Economic Outlook

CALAMOS INVESTMENTS

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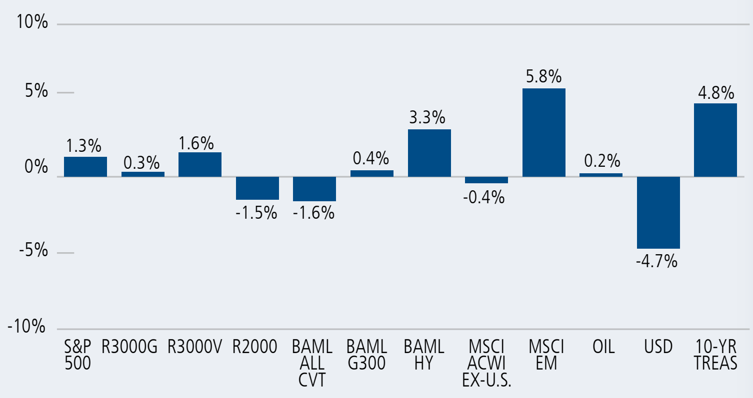
Dramatic shifts in sentiment and positioning resulted in a highly volatile market in the first quarter. Investors had a multitude of issues to digest, including commodity price and dollar volatility, U.S. recessionary fears, and central bank monetary policy shifts. Our outlook is unchanged from the beginning of the year: We are cautiously optimistic, but expect volatility throughout the year.

Recent comments from the Fed and other central banks point to more coordinated action and fewer interest rate increases in 2016. This shift in policy has resulted in the dollar retreating from its highs and commodity prices rebounding from multi-year lows. Fortunately, as first quarter earnings announcements get underway, market expectations have been tempered, which should mitigate downward volatility. However, swings in market sentiment (Figure 1) show investors' inclination to make quick moves in response to data and uncertainties. In this environment, we believe:

- The U.S. is not facing an imminent recession, but the pace of economic growth will be modest, both in the U.S. and globally.
- Many factors are likely to fuel volatility throughout 2016, including Brexit, the U.S. presidential election, central bank policy shifts and global growth concerns.
- Conditions do not call for defensive positioning but warrant caution.
- In a slow growth environment, growth stocks remain attractive, but a weakening dollar and stimulative central bank policies have created select opportunities among cyclicals.

