Economic Outlook

CALAMOS INVESTMENTS

October 2017

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Positive economic data, supportive central bank policies, solid corporate earnings, contained inflation and a stable-to-weaker U.S. dollar have all combined to sustain the synchronized global narrative. The U.S. recovery is mature but still has steam, while other economies are in more fledgling stages of recovery. As global growth continues and reflationary tailwinds strengthen, we see additional upside in the global business cycle and in turn, for equities, convertible securities, and select areas of the credit markets.

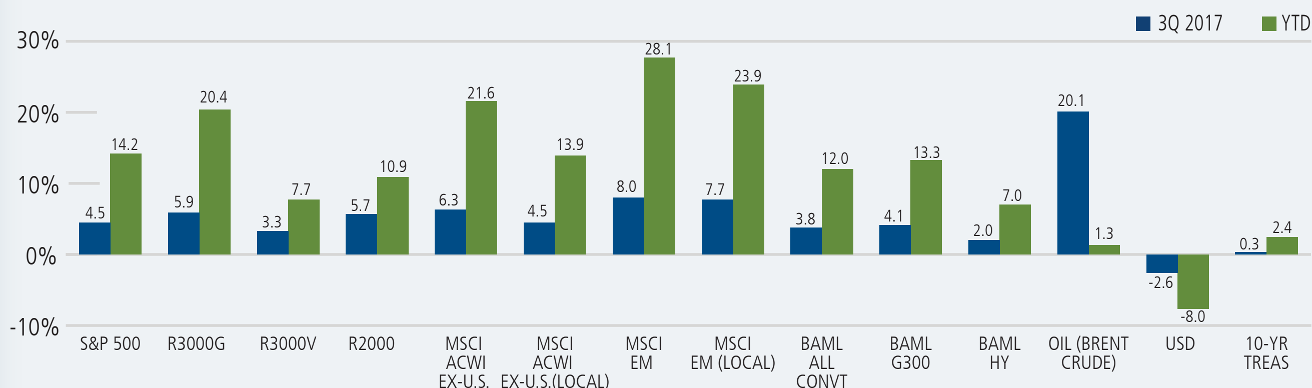
Attention to potential downside risk and valuations remain paramount. Although market participants are not shying away from risk assets, they have been quick to punish companies that disappoint. We may see consolidation and sector rotation as we move through the final months of the year; and given the sustained rally in equities, we would not be surprised to see a pause or even a correction. In an environment of economic expansion, a breather in the markets could provide buying opportunities for our long-term approach. Historically, market corrections have tended to be modest, provided that sales and earnings were improving.

Among the potential risks on the horizon, monetary policies are moving away from the exceedingly accommodative stances of past years. In particular, the Fed will be entering uncharted waters with its balance sheet normalization. Rising rates could revive deflation and prove especially troublesome for

MARKET REVIEW

Amid growing optimism in the health of the global economy, risk-on sentiment prevailed during the third quarter. As the U.S. equity market rally broadened, cyclical, value oriented and smaller-cap names garnered increased market interest. International equity markets performed strongly during 3Q, driven in particular by Hong-Kong listed Chinese shares, and strength in most foreign currencies against the U.S. dollar.

FIGURE 1. GLOBAL ASSET CLASS PERFORMANCE, 3Q 2017 & YTD



Past performance is no guarantee of future results. Source: Morningstar and Bloomberg. Data shown in USD unless otherwise noted.

