Economic Review and Outlook

CALAMOS®

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IN THIS COMMENTARY

We explain why we believe:

> By some measures, the global economic recovery looks to be on the ropes. However, there are many indications that the healing process has begun.

> While the banking crises and debt levels we see today are not unlike those of the Great Depression, global economic data indicates a better scenario today.

> Emerging markets are in good shape on the whole, providing a possible source of global stability and growth into the future.

> Debt deleveraging has often sown the seeds for strong equity market performance.

> The imbalances of the global economy create opportunities for countries and companies that position themselves to supply the emerging markets.

> Global growth equities offer the best risk/reward prospects, on the whole.

The same old song and dance

During the second quarter of 2011, the financial markets were in a holding pattern, awaiting resolutions to many global economic concerns (see our July commentary, "Waiting on the World to Change"). Unfortunately, in the third quarter the answers to many of the issues emerged, and they did not surprise any student of history. The debt ceiling was raised without any progress toward a long-term debt solution. The Greek crisis was papered over with promises and bailout packages that offered no chance of fixing the Greek solvency problem. The full extent of European sovereign debt issues went unaddressed. It was the same old song and dance at the European Central Bank.

> It appears that emerging markets are large enough and healthy enough to provide a global growth path on which the developed world can be pulled along.

It's been the same old song and dance at the Federal Reserve as well. Amid the uncertainties surrounding the end of QE2,* Fed Chairman Bernanke stated firmly that he had many bullets left in the chamber and would do what was necessary to support the economy. His words have lost some of their punch, however. In his latest policy speech, the chairman spoke to the significant risks to growth the Fed sees, and then proceeded to offer up "Operation Twist." The markets sold off on this neutral and weak policy response—one that signaled that, with interest rates near zero, the Fed was in fact running out of options. The equity markets want more quantitative easing that injects liquidity into financial assets. We believe the Fed is correct in avoiding more QE, but we wonder how long its resolve will last. As assets decline further and weakness in the economy continues, we expect to see the Fed step in with some form of QE in an attempt to stave off further asset deflation.

*Quantitative Easing 2 (QE2) refers to the Federal Reserve's most recent round of quantitative easing.

In the U.S., the president's new solution to the employment problem was the same old fiscal policy song and dance: increase government spending and increase taxes with some temporary tax relief thrown in. Once again, we saw a plan that offered no relief for capital owners and increased concerns about future capital investment in the United States. Rather than encouraging the private sector to take risks, expand and create jobs, the plan casts the private sector as the bank for the public sector's unchecked expansion. We believe that a lack of capital investment has held back the recovery; and penalizing capital owners is not the solution. Debt and deficit spending is a tax on future income and capital. In our view, the government is taking as much future wealth as it can from its citizens; and policymakers do not seem to understand why businesses and citizens will not risk more capital by investing in new ventures and expanding current ones. Incentives matter in raising children, compliance with laws and contracts—and in business. To us, it is clear that government disincentives to risk capital must be readdressed if we are to unlock growth.

The creative destruction that leads to improvements in the developed world's productivity cannot be centrally managed.

To a hammer, everything looks like a nail. To a central government planner, everything looks like a public sector solution and chance to increase government reach. Often, the intervention is put forth under the premise of benevolence. Where are the "benevolent and caring" governments that can assure we live without any risk and that everybody has equal outcomes? They don't exist and can't. Governments are not compassionate, caring entities. If you're not sure about this, try to get something accomplished or corrected through Medicare, a department of motor vehicles, or any other agency. User-friendly, caring and effective do not come to mind. Governments are no different than private businesses, except that governments don't have to please the customer; and generally, they don't have to compete to stay effective or use capital (your money) efficiently.

Government spending that leads to higher real productivity will grow the economy, but in a developed economy, this sort of government spending is hard to come by. Gains in GDP result from population growth and productivity growth. Population growth is nearly zero in developed economies, while productivity growth is risky and often not easy to tolerate, politically and otherwise, given that it comes with job displacement. China can drive growth with central planning because moving people off small farms to factories is 10 times more productive.

