Calamos Phineus Long/Short Fund (CPLIX): 2019 Review and 2020 Outlook

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2019 Review

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity …"

– *A Tale of Two Cities,* Charles Dickens

2019 was a frustrating year for CPLIX. Our market exposures were based on our expectation of how fundamentals would evolve and we were more right than wrong in our analysis. But like *A Tale of Two Cities*, it was a year of radical opposites locked in struggle. The first tale was that of challenged fundamentals as global economic data disappointed and earnings stalled. The second was one of remarkable gains in equities, which defied the gravity of these fundamental concerns. Reconciling these contrasting narratives requires thought and explanation.

The start of a new year is the time to assess what happened, where we missed the mark and to review the opportunities at hand. Cutting to the chase, our positioning in 2019 was simply too defensive for the liquidity and sentiment that drove US equities and valuations to new highs. While it can be hard to distinguish the quality of an investment decision from the eventual outcome, we maintain conviction in our investment approach and its execution. Moreover, we see developments at the macro and micro levels as consistent with the return opportunities in the portfolio today.

History teaches that understanding the investment regime and positioning oneself accordingly is essential for one's well-being. Entering the 2020s, we believe financial markets are confronting a paradigm shift. These shifts can be hard to perceive in real time, which is why today's environment appears unusually complex. Investors should resist extrapolating "what worked" through the post-2008 environment which has produced one of the strongest decades on record for financial assets. Instead, we anticipate a different regime and seek to position our clients accordingly.

What We Got Right in 2019

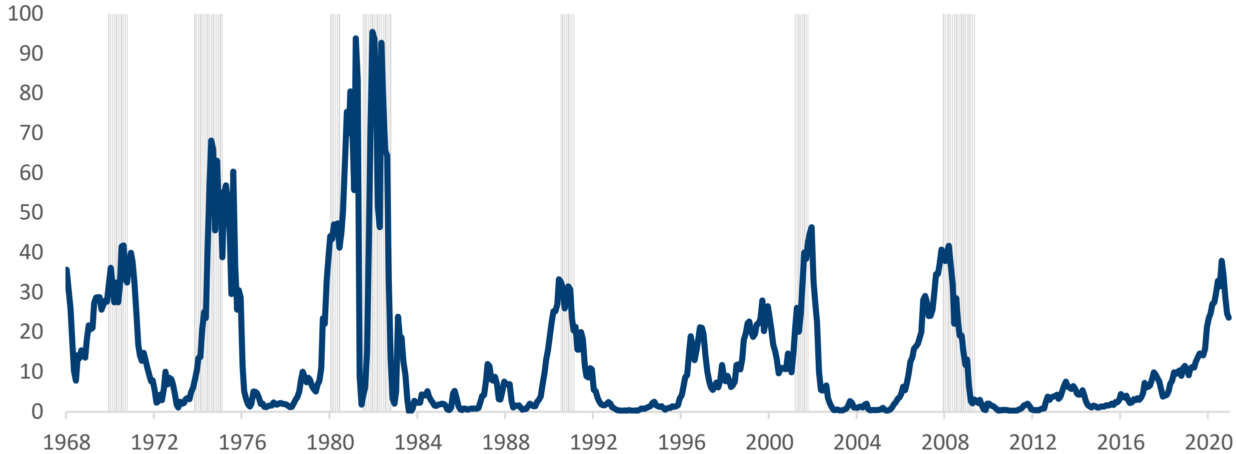
In 2019, we expected economic data to weaken domestically and abroad. Most developments did bear this out. US activity slowed progressively in response to the long Fed tightening cycle, with the US economy entering into a "soft landing." Across the pond, the European story remained one of stagnation. German manufacturing, one of the past bright spots, slipped into recession. China and EM were dogged by trade conflicts and slowing global output. While the US consumer was a source of resilience, the global producer industries entered a virtual recession. Almost all leading economic indicators deteriorated through the course of the year.