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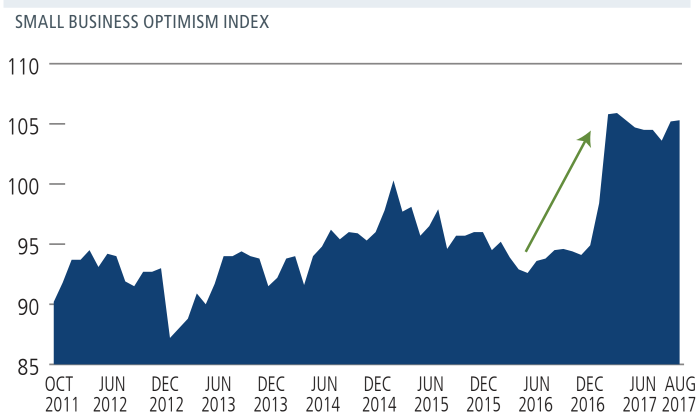
NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

FIGURE 2. SMALL BUSINESS OPTIMISM HAS IMPROVED



Source: Bloomberg. Data as of 10/31/11 to 8/31/17.

FIGURE 3. EARNINGS RECOVERY INTO 2018

Source: Morgan Stanley Equity Strategy, "Weekly Warm Up: Don't Fight the Trend — Sticking With Our Sector Calls," October 2, 2017, using data from FactSet, Bloomberg, Robert Shiller, Morgan Stanley Research, as of September 28, 2017.

FIGURE 4. GLOBAL VALUATIONS

AS OF 9/30/2017

	FWD P/Ex	TRAILING P/Ex	EPS 2017E REVISION YTD	EPS CAGR 2016-2018	FWD Px/SALES	TRAILING Px/SALES	SALES CAGR 2016-2018
U.S.	18.2	22.1	+1%	16.8%	2.1	2.2	6.1%
Japan	14.4	15.6	+3%	23.5%	0.9	0.9	7.2%
Europe	15.5	21.8	+9%	41.0%	1.3	1.3	7.8%
EM	13.8	16.0	2%	23.4%	1.3	1.3	8.7%

Past performance is no guarantee of future results. Source: Bloomberg. Data in USD terms. EPS 2017E Revision YTD data is from 4/3/17 to 9/29/17 is to provide a consistent point of comparison (Japanese companies typically have fiscal year ends of 3/31)

corporations that have taken on high levels of debt in a low-interest rate environment (for more, see our recent post, "More Upside for Equities?"). We are watchful of political instability and potential setbacks in eurozone growth, strained trade relationships, deceleration in China, and acrimonious rhetoric between the U.S. and North Korea.

United States

The U.S. economy looks set to continue on an expansion course through at least the first half of 2018, although we are watching for signs of late-cycle pressures. Strong corporate earnings, very positive employment data, healthy consumer trends, muted inflation, and well-behaved long-term interest rates suggest a low risk of recession. The prospect of tax reform has revitalized the reflation narrative and the passage of new tax policies could catalyze corporate spending and earnings, and thus another leg of the equity market rally. Also, small business optimism has settled at an elevated level (Figure 2), which bodes well for the economy as whole, as small businesses have historically been the engine of U.S. job creation.

We expect earnings-per-share for the S&P 500 to rise nicely into 2018 (Figure 3), albeit at a slowing rate of change. With broad-based earnings strength, we believe the markets have more upside. As the rally in U.S. equities has broadened, our U.S. equity portfolios reflect diversified opportunity sets, including cyclical exposures (in financials, industrials and consumer discretionary) and traditional growth exposure (in technology and health care).

Global and International

Stable or improving economic conditions, ongoing monetary policy accommodation, significant headroom for corporate margin expansion and in many cases, better valuations (Figure 4) have led us to maintain substantial exposure outside of the U.S. in our international and global strategies. We continue to emphasize a balance of cyclical growth and secular growth opportunities, with less exposure to traditionally defensive sectors where we believe valuations are elevated.

Outperformance of European shares (in local currency terms) paused during the quarter, but euro appreciation resulted in continued outperformance of dollar-based returns versus broad global and U.S. equity benchmarks. Looking forward, the investment landscape in Europe remains compelling. As usual, there are near-term political risks and longer-term questions about the sustainability of monetary and political frameworks but on balance, improving earnings, still-accommodative monetary policy conditions, and reasonable valuations provide an attractive backdrop over our investment horizon.