The creative destruction that leads to improvements in the developed world's productivity cannot be centrally managed. Most significant productivity enhancements come from the displacement of workers or from a major technological change that makes a production system or distribution network obsolete. Governments protect the status quo where voting blocks are clear and political lines are established, all at the expense of change and growth. Changes in productivity can be very unsettling and disruptive, but we see them as necessary to creating the new growth and productivity that will raise living standards for most citizens.

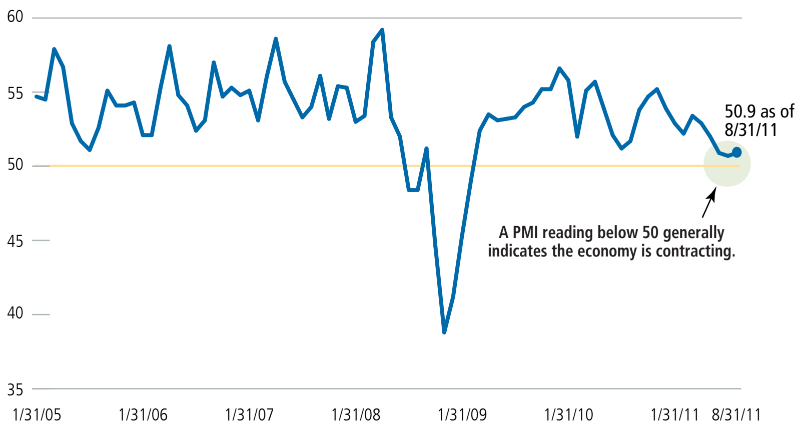
Therefore, instead of government spending stimulus, we believe it is time for business and investment stimulus. Because the lack of jobs, new capital formation and risk capital are at the core of the growth problem we face, how about policies directed at incentivizing these areas? Yes, we know it looks like an approach that favors those that are already wealthy and successful; but when you need growth in capital and investment, that's where we believe policy must go. Lower the costs of business, risk and investment, and get a boom that we believe ultimately can help more people achieve greater prosperity and security. In the U.S., that would mean lowering the corporate tax rate to 15%, bringing dividend and capital gains to zero, expanding research and development credits, eliminating U.S. taxation on repatriated profits brought back to the U.S., normalizing short-term interest rates to help savers, and putting a hold on all new business regulations imposed over the past few years until a cost/benefit analysis is completed. We believe that capital flow and risk taking will emerge—along with new jobs, and yes, even higher tax revenues.

Can we have another recession if we have not emerged from the last one?

By a number of measures, the global economic recovery looks to be on the ropes. The emerging economies are holding stubbornly to monetary policies in a bid to fight off inflation and restrict hot money flows and loose credit. All eyes are on China, where inflation remains high and monetary officials continue to tighten the reins on credit

FIGURE 1. CHINA MANUFACTURING INDEX

JANUARY 2005–AUGUST 2011



Source: Bloomberg

expansion. Food price inflation in China is a major concern. It hits the poorest the hardest and rallies the populace around change, as we have seen in the Middle East. We have been expecting China to become neutral with its credit policy and even reverse the tightening by early next year, but at this point China remains vigilant about restricting credit and keeping inflation in check—even at the expense of GDP growth targets. The global growth wagon is hitched to the emerging markets' growth, and particularly China's, so stay tuned to its policies. At this juncture, we don't see China adding to global liquidity and the country may experience further weakness, as its recent manufacturing index indicated (Figure 1).