All of this coalesced into a concerning picture for corporate fundamentals. S&P500 earnings were essentially flat in 2019, while earnings for the broader indices, such as the S&P1000 and Russell 2000 Indices, declined by high single digits to low teens. This fine line between flattish earnings ("mid-cycle pause") versus an outright decline ("recession") is a material consideration. Historically, the most deleterious outcomes for equities were associated with economic or earnings recessions.

The chart below, the US Recession Probability Model of the New York Federal Reserve, captures this fundamental risk in 2019. For equity investors, the point is that the S&P500 has historically suffered a median decline of 36% in the lead up to a US recession, with a downward range of 17% to 56% in the past half century. Although a "soft landing" rather than a recession has been our central forecast, we have been reluctant to ignore the downside risks as long as the evidence was tilting and continues to tilt negatively.

The cautionary messages of 2019: "Late-cycle", not "New-cycle"

US Recession Probability Model of the New York Federal Reserve
Recessions indicated by shaded areas



Source: Calamos using Macrobond, Ned Davis Research

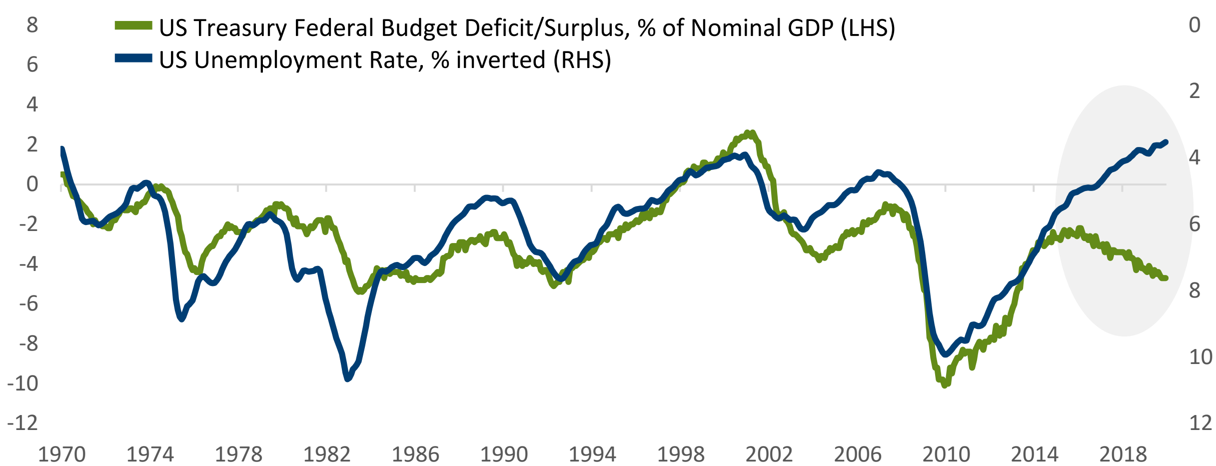
Of course, risk-assets eventually shrugged off poor economic data on the belief that markets could "look through" the bad news in anticipation of a more positive 2020. Consequently, all of the gains registered by equities represented multiple expansion and valuations are back to cycle highs. The sustainability of this is the central debate today, which we will explore in the subsequent discussion. The punchline: consensus expectations for a meaningful recovery in worldwide profitability in 2020 are illusory.

What We Got Wrong in 2019

Why was it different this time? Why did the economy (and equity markets) overcome the warning signs that have proven predictive in the past? In retrospect, we attribute the benign outcome for equities in 2019 to two factors.

First, US fiscal policy has been crucially supportive of the economy at a point when it has historically been countercyclical. In other words, fiscal policy normally weighs on growth after a long expansion. A rising (and thus stimulative) budget deficit in the latter stages of an economic expansion is unprecedented. Had the fiscal side of the US economy behaved more typically, it would have been rougher sailing for the overall economy.