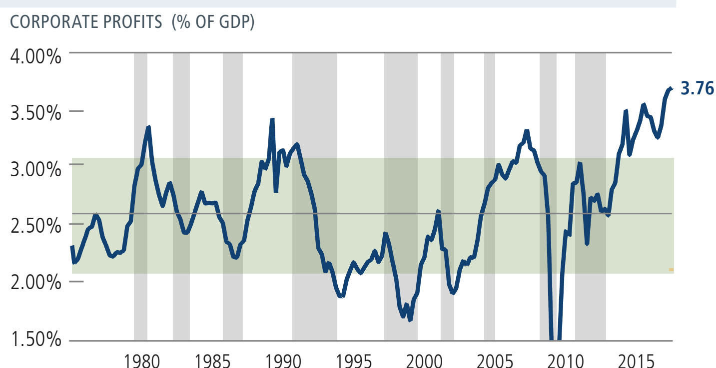
Emerging economies are also well represented in our strategies. We have often commented that the diversity among these economies requires selectivity from both top-down and bottom-up perspectives. Still, it's important to recognize the extent to which the Chinese economy influences the macroeconomic landscape across emerging and developed economies. While we are watching for signs that selective policy tightening may result in a sharper deceleration in Chinese economic activity (particularly following the country's National Party Congress later this month), we have also seen encouraging data, including in construction (Figure 5), auto sales, and online goods sales. Given our view that near-term conditions in China are likely to remain stable, as well as the improving growth trends we see in other emerging economies, we maintain a favorable outlook on emerging markets. We have identified many bottom-up opportunities—particularly in China and India—that provide exposure to long-term growth themes. A stable-to-weaker dollar is a precondition for continued short-term emerging market outperformance but at this point, we do not anticipate a near-term resurgence of the dollar and tightening global liquidity conditions. (For more on our emerging market outlook, see our paper "The Longer-Term Opportunity in Emerging Markets.")

In Japan, economic conditions have improved, monetary policy remains very accommodative and valuations are attractive. Corporate reforms over the past several years are bearing fruit as corporate profits have reached a record high percentage of GDP (Figure 6). We continue to favor multinational Japanese businesses, particularly those benefiting from the improving global growth backdrop and strong thematic tailwinds, including in automation and robotics.

FIGURE 5. REBOUNDING CHINESE CONSTRUCTION ACTIVITY

Source: JP Morgan Cazenov, Global Equity Strategy, October 2, 2017, using data from NBS.

FIGURE 6. CORPORATE PROFITS SOAR IN JAPAN



Source: Charles Gave, Gavekal Research, "Japan is Back!" October 2017 using Gavekal Data/Macrobond.

Convertible Securities

In an environment of upbeat market sentiment and global economic expansion, global convertible issuance has maintained a good clip, with $61 billion through the end of the third quarter. U.S. companies have represented the lion's share of issuance at nearly $33 billion, followed by Europe with close to $20 billion.

We believe the hybrid attributes of convertible securities can be particularly advantageous in an environment where interest rates rise gently and leadership rotation and consolidation accompany further advances in the equity market. In addition to offering the opportunity for equity upside with potential downside protection, convertibles have historically offered a more attractive risk/return profile during periods of rising interest rates than investment grade bonds. Further, as small and mid-sized companies figure prominently among convertible issuers, the asset class is well positioned to benefit from the increased interest in small caps.

However, active management is essential for achieving the appropriate balance of risk and reward against a continually evolving market backdrop. In that regard, we are focusing on securities that offer a prudent balance of upside participation and downside protection, as well as reasonable valuations. We are favoring companies that can benefit from consumer activity and technology companies positioned to capitalize on secular and cyclical growth trends. In contrast, we have maintained a more selective stance toward more defensive areas of the market and convertibles that do not offer balanced risk/reward attributes, such as utilities and consumer staples.

Fixed Income

Since 2008, many investors have bought bonds for capital appreciation and equities for income—a reverse of historical norms. We believe we are at the beginning of a long transition as both asset classes return to their traditional roles. In other words, even as rates rise around the world, there is still a compelling case for fixed income allocations.