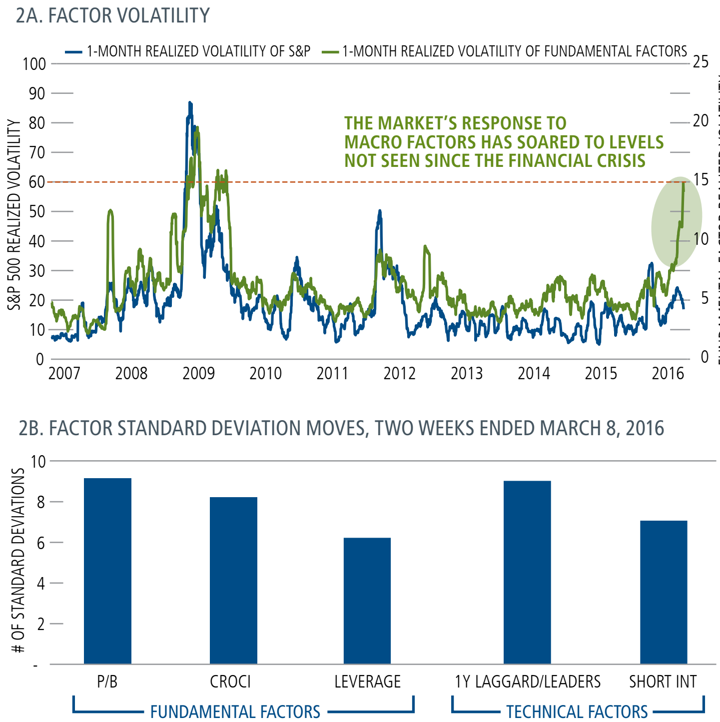
FIGURE 1. 1Q RETURNS LARGELY OBSCURE THE MARKETS' TWISTS AND TURNS

In the first weeks of the year, investors maintained a risk-off stance and crowded into a narrow group of stocks. As the quarter progressed, increased confidence in the U.S. economy, the likelihood of fewer Fed increases, and stabilizing commodity prices fueled a rally in emerging markets, high yield, and value and cyclical stocks. Growth equities gained a better footing during the second half of March, when Chair Yellen's remarks called into question the strength of the global economy. Convertibles participated in the equity market's ups and downs, with U.S. convertibles continuing to reflect the performance of small and mid-cap growth issuers.



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

FIGURE 2. MARKET SHIFTS WERE EXTREME IN 1Q 2016



Factors are quantitative characteristics associated with a group of securities. Fundamental Factor Volatility (Figure 2a) is an equal weight measure of three Goldman Sachs Investment Profile factors: return, growth and valuation. Source: Goldman Sachs Investment Research, "Quantamental 101, Factor Investing, the rise of the Machines," Robert D. Borougerdi, John Marshall, Jessica Binder Graham, Katherine Fogertey. Figure 2b: See definitions on final page for additional information.

U.S. equities. While trends in employment and housing continue to support our view that the U.S. is not facing an imminent recession, we see a lack of fiscal policy, election uncertainty and constraints on entrepreneurship raising barriers to more robust economic growth in the U.S. Given our view of a slower growth and more volatile environment, we continue to favor growth companies but remain cognizant of the macro dynamics driving the rebound in cyclicals (dollar, oil and central bank reflation). As we have discussed in the past, when earnings growth is scarce, investors are more inclined to reward those companies that can achieve it.

Information technology, including companies related to the cloud, social media and semiconductors, remains a key theme, as does consumerism, particularly companies that are focused on entertainment and travel. We remain cautious on health care given upcoming elections but have invested selectively in areas such as services and animal health. While we maintain an overall emphasis on growth, we have identified select cyclical opportunities on a bottom-up basis, including energy companies that we believe can better capitalize on supply/demand imbalances.

This positioning reflects our view that dramatic market shifts, such as the first quarter's rotation to low-quality stocks, are not sustainable. As we noted, investors crowded into a narrow group of growth stocks at the start of the year due to heightened fears of recession but as these fears subsided, investors moved very quickly into many of the most battered names. Figure 2a reveals the extreme nature of the market's response, as fundamental factor volatility rose to levels not seen since the financial crisis. As Figure 2b shows, the standard deviation of returns of a range of factors soared during a two-week period at the height of the cyclical rotation. There was a significant ramp up in the market's preference for companies with lower price-to-book ratios (P/Bs), with less concern about leverage levels and cash return on cash invested (CROCI). Short interest soared as investors shifted portfolios rapidly, and there were strong rebounds among last year's laggards.

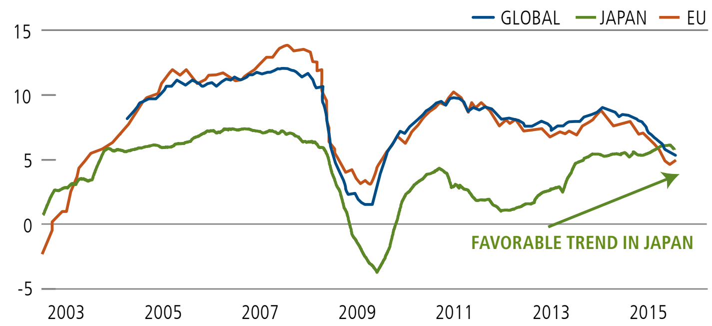
Europe. European equities struggled during the quarter, largely in sympathy with global growth concerns. In Europe, the challenges facing the banking industry are particularly concerning as banks face compounding headwinds: weak demand for loans, net margin pressures due to European Central Bank policy to repress interest rates, a continued regulatory overhang, and legacy non-performing loan issues. The market's increasing recognition and concern over these headwinds resulted in meaningful volatility and underperformance of a variety of bank securities during the quarter, and we remain cautious on the group.