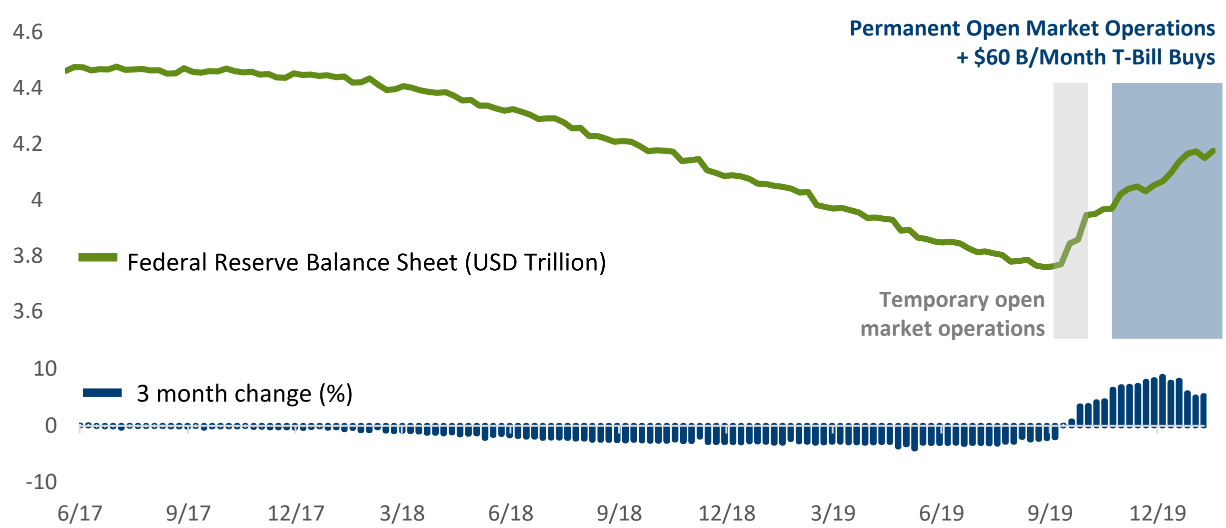
Unprecedented divergence: US fiscal policy has been key



Source: Calamos using Macrobond

The second factor was the aggressive capitulation by the Fed, especially into autumn when the Fed commenced its "not QE" actions to address the repo market disruption in mid-September. We view this dislocation in money markets in combination with the gradual deterioration in credit quality and bank lending, especially leveraged loans. Taken together, they may signal the limits of leverage for this cycle.

Remarkable reversal: "Not QE" at a faster pace than QE3



Source: Calamos using Macrobond.

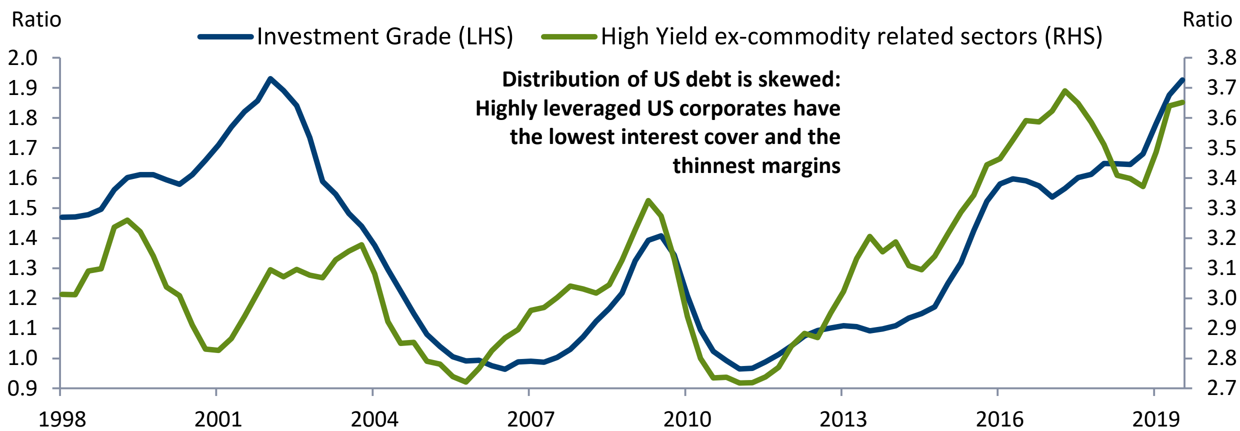
The Fed has demurred from describing these policies as quantitative easing for political reasons. Apparently, "QE" is insufficiently woke because it benefits the bankers. Nonetheless, the Fed has grown its balance sheet by around $400 billion since September, a pace comparable to 2013–2014 when QE3 was near its peak. Exactly how this excess liquidity contributed to financial returns is hard to quantify, but weight of money matters.