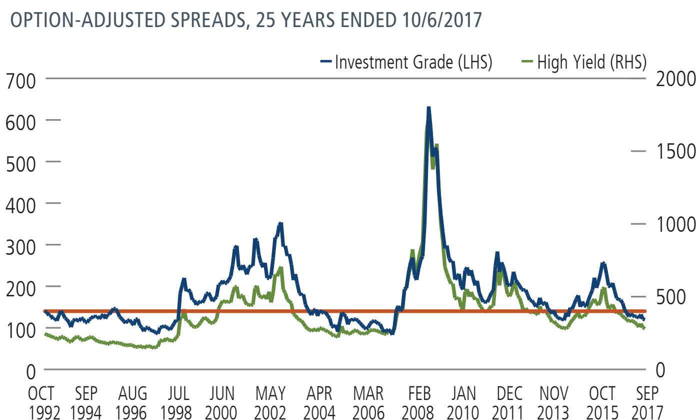
For both the year-to-date and third quarter periods, fixed income assets exhibited resilience in the face of Fed tightening. While the U.S. 10-year yield has risen over recent weeks, it hovers below where it started 2017, dispelling the widely held misconception that short-term and long-term rates rise in tandem. As we have discussed in our past outlooks, these parallel shifts are more the exception than the rule.

There is lively debate around the Federal Reserve's course from here, both in regard to interest rate increases and balance sheet normalization. The Fed has noted the potential for four hikes over the next 18 months, but we may see fewer, depending on inflation and global economic conditions. In regard to quantitative tapering, the Fed's guidance is best thought of as a ceiling, not a floor. What we see next will depend on market and geopolitical conditions, other central banks, and Fed leadership changes (see "Perspectives on Fixed Income" for more).

In the U.S. bond markets, valuations are not cheap on an asset class level, as evidenced by narrow spreads for both investment grade and high yield. As Figure 7 shows, once these levels have been reached, they can persist for a number of months, as they did prior to the last recession and in the late 1990s (see the post, "Today's Risk: Foregoing Income by Exiting Strategic High Yield"). With high valuations, there is little margin for error, which creates an environment that favors the skilled and active manager. Indeed, this is a backdrop which is particularly well-suited to bond-by-bond selection. Overall, we are most constructive on high yield securities and have identified opportunities in out-of-favor areas of the market, including telecommunications, retail, steel and pharmaceuticals that offer appropriate compensation for their potential risks.

FIGURE 7. SPREADS ARE TIGHT AND CAN STAY TIGHT FOR AN EXTENDED PERIOD

OPTION-ADJUSTED SPREADS, 25 YEARS ENDED 10/6/2017



Source: Bloomberg. High yield is represented by the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index; Investment grade is represented by the Bloomberg Barclays U.S. Aggregate Corporate Index.

Conclusion

Global economic conditions and reflationary tailwinds provide a supportive backdrop for equities and other risk assets. However, rich valuations in some areas and the potential for leadership rotation and consolidation create an environment that will increasingly favor experienced, risk-aware managers.

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 **Russell 2000 Index** measures U.S. small cap stock performance. 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. The **Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index** measures the performance of high yield corporate bonds with a maximum allocation of 2% to any one issuer. The **Bloomberg Barclays U.S. Aggregate Corporate Index** measures the performance of investment grade corporate bonds. **Oil** is represented by current pipeline export quality Brent blend. **Purchasing Managers Indexes** measure manufacturing sector strength. **Earnings per share (EPS)** is a company's profit divided by its number of common outstanding shares. **Price-to-earnings ratio (P/E)** is a valuation ratio of a company's current share price compared to its per-share earnings; forward P/Es are based on forecasted earnings. **CAGR**, or compounded annual growth rate measures year-over-year growth. **Price-to-sales ratio** measures a company's stock price versus its revenues.

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