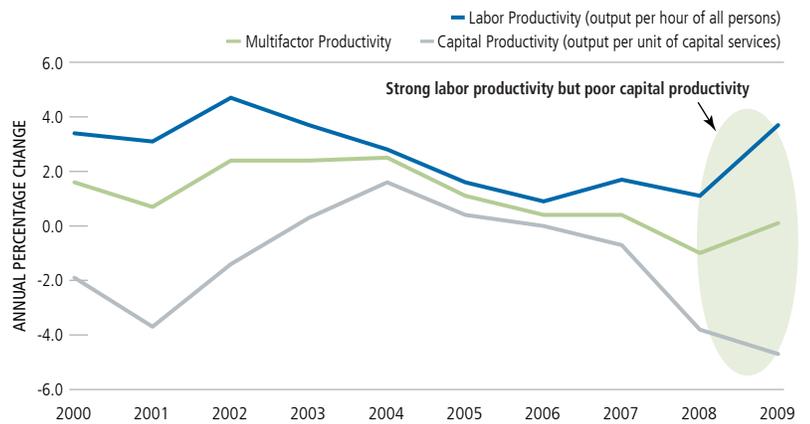
Source: Federal Reserve Bank of St. Louis

1950 to 1980, interest rates and credit costs were below the economic growth rate. These low rates kept government debt costs down in most periods and added to inflation to further reduce the debt burden on the economy. As one would expect, the low cost of capital led to bubbles and inflation spikes as we experienced in the 1970s and 2000s.

Fortunately, the technology bubble was not as destructive as a credit-induced bubble. The technology bubble left many productive assets in place. It was also a bubble financed primarily by equity. The Fed overreacted with an expectation that further deflationary forces would take hold. But not all bubbles are created equal. The worst type of bubbles are those that are financed with large amounts of debt backed by banks and which leave unproductive assets in their wake. The housing bubble is an example of this worst type, as it was financed by banks on top of a mountain of consumer and government debt. It was a bubble that the Fed helped fuel after the technology bubble burst in 2000. The flood of cheap money (thanks to the Fed), cheap imports (thanks to China) and declining consumer products (thanks to rapidly changing technology) caused some major dislocations in credit costs, labor markets and global business competitiveness. China's drive for more advanced infrastructure furthered the pressures on labor competitiveness while also helping spark ongoing fears of commodity shortages. Thus, the result of cheap money and credit was a speculative bubble in housing, commodities and other hard assets. Governments don't react well to change and with significant structural change occurring on many fronts, the stage was set for a bust.

FIGURE 7. PRODUCTIVITY TRENDS

2000-2009, ANNUAL PERCENTAGE CHANGE



Source: Bureau of Labor Statistics, U.S. Department of Labor.

Today, the developed world is choking on debt and future promises to pay for services that are beyond the reach of overburdened countries. One of the major impediments to growth is an overcapitalized infrastructure. Although labor productivity has been quite strong in the past decade, the productivity of capital has been very poor (Figure 7). It will be difficult to get back to the long-term GDP growth track without capital investment helping to goose the GDP growth numbers. Capital is less productive for a number of reasons, including an overbuilt retail and housing stock, and a more productive manufacturing, distribution and inventory infrastructure that can operate with a much smaller footprint, and the closing of manufacturing plants over the past decade.

Figure 8 illustrates a striking decline in total fixed investment in U.S. GDP, with the current level of total fixed investment unchanged from 15 years ago. The fall-off in fixed investment is partly a function of demographics but also a function of a

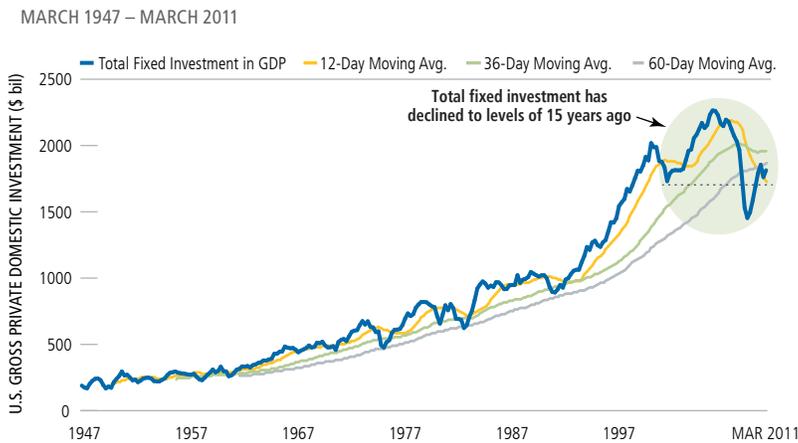
shrinking manufacturing sector and changing economy. As a result, we believe GDP growth will probably not be able to sustain a rebound until fixed investment in housing and manufacturing rebounds.