Meanwhile, the developed economies are mired in a debt crisis that policy makers seem incapable of understanding and destined to deepen. In a response to the flagging economic recovery, global market participants have driven commodities and equity prices down and have fled to U.S. government bonds. The ECRI Weekly Leading Index and ISM Manufacturing Prices Paid Index continue to show weakness

FIGURE 2. S&P 500 INDEX TOTAL RETURN, LESS 10-YEAR TREASURY VS. ECRI INDEX

SEPTEMBER 1997–SEPTEMBER 2011

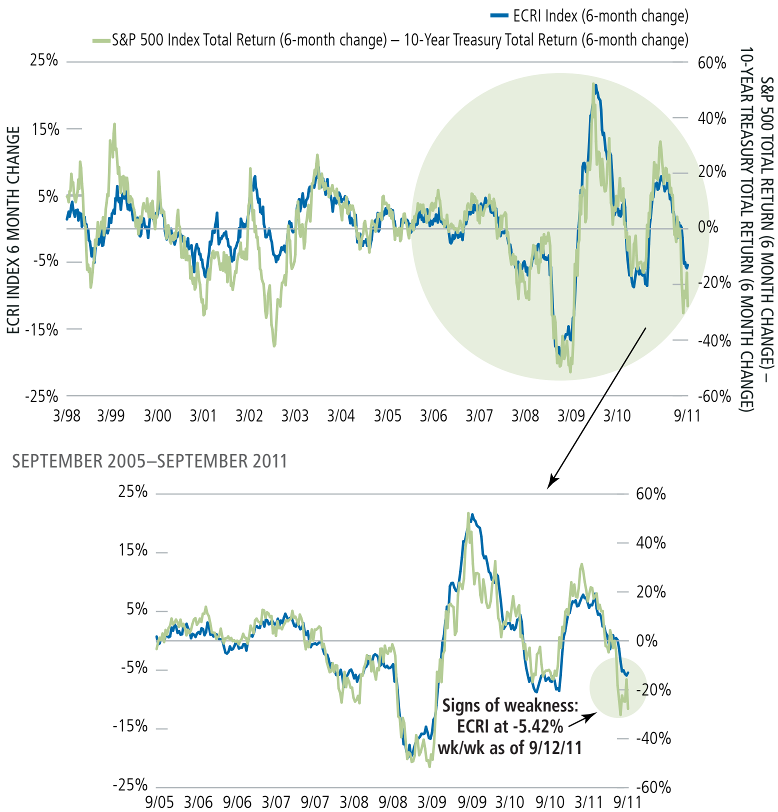
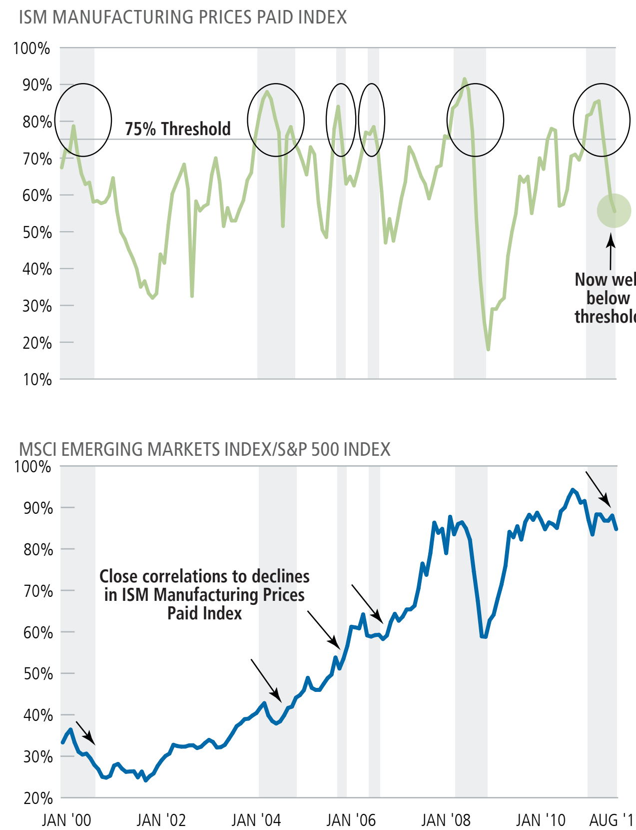


FIGURE 3. ISM INDEX AND IMPACT ON EMERGING MARKETS

DECEMBER 1999–AUGUST 2011



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. The MSCI Emerging Markets Index is a free float adjusted market capitalization index. It includes market indexes of Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. The ISM Manufacturing Prices Paid Index tracks business sentiment regarding future inflation. A higher figure indicates increased inflation expectations.