We recall the sizable liquidity injections in late 1999 and into Q1 2000 as central banks insured against the disruptive economic potential of Y2K. Very little of that liquidity found its way into the real economy. From the start of that program in November to its termination in March 2000, the Nasdaq Composite Index rose from about 3000 to over 5000. That late-cycle extension in the major indices marked their peak for many years.

2019 was emblematic of the entire investment paradigm of the post-2008 era. All of the equity gains represented valuation inflation due to central bank largesse. The year commenced with the Fed's abandonment of monetary normalization and concluded with a "melt-up" associated with "not QE". The US corporate cost of debt fell to decade lows, perhaps the lowest levels ever if one adjusts for today's higher level of operating leverage. The lower cost of debt has perpetuated higher levels of credit risk, particularly in those classified as investment grade.

Pointing fingers: Corporate credit is a good target

Net Debt to EBITDA ratio for the median investment grade and high yield bond issuers



Source: Goldman Sachs, "Top Ten Market Themes for 2020: Learning to Fly Without the Fed," November 21, 2019, using Bloomberg, Factset, Goldman Sachs Global Investment Research

We initially expected that less rate subsidization, starting with the Fed's agenda for monetary normalization, would weigh on financial asset inflation.

Entering 2019, we thought equity valuations would be forced to heel to rising economic vulnerability and stalled corporate profitability. *Aggressive capitulation by the Fed was the key development that worked against this forecast.* The judgement now is whether this sugar high has caused market participants to overlook the structural challenges in favor of near-term dynamics that are more plainly in sight.

We believe there are inevitable limits to the market logic of the post-2008 cycle, which is the argument for paradigm shift. In our view, the centrality of monetary policy is exhausted, not just for the economy but also for this long dynamic of inflation in financial prices. This especially has consequences for the traditional 60/40 asset allocation model in the coming decade.

Recap of 2019:

- We expected US equities to be range bound. Due to the troubled backdrop for economic and corporate fundamentals, we anticipated numerous reversals of "trend perception" in the context of a multi-year transition.

- However, 2019 saw the third-largest gain for the S&P 500 of this century—all driven by the expansion of valuations. Fed policies elevated asset prices amidst broadly slowing economic activity and a stall in earnings.

- Steady employment, lower taxes, benign energy costs and rising wages supported the US consumer in spite of weakening business investment and virtual recession across the global producer industries.

- Risk assets shrugged off poor economic data, based on the belief that markets can look through "bad news" in anticipation of a more positive 2020. This is the central debate today.

- Investors took encouragement from a reduction in political tail risks (US-China trade, Brexit), the expansion of Fed and ECB balance sheets, and some signs of stabilization in global manufacturing.

- This discrepancy between our expectation and the reality of market behavior was detrimental to relative performance; much of the performance gains of our long exposures were offset by our short exposures.

- The Fund's long portfolio outperformed both the S&P500 and MSCI World Indices in 2019, primarily by emphasizing the quality factor across sectors and industries.

2020 Outlook

Equity gains in 2019 have encouraged investors to discount better economic growth into 2020 as trade tensions, monetary policy and comparisons all begin to ease. However, we lean more defensively, as the cyclical and structural challenges ahead have not been resolved.

One legacy of the bull market of the past decade has been to reinforce the perception that forecasting is futile, at least with respect to unfavorable investment outcomes. Therefore, 2019 has restored "misplaced" faith in the refinement and extension of permanent liquidity support. After all, if neither Chairman Powell nor President Trump want financial assets to decline, why would they?