In "Farewell to cheap capital? The implications of long-term shifts in global investment and saving," the McKinsey

Institute discussed an alarming decline in investment in infrastructure and capital in the global economy. In 1970, 25% of GDP was investment in fixed assets and equipment. Then a secular decline occurred; by 2010, investment in infrastructure bottomed at 20% of global GDP (Figure 9). The McKinsey Institute expects global infrastructure spending to climb and support global GDP while putting upward pressure on capital costs. Although this may be true in the emerging economies, it is difficult to see how the developed economies can afford additional spending without better budgets and given near-term pressure for fiscal austerity. While we share the McKinsey Institute's expectation that the trend will reverse, we expect most of the growth to come from the expanding emerging economies. We would expect another five years to pass before the U.S. and Europe make any significant progress on this front.

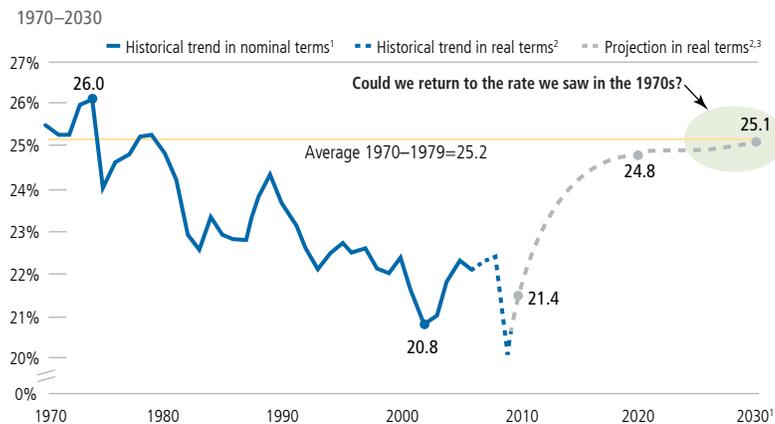
A change in the composition of GDP growth in the global economies will likely put pressure on capital costs, as the McKinsey study indicates. It should also tax the commodity and energy markets. Along with the "financial repression" of debt restructuring (which we will discuss at greater length), it is likely that these forces continue to call for a secular adherence to the global reflation trade investment positioning. Figure 10 shows the capital-output ratio to GDP in the global economy, with an average capital stock of around 250% of GDP. (In other words, on average, it takes \$250 of capital to generate \$100 of global GDP. If a country's capital stock is not growing, it may be very difficult to add to GDP without heroic assumptions in capital and labor productivity.) China, Brazil and India are all very close to this ratio. If growth continues in these countries at 6% to 10%,

FIGURE 8. TOTAL FIXED INVESTMENT IN U.S. GDP



Source: Bloomberg.

FIGURE 9. GLOBAL INVESTMENT RATE AS A % OF GLOBAL GDP



¹ Based on actual prices and exchange rates of each year ² Shown in 2005 prices and exchange rates ³ Forecast assumes the price of capital goods increases at the same rate as other goods and assumes no change in inventory.

Source: McKinsey Global Institute. Richard Dobbs, Susan Lund, Charles Roxburgh, James Manyika, Alex Kim, Andreas Schreiner, Riccardo Boin, Rohit Chopra, Sebastian Jauch, Hyun Kim, Megan McDonald, John Piotrowski, "Farewell to cheap capital? The implications of long-term shifts in global investment and saving," http://www.mckinsey.com/mgi/publications/farewell_cheap_capital/index.asp (December, 2010)

the global investment ratio will climb back toward the 25% mark, just due to the footprint of these growth markets.