FIGURE 4. U.S. REAL PER CAPITA GDP

PERCENT OF PREVIOUS PEAK

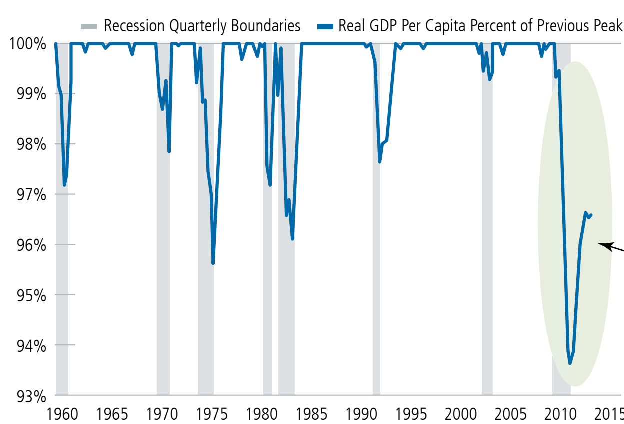
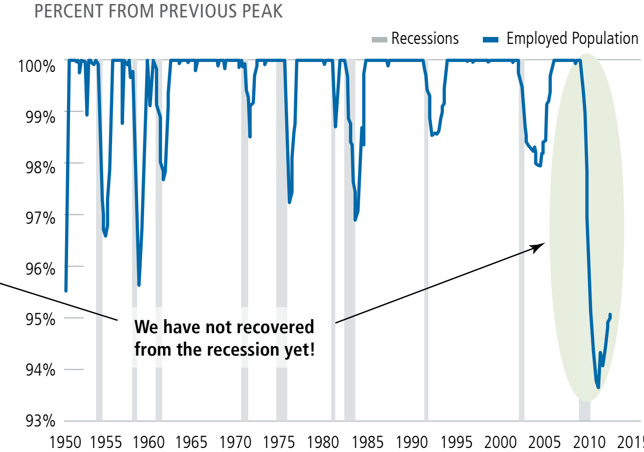


FIGURE 5. U.S. EMPLOYMENT

PERCENT FROM PREVIOUS PEAK



Source: "Recession? No. We're in the Second Great Contraction," Advisor Perspectives (dshort.com), Doug Short, August 31, 2011

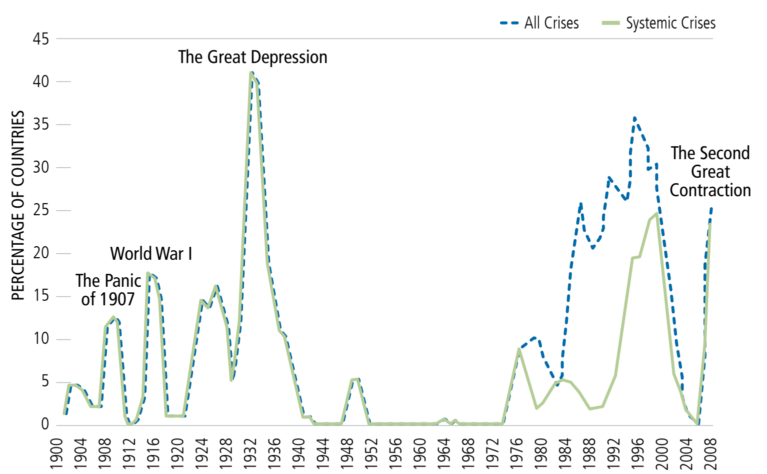
(Figures 2 and 3), while the employment picture remains bleak and housing stubbornly depressed.