This presumption reveals that hyperactive monetary policies—originally intended as a temporary expedient—have become institutionalized. Financial markets no longer follow the fundamental views of the consensus. The causation has been reversed. Today, investors anticipate cyclical revival because the momentum of financial price inflation has been relentless. And yet, we would do well to remember that equity and credit signals have become less-than-reliable barometers of financial risk.

We believe the current phase of multiple expansion driven by dovish central banks will be exhausted by Q1 2020. The Fed has signaled that it has "done enough" to insure against recession. By early spring, investors need to see a genuine revival of the global economy to support the rise in expectations. Otherwise, recession anxiety will return in the guise of rising political uncertainty.

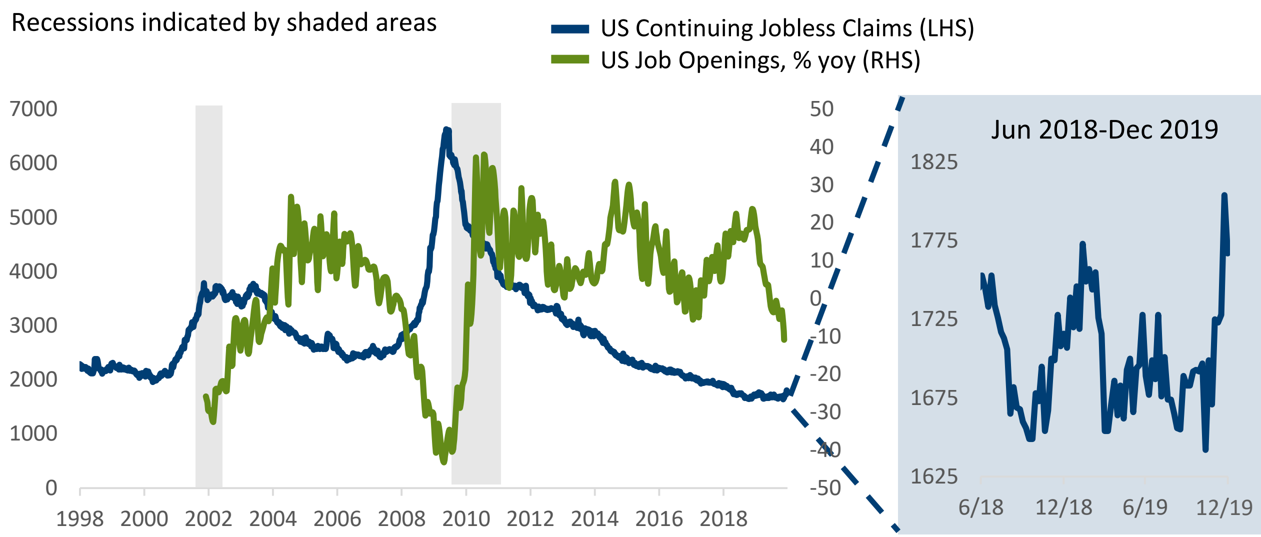
Why are we skeptical that rising US equities are signaling a revival of the global output cycle?

Central bankers and investors alike believe enough has been done to remove the risk of stagnation. In contrast, we see the combined effects of 1) a rising preference for savings in the private sector due to high indebtedness, 2) weak business investment worldwide, and 3) the reassessment of globalization will keep the world economy stuck in some version of a "soft landing." Expectations for a revival of earnings growth worldwide are illusory in 2020.

We do not believe the Fed's rate cuts and Trump's trade deal can overcome this. First, we see diminishing benefits from the changes in monetary conditions, especially for the corporate sector where the accumulation of credit risk is unsustainable except in conditions of prolonged tranquility. In our view, the rising preference for the *quality style* across equities reflects perceptions of rising credit risk. Weakness in business investment is chronic and needs to revive dramatically for the developed economies to achieve escape velocity.

Without this recovery, the pressures on Western consumers will persist, which is why we are watching the employment data closely. Continuing claims have not improved in the past year and the change in aggregate hours worked, a function of jobs and the workweek have stagnated. This "gear down" in employment conditions is synonymous with a "soft landing." Soft landings can be lengthy and this one could last through 2021, but they never conclude with a re-acceleration of activity.

Decline in job openings coincides with increase in continuing jobless claims



Source: Calamos using Macrobond. Data is seasonally adjusted

Equally, we see constraints upon growth through much of the Emerging world. China will be a decisive force for perceptions around global activity in 2020, and here we are not optimistic in our expectations. The upending of the global trading system has only just begun. The "phase one" trade deal is an agreement to halt the escalation of trade tensions, while continuing the rivalry through other means. Internally, Beijing's battle against financial risk is entering a critical phase. More Chinese corporate defaults loom in 2020.

For investors, the bull move since autumn has been associated with cyclical revival. And yet, markets are signaling caution with their enduring preference for *quality* across sectors and industries. The rotation into higher-risk, cyclical and value styles has been tentative rather than decisive. US small caps, for example have lagged notably. In our view, consumers and businesses alike have observed the persistent rise of leverage and conclude that rising leverage equates to rising financial risk.

We agree. The latest extension of the major indices is assessed as "late-cycle", not "new cycle." Investors face an unattractive asymmetry of risk versus reward. This contrasts with the extrapolative climax of "financial asset prices cannot deflate" implied by volatility measures near record lows.

Our business always contains a mix of facts and subjective interpretations. However, we are struck by the increasing role of "the machines"—non-fundamental, quantitative, passive rather than active. There was a time when active fundamental investors dominated equity behavior. Thus, price signals mattered. Investors like ourselves would develop fundamental theses and discern whether stock prices were confirming or denying our premises. Today, the relationship between price action and the fundamental setting has become tenuous.

Welcome to the 2020s

We expect 2020 to be very different. The momentum of risk assets can carry into the first quarter amidst perceptions of permanent liquidity support by the Federal Reserve. However, the logic of "bad news is good" cannot continue forever. Central banks cannot repeat the effect of their policy reversal of 2019. The absence of genuine recovery in the global output cycle must make itself felt eventually. The question is when?

The constructive view of equities rests upon the "there is no alternative" argument in a world of exceptionally low rates and low corporate cost of capital. Many bullish assessments for equities start with interest rates, the *only* reference by which they are reasonably priced. However, the rejoinder can be found in Europe and Japan, where QE and its repression of interest rates has not mattered because earnings growth has been absent.

Paradigm shift: Why the logic of central bank suppression of rates is not enough

Paradigms are long periods in which market relationships operate with a specific logic. A classic one is an unsustainable growth of indebtedness that supports the accumulation of financial assets. Another paradigm involves consumers, businesses and investors embracing an extended period of low volatility, which paradoxically leads to high volatility.[1] In other words, investors typically adopt and extrapolate the paradigm's logic until it is overdone and breaks, requiring a new paradigm.

That is where we are today. If the decline in corporate yields of the past year does not lead to stronger business investment in 2020, we are witnessing the *prime facie* evidence that the monetary paradigm is exhausted.

The organizing principle of the post-2008 regime has been the collapse in the cost of debt in the Western world. In this sense, the bull market in equities and fixed income has been a leveraged derivative of duration. This past year witnessed a frenzy of duration as investors came to believe the suppression of interest rates would become institutionalized. There are ideological concerns with this interventionism, but the lynchpin of its success has been the long outperformance of US corporate profitability.

[1] This was the essence of Hyman Minsky's argument in his book, *Stabilizing An Unstable Economy*.

What are the salient features of the coming paradigm shift?

Social and political equilibrium in the West requires that inflationary growth follow a prolonged period of economic stagnation. Indebtedness can only be reduced by raising nominal growth rates, which entails rebalancing the relationship between capital owners and labor. **This implies the end of capital subsidization for capital owners, the extension of full employment and the restriction of globalization.** All of this represent headwinds for future returns on capital.

Some aspects of this transition are visible in the policies of the Trump Administration. We are also describing the contours of the new Boris Johnson Administration in the UK, where the priorities include fiscal expansion, an emphasis upon infrastructure and public services, lower taxes for the lower paid and higher minimum wages. On the Continent, policy change is hypothetical at this stage, although the EU will use the irresistible mantle of climate change for intervention, regulation and protectionism.

The complete emergence of this new regime will take time and depends upon a wider sense that the old regime has failed. We are not there yet, which is why the election verdict in November is crucial. Central banks cannot deliver reflation on their own. In the meantime, the absence of a recovery of business investment, in particular, will validate our belief that the effectiveness of monetary policy is waning.

Navigating markets well requires us to be more accurate in discerning what is going to happen than the widely held view incorporated in prices. The consensus view is that the rise of equities to new highs is sustainable due to the institutionalized support of central bankers. Our view is that the cyclical and structural setting is cautionary, typical of end-cycle markets and represents high financial risk.

Summary

The 2010s have been the decade of excess returns for the 60/40 asset allocation model. The next decade will be one of very low returns for all financial assets. Consumer sources of return will outperform the global producer industries, as we do not expect an investment boom in the EM world. China, the *wunderkinder* of the past three decades is the next likely locus of a growth or credit crisis.

Overreliance upon monetary policy in the major economies is exhausted and the search for alternatives has begun, albeit tentatively. The absence of genuine recovery of the global business cycle, and of capital investment in particular will confirm this and contribute to the perception of end-cycle risk. Western democracies are desperate for reflation, which will drive the new paradigm of the coming decade. But we are not there yet.

2020s: How long does it take to reflate?

- A disruptive 2020/21 transition, then gradually stronger nominal GDP growth
- Lower corporate profitability; the election verdict will be decisive
- Fragmentation of the world economy; US resists deflation from China and EU
- Global producer industries underperform the Western consumer
- China is in trouble, the next locus of a credit crisis
- Climate policies extend bureaucrats’ claim on the private sector

This is our recipe for a different sort of investment year: transitional and uncharted, and not a more reasonable version of 2019. Between spring and early summer, we think recession anxiety will return with rising US political uncertainty. The odds favor a “soft landing” for the US economy rather than recession, but the ‘window of vulnerability’ for stalling economic growth is from H2 2020 to Q1 2021. This implies the persistence of low volatility will climax in Q1.

Most of our clients would agree that the recent investment landscape is without precedent. The larger question is how to respond to this asymmetry of risk, particularly in the context of expectation pressures after a decade of excess returns. In our view, this is not the time to “reach” for return; it is not the time to ignore the structural and cyclical risks. It is the time to acknowledge the different opportunity set and adapt accordingly.

As this “back to reality” paradigm emerges, we believe annualized returns that are comfortably above measures of nominal economic activity, say high single digits to low double digits will prove compelling in coming years. Our strategy aims to generate these returns, uncorrelated and risk-adjusted, without exposing our clients to today’s ubiquitous “beta risk.”

CPLIX Positioning: Discontinuity Argues For Balance

Investors are interpreting the stabilization of business indicators as the prelude to a 2020 global recovery. However, our interpretation is “late-cycle”, not “new cycle.” The cyclical pattern of the past decade will likely not reproduce itself. In 2019, the greatest reversal of monetary policy worldwide since 2008 failed to restore confidence in cyclical, lower-quality, higher-risk assets.

Sector Key Points

- Elections have consequences that can be meaningful at the sector level. We are especially focused on the political crosscurrents in health care, technology, financials and energy. US elections could be decisive for the longer-term outlook of corporate profitability.

- Technology leadership is narrowing. We emphasize attractive GARP quality, while avoiding names without valuation support. 2020 should be another record year for online ad spending, but political rhetoric and scrutiny continue to be an overhang.

- The outlook for financials remains positive, but the group is unlikely to lead on the upside. Select US large-cap financials benefit by returning shareholder capital. Banks are a good cyclical hedge priced appropriately for downside risks.

- Energy is intriguing as a high risk/reward proposition given its crowded short positioning, depressed valuation and peak insider buying. Markets will focus on the second derivative of oil supply and demand. Energy can be a good cyclical hedge with upside if the US dollar fades.

- We avoid expensive defensives and bond proxies, such as consumer staples and utilities, given risks of crowding and record valuations. We prefer dividend yield opportunities in energy, and select cyclicals and UK equities.

- Health care is an attractive idiosyncratic opportunity following its 2019 underperformance despite stable earnings. Democratic Party proposals (such as a single-payer system) will prove too difficult to implement without bipartisan support.

Asset Allocation Key Points

- Beta and value styles have enjoyed a modest run because the 'growth spread' has narrowed. However, a decisive and broad shift has historically been associated with poor equity returns.

- Part of the problem for many cyclical and value industries is that they represent the "disrupted" rather than the disruptor business models. Growth versus value is often New Growth versus Old Growth. Convergence of economic growth has implications for fixed income. Upside targets for yields are muted almost everywhere and are inconsistent with expectations for global revival.

- Net equity exposures are tactical at a low level, while style and sector allocations are balanced with some emphasis upon *quality*.

Geographic Key Points

- The US, with technology at the vanguard, still leads in terms of cash-generative and cash-returning businesses. This advantage is narrowing, but remains powerful in a world of negligible interest rates.

- Non-US markets could be a risk-on catch-up trade for 2020 if the 'global beta' trade emerges. The UK is a "store of value" within global equities, but its defensive composition and pound strength could be headwinds.

- We prefer US versus non-US, UK versus continental Europe, large over small capitalization. Our sector and style biases emphasize balance, given a gradual inflection in the investment regime into the 2020s.

- If the global economy enjoys authentic revival in 2020-2021 (contrary to our expectations), then quality fixed income and their derivatives in the equity world are outrageously expensive.

For more information, please visit www.calamos.com or contact us at 800.582.6959.

Additional Resources:
https://www.calamos.com/funds/mutual/phineus-long-short-cplix/#_literature

Before investing carefully consider the fund's investment objectives, risks, charges and expenses. Please see the prospectus and summary prospectus containing this and other information which can be obtained by calling 1-800-582-6959. Read it carefully before investing.

Important Risk Information. An investment in the Fund is subject to risks, and you could lose money on your investment in the Fund. There can be no assurance that the Fund will achieve its investment objective. Your investment in the Fund is not a deposit in a bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. The risks associated with an investment in the Fund can increase during times of significant market volatility. The Fund also has specific principal risks, which are described below. More detailed information regarding these risks can be found in the Fund's prospectus.

The principal risks of investing in the Calamos Phineus Long/ Short Fund include: equity securities risk consisting of market prices declining in general, short sale risk consisting of the potential for unlimited losses, leverage risk, and foreign securities risk. As a result of political or economic instability in foreign countries, there can be special risks associated with investing in foreign securities, including fluctuations in currency exchange rates, increased price volatility and difficulty obtaining information. In addition, emerging markets may present additional risk due to the potential for greater economic and political instability in less-developed countries.

Alternative investments may not be suitable for all investors. The fund takes long positions in companies that are expected to outperform the equity markets, while taking short positions in companies that are expected to underperform the equity markets and for hedging purposes. The fund may lose money should the securities the fund is long decline in value or if the securities the fund has shorted increase in value, but the ultimate goal is to realize returns in both rising and falling equity markets while providing a degree of insulation from increased market volatility.

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The portfolio is actively managed. Holdings, sector weightings, net exposures and geographic weightings subject to change daily.

Definitions

The **S&P 500 Index** is a market-value weighted index consisting of 500 stocks chosen for market size, liquidity, and industry group representation. It is widely regarded as the standard for measuring U.S. stock-market performance. The **S&P 1000 Index** includes 1000 U.S. stocks and is a measure of mid to small-cap U.S. stock market performance. The **Russell 2000 Index** is a measure of small cap stock performance. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect any fees, expenses or sales charges. Investors cannot invest directly in an index.

GARP is an abbreviation for growth at a reasonable price, an investing strategy that seeks stocks with consistent earnings growth while avoiding overly high valuations. **Beta** is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

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