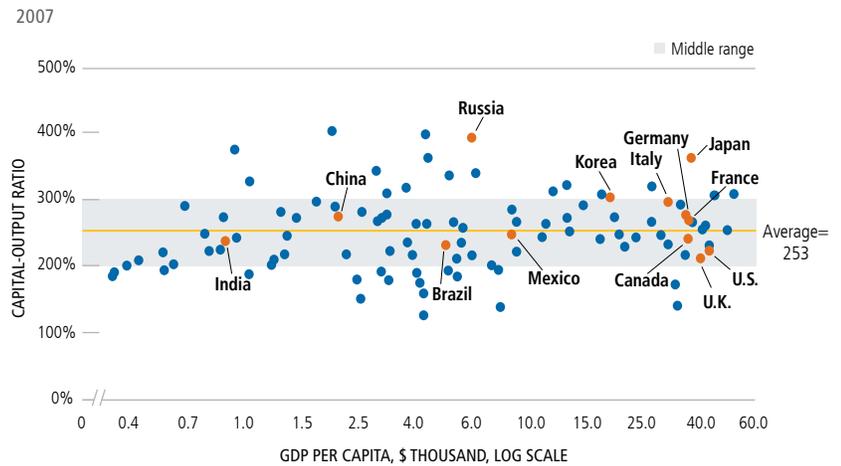
We have sought to position our portfolios to benefit from this trend, staying attuned to potential disruptions that may result and, of course, measuring the benefit of increased capital on each economy's overall productivity. These economies can create high levels of productivity improvement and therefore GDP growth and wealth because such a large number of people are toiling in such low-productivity activities. The U.S., Japan and Europe cannot create high productivity capital investments as easily for the opposite reason.

Investing in a bipolar world

Determining a proper asset allocation in a bipolar world with tremendous macro issues and high correlations to event risk is analogous to playing offense and defense at the same time. The global markets are focused and highly dependent upon favorable outcomes of the following five issues over the next few years: 1) oil prices, including Middle East disruptions, 2) sovereign debt crises and global banking, 3) Fed monetary policy moves, 4) emerging market inflation and the strength of China's economy, and 5) global exchange rates and currency volatility.

The global economy is more prone to government action than in the past. Due to more regulation, higher taxes, high sovereign debt levels and general intrusiveness, governments have an increasingly concentrated impact on banking, business, and by extension, economies on the whole. Just to complicate things further, the global financial markets are more correlated than at any time since at least

FIGURE 10. CAPITAL-OUTPUT VS. GDP PER CAPITA BY COUNTRY

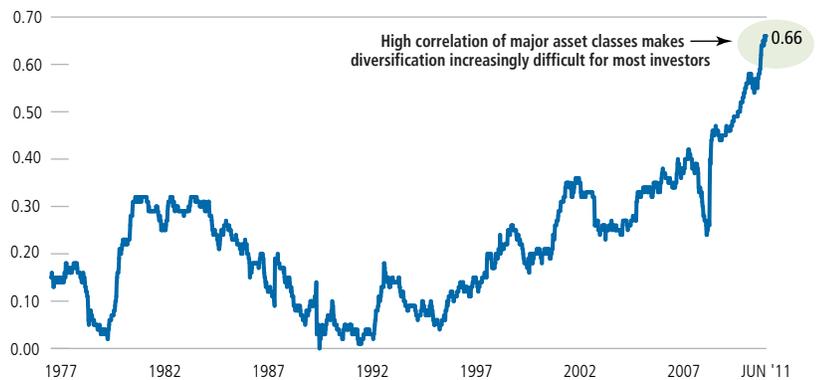


Source: McKinsey Global Institute. Richard Dobbs, Susan Lund, Charles Roxburgh, James Manyika, Alex Kim, Andreas Schreiner, Riccardo Boin, Rohit Chopra, Sebastian Jauch, Hyun Kim, Megan McDonald, John Piotrowski, "Farewell to cheap capital? The implications of long-term shifts in global investment and saving," http://www.mckinsey.com/mgi/publications/farewell_cheap_capital/index.asp (December, 2010)

FIGURE 11. CORRELATION OF EVERYTHING: S&P 500 INDEX VS. ...

Average, trailing 2-yr correlation of weekly % changes in the S&P 500 Index with weekly % changes in: Nasdaq Composite, MSCI EAFE Index, S&P GSCI (Commodity markets), Gold, 10-year U.S. T-Bond Yield, U.S. Trade-weighted \$

JANUARY 3, 1975 – JUNE 24, 2011



Source: The Leuthold Group

1977. Figure 11, a correlation chart courtesy of The Leuthold Group, shows that most major asset classes are now highly correlated, making diversification difficult for most investors. This reality calls for unconventional asset allocation. We have approached this marketplace with heavy sector emphases,

as well as currency biases toward hard currency countries and store-of-value currency countries, primarily short-term non-dollar instruments. We believe that this currency positioning adds a degree of inflation protection and some diversification benefits.