As many others have maintained over the past few years, we believe the debt cycle will run its course and markets will need to clear, it is just a matter of how long we will have to wait. Adding to the debt burden and spending future wealth is not the solution. It's a dangerous course that puts off the corrective phase, while building pressures and increasing the downside impact on wealth when the cycle finally takes hold. The U.S. economy has yet to reach the output peak level of 2008. The economy is still smaller despite a growing population and growing global economy. The problems in the developed economies stand in contrast to the recovery in the emerging markets, but one has to wonder if the debt deleveraging process of the developed world engulfs the entire global economy and sinks all. Can the emerging markets withstand a weak customer in the developed markets? Can we find a path to recovery that is strong enough to employ more members of society?

The current economic data from the U.S. indicates that the recovery continues, but at an anemic pace. Thus far, the recovery is the weakest since the Great Depression. Figures 4 and 5 show the severity of the dips in U.S. real per capita GDP and employment.

FIGURE 6. PROPORTION OF COUNTRIES WITH BANKING CRISES

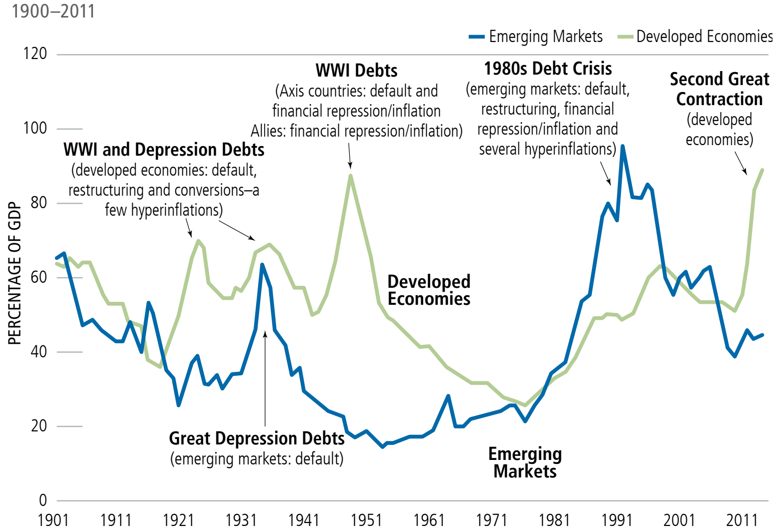
1900–2008 (WEIGHTED BY THEIR SHARE OF WORLD INCOME)



Source: Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009, Figure 13.1, page 205

FIGURE 7. SURGES IN CENTRAL GOVERNMENT PUBLIC DEBTS AND THEIR RESOLUTION: DEVELOPED ECONOMIES AND EMERGING MARKETS

1900–2011

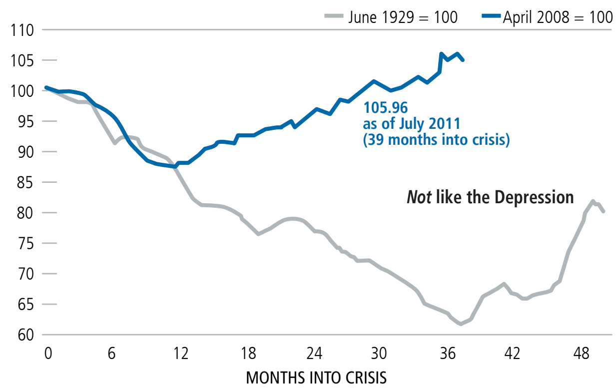


Source: Carmen Reinhart and M. Belen Sbrancia, "The Liquidation of Government Debt" NBER Working Paper No. 16893, March 2011