Europe's broader economic recovery continues at a tepid course, though several geopolitical flashpoints present risks this year, including the Brexit referendum and other elections, the ongoing refugee crisis, and the threat of terrorist attacks. Despite these headwinds, we are finding investment opportunities. Equity valuations are relatively attractive and monetary policy remains reflationary, while lower energy prices, interest rates, and currency should drive corporate earnings improvement in coming quarters. We remain constructive on real estate assets, particularly in Germany, given the current rate environment. However, monetary policy appears to have shifted recently from targeting the euro, so we are less constructive on some export-driven growth opportunities. Due to the uncertainty associated with the Brexit referendum, we remain cautious about the UK and are leveraging our economic exposure research to better understand the potential impacts of either vote outcome to businesses in the UK and elsewhere.

Japan. After being one of the strongest performing markets during 2015, Japanese equities stumbled out of the gate in 2016, as the Bank of Japan's surprise announcement that it would move to a negative interest rate policy did not have the desired effect on equity markets and the yen. Instead, the market began to question the efficacy of the BOJ's aggressive monetary policy, and indeed Abenomics overall, with Japanese banks among the hardest hit. Throughout the remainder of the year, we expect a range of measures to support the Japanese economy, such as a fiscal response including a potential delay in raising the consumption tax, and additional monetary support. Historically, the market has responded favorably to these types of policy measures, but caution is warranted given the extent to which both monetary and fiscal policy have struggled in addressing Japan's deflationary headwinds. We remain focused on identifying opportunities where corporate governance and capital allocation are improving. Notably, Japanese companies are diverging from the global trend of lower returns on equity less the cost of capital (Figure 3), which we view as a reflection of these improvements. We also see secular trends and policies supporting opportunities in a number of industries (See our blog, "Field Notes: Japan.")

Emerging Markets. We are more positive on emerging markets than we were at the start of the year, as more stability in commodities and currencies can benefit the group. However, we remain highly selective and believe many of the countries that rallied most during the first quarter do not offer the most attractive risk/reward opportunities going forward. As we outlined in a recent paper, we don't believe gains in twin deficit countries such as Brazil, Russia, and South Africa are sustainable. In contrast, we are more constructive

FIGURE 3. RETURN ON EQUITY LESS COST OF CAPITAL



Source: BCA, "The Bank Credit Analyst," April 2016, using Datastream Worldscope, BCA Calculations. Data is for non-financial companies and uses weighted average cost of capital. © BCA 2016

on India, the Philippines, and China. These countries are pursuing favorable economic reforms, making them better destinations for capital, and are beneficiaries of lower commodity prices.

China. Concerns about China's currency have been a significant driver of market volatility. We don't believe China will force a marked devaluation of its currency or target the yuan as a source of growth for the Chinese economy. Additionally, we are encouraged by the progress that China is making toward its long-term goal of becoming a more consumption-driven economy. Many of our investments are focused on this consumption theme, including companies tied to e-commerce, a very healthy segment of the Chinese economy. We are also finding opportunities in the financial sector, as a prospering middle class increasingly seeks financial products. Finally, we see opportunities in infrastructure build out, such as the massive One Belt, One Road stimulus initiative.

High Yield. During the first six weeks of the year, high yield spreads widened by nearly 200 basis points, reflecting expectations of a default environment typically only experienced during recessions. However, spreads narrowed and ended the quarter only modestly wider than year-end levels as more encouraging economic data, rising commodity prices, and further stimulus from global central banks stimulated investor appetite for riskier yield opportunities.

We expect default levels to rise but not materially above long-term averages, with the majority of defaults confined to commodity-related sectors where low security prices already reflect default expectations. While we believe that we are in the late stages of the credit cycle, defaults are currently dominated by issuers that have survived for longer than they otherwise would due to an accommodative lending environment and less restrictive covenants.

Compared to the start of the year, we believe security selection will become even more paramount to outperformance in the months to come. Consequently, we are strictly adhering to our risk management discipline as we progress through this debt cycle. While lower-quality high yield has outperformed in the recent retracement, we believe higher-quality high-yield issuers that can generate stable financial results even in a slowing global economy provide the better potential from a risk/reward standpoint. We maintain a particular focus on identifying "rising star" candidates ahead of ratings agencies. (Rising stars are issuers that are upgraded to investment-grade status.) Historically, these upgrades have generated significant spread compression and alpha generation. From a sector perspective, we have a more constructive outlook for consumer goods, select auto suppliers, and outpatient health care, remaining more cautious about financials, lower quality energy, and media.

Convertibles. During the first quarter, convertible new issuance was $16 billion globally. Europe led with $8 billion, while the U.S. contributed $3 billion. So far, issuance has been below historical trend lines, which is understandable given market volatility. New issuance should pick up as cyclical sectors continue to shore-up balance sheets, growth firms seek capital for expansion under more certainty, and stock buybacks continue.

In a volatile environment where the valuations of many defensive stocks are high, we see pronounced opportunities for convertibles as a means to pursue lower-volatility equity participation. We remain focused on the more balanced structures within the convertible market, which we believe enables us to protect on a downside equity move, yet participate in the upside of a volatile market. We are also favoring higher credit qualities. In this low-growth environment we're experiencing, companies with strong balance sheets that generate above-average organic growth have typically been rewarded by investors.

Similar to our positioning in U.S. equities, our convertible positioning reflects our overall emphasis on growth sectors such as information technology and consumer discretionary. We are becoming even more selective in health care, although we have identified potential beneficiaries of long-term secular themes. Although we've been quite cautious on energy, materials and industrials, we've opportunistically added at the margin when we've found attractive valuations and improving fundamentals.

Conclusion

As we have observed throughout the years, short-term volatility in the markets creates long-term opportunities for disciplined investors. While staying highly cognizant of how the market is responding and the implications to portfolios, we are maintaining a research-driven approach and will not rush to follow the herd. Having invested through multiple market cycles, we are confident that we can respond thoughtfully as opportunities emerge and identify a breadth of opportunities—across asset classes and geographies—even in an environment of slow economic growth, where uncertainties are formidable and spates of volatility are likely to continue.

Indexes are unmanaged, not available for direct investment and do not include fees and expenses. The **U.S. Dollar Index** measures the value of the U.S. dollar relative to a basket of foreign currencies, including Euro Area, Canada, Japan, United Kingdom, Switzerland, Australia, and Sweden. The **Russell 3000 Growth Index** and **Russell 3000 Value Index** measure U.S. growth and value equities, respectively. The **S&P 500 Index** is considered generally representative of the U.S. equity market. The **MSCI All Country ex U.S. Index** represents the performance of global equities, excluding the U.S. The **MSCI Emerging Markets Index** is a measure of the performance of emerging market equities. The **BofA Merrill Lynch U.S. High Yield Index** is an unmanaged index of U.S. high yield debt securities. The **BofA Merrill Lynch All U.S. Convertible Index** (VXA0) is a measure of the U.S. convertible market. The **BofA Merrill Lynch G300 Index** measures the performance of 300 global convertibles.

Quantitative easing refers to central bank bond buying activities. **Price-to-book ratio** is the current closing price of a stock divided by the latest quarter's book value per share. **ROE** is return on equity, a measure a company's profitability, measuring how much profit is generated with the money shareholders invested. **Weighted cost of capital** is a weighted average of all capital sources a company uses. **Short interest** is the quantity of stock shares that investors have sold short but not yet covered or closed out. **Standard deviation** measures the dispersion of data from around its mean.

Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. The views and strategies described may not be suitable for all investors. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations.

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