Globally, investors are scrambling for yield. In a world of low interest rates, this may force those who rely primarily on an income stream to reach their goals by investing in higher-risk assets. Given the current landscape, we believe that the strongest case is for strategies that seek to earn a fixed percentage each year, through capital appreciation as well as income. Thus, portfolios of equities, combined with short-term currency instruments, may be the best alternative for many investors.

Why stay long the reflation trade?

In past commentaries, we have praised Carmen M. Reinhart and Kenneth S. Rogoff's seminal work, *This Time is Different: Eight Centuries of Financial Folly*. In a great follow up white paper, "The Liquidation of Government Debt" (National Bureau of Economic Research, March 2011), Reinhart and M. Belen Sbrancia provide a view into what the world may expect as a result of the current debt crisis. This study covers a broad spectrum of debt cycles and countries and outlines the regrettable road map that the U.S. has been following already.

The authors use the term "financial repression" to explain the policies, absent immediate default, of debt restructuring. Debt restructuring takes the form of interest rate caps and

regulated capital flows. The policy of low nominal interest rates and inflation erodes the level of debt while keeping the servicing costs low. Reinhart and Sbrancia also cite many incidences where governments force captive lending by domestic audiences such as pension plans. The authors suggest that we should expect periods of unexpected surges in inflation and other disruptions as a result of uneconomic interest rates and the misallocations of capital that result. Stay long the reflation trade; the 25-year bull market in bonds is over.

Many of the most exciting secular trends we see center on the growing economic freedoms and prosperity in emerging markets.

We have been positioned for a global reflation outcome since early 2009, as the debt cycle imploded and global monetary easing and fiscal easing were set in motion to offset the deflationary forces of a bursting credit bubble. We are in the camp that the debt deleveraging cycle has many innings left and that the drag on growth, along with poor demographics and deficit spending, will result in a need for further currency debasement and inflation. The U.S., Europe and Japan still face considerable challenges to grow out of their debt burdens, but we expect a limited appetite for fiscal austerity and government right-sizing. We believe this will result in "more of the same"—continued stimulus that spreads out the impact over many years. We expect

the more cyclically sensitive sectors should respond best to the liquidity surge and wealth effect that we see many governments engineering, providing support to companies in the information technology, industrials, materials and energy sectors.

In addition to reflation, there are a number of secular themes that we see creating growth opportunities for companies all over the world. These trends include global corporate competition, strong consumer demand for connectivity to information, entertainment and others, and demographic shifts. As we have discussed in the past, many of the most exciting secular trends we see center on the growing economic freedoms and prosperity in emerging markets. Even as the developed economies are mired in “financial repression,” we believe wealth creation in the emerging nations is creating extremely exciting opportunities for investors globally. Thus, we are maintaining our emphasis on companies with global business strategies, as these companies have more choices about where to put their capital to work.

Conclusion

Even though we may find ourselves in a waiting game as the global financial markets and economy navigate the current challenges, we are not sitting by passively. We see opportunities, and we are acting on them. Reflation, the growth and prosperity of emerging markets, global corporate competition and the technology revolution are creating a breadth of investment choices for us. As we

noted, we believe equities remain especially compelling, on the whole. Valuations in the developed market equities, most notably within the U.S., remain especially attractive relative to bonds and direct commodity investments. We believe that access to cheap capital, robust corporate cash and good profit margins should support equity prices in the near term. We also feel that our selective investment criteria position us well to uncover opportunities across other asset classes, and across the global marketplace.

There have always been challenges in the markets and economy, frequently unprecedented and often disconcerting. However, global capital markets have responded to—and navigated through—the ups and downs of many economic environments. We believe that our experience and active, risk-managed approach will serve us well as we pursue growth opportunities, globally.

Sectors and countries mentioned are presented to show sectors and countries in which a portfolio may invest.

Portfolio holdings are subject to change daily. Investments in overseas markets pose special risks, including currency fluctuation and political risks, and greater volatility than typically associated with U.S. investments. These risks are generally intensified for investments in emerging markets.

Hot money is used in economics to refer to funds which flow into a country to take advantage of a favorable interest rate, and therefore obtain higher returns.

The Eurozone is comprised of 12 countries: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxemburg, Netherlands, Portugal, Spain, and Greece.

Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

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