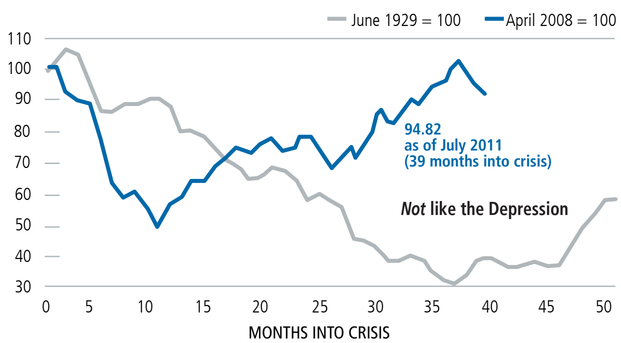
If the Depression is the closest example to what we are going through now, how do we compare to that era's recovery? What does history suggest about what we might expect in the near future? Indeed, the global debt and banking crisis we are experiencing now is similar to that of the Depression. Figure 6 shows the proportion of countries with a banking crisis since 1900. The global banking industry is under severe strain as was the case during the Depression, while Figure 7 (courtesy of Reinhart and Sbrancia) shows the developed and emerging markets public debt-to-GDP cycles since 1900. Today, the public debt and banking crisis in the developed world is very close to the levels seen during the Depression. The debt level for developed markets is also close to its post-WWII peak. So, how did markets perform during the last major debt deleveraging cycles? What might investors expect in the future?

FIGURE 8. NOW VS. THEN

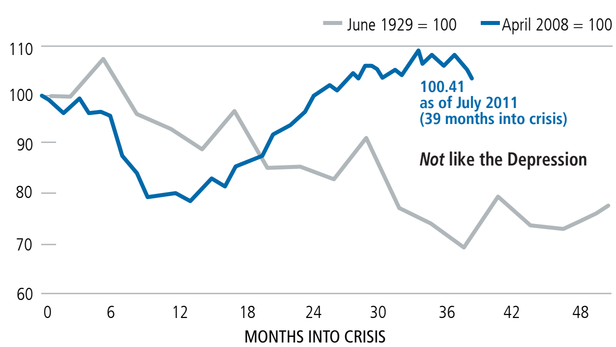
WORLD INDUSTRIAL OUTPUT



WORLD STOCK MARKETS (MSCI WORLD INDEX)



VOLUME OF WORLD TRADE



Past performance is no guarantee of future results.

Sources: Barry Eichengreen and Kevin H. O'Rourke © voxEU.org, Netherland Bureau for Economic Policy Analysis, Bloomberg

The MSCI World Index is a market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America, Europe, and Asia/Pacific region.

What's different now versus the Depression?

During the Depression, both emerging and developed markets had banking crises and high levels of public debt. Figure 8 compares the global economic output, trade, and equity markets today and at similar points during the Depression. The global economy, global trade and global equity markets are indicating that the current crisis is **not** like the Depression, although the early months looked and felt like it. Developed economies are still below peak levels in output, trade and employment but emerging markets are helping to stave off a global collapse. Emerging markets' industrial production is 115% above its 2008 peak, and trade in emerging markets is also above its historic peak.

The emerging markets currently look to be in very good shape and could be a source of global stability and growth into the future. Emerging market debt levels initially peaked at 65% of GDP in the early 1930s (Figure 7). By 1945, they were a healthy 20% of GDP, while the debt levels of developed economies ballooned to almost 90% of GDP as a result of wartime spending. But the U.S. consumer continued to reduce debt and was in good shape by the end of the war. This current debt deleveraging cycle may look more like the post-WWII cycle, except the current banking crisis is much worse. The potential offset to the weakness in the developed economies' banking sector is that now, emerging markets are healthier and significantly larger drivers of the global economy than they were at the end of WWII (Figure 9).

Today, emerging markets represent almost 40% of global GDP, versus less than 20% in 1960. Emerging markets are growing quickly and wealth is accumulating at an incredible pace. It appears that emerging markets are large enough and healthy enough to provide a global growth path on which the developed world can be pulled along.

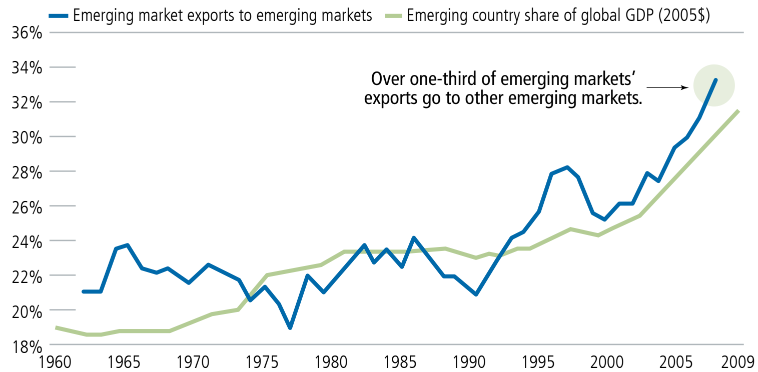
Additionally, the share of exports from emerging markets to emerging markets is rising, indicating a more balanced global economy. In 1960, about 15% of emerging market exports went to other emerging market countries. Today, more than one-third—and probably close to 40%—of emerging market exports go to other emerging markets.

> The share of exports from emerging markets to emerging markets is rising, indicating a more balanced global economy.

This time around, the emerging markets are not going through their own debt and banking crises, having faced those struggles during the 1980s and early 1990s. (Figure 10). During this period, the developed world grew and equity and bond markets performed well. Therefore, we believe the next secular bull market in the developed economies begins with significant deleveraging of the public and private sectors.

FIGURE 9. EMERGING MARKETS: A SIGNIFICANT FACTOR IN THE WORLD TODAY

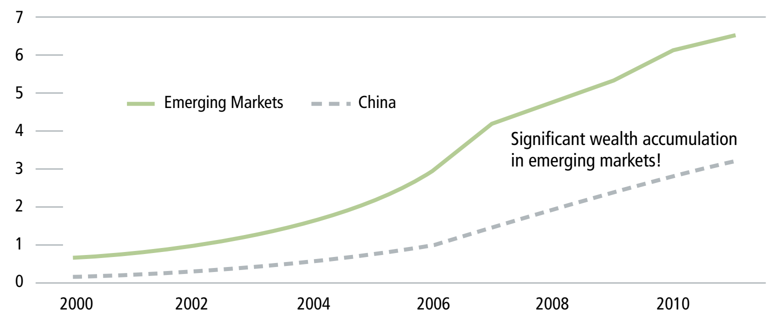
FIGURE 9A. GDP AND EXPORTS



Source: George Magnus, *Uprising: Will Emerging Markets Shape or Shake the World Economy?*, page 77, John Wiley & Sons, 2010 (developing country share of GDP) and Otaviano Canuto, "Recoupling or Switchover: Developing countries in the global economy" presentation, Inter-American Dialogue , Washington DC, July 6, 2010

FIGURE 9B. FOREIGN EXCHANGE RESERVES HELD BY EMERGING MARKETS

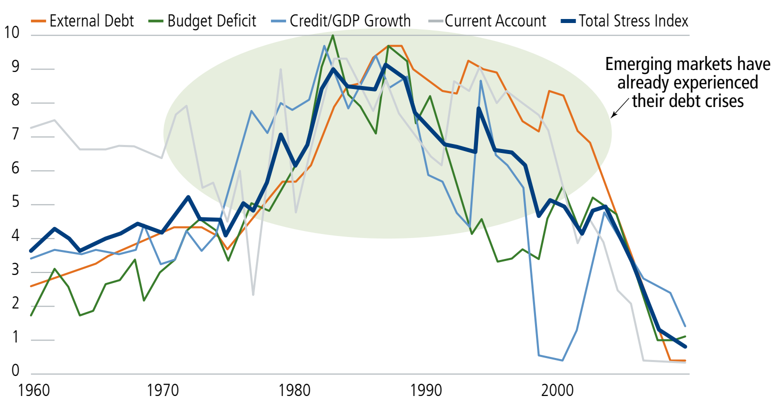
TOTAL FOREIGN EXCHANGE RESERVES (TRILLIONS USD)



Source: Eswar S. Prasad, "Role Reversal in Global Finance," The Brookings Institution, August 2, 2011

FIGURE 10. UBS TOTAL EMERGING MARKETS STRESS INDEX

INDEX LEVEL



Source: UBS, "Emerging Economic Perspective", August 17, 2009, page 30.

FIGURE 11. DELEVERAGING AND EQUITY MARKET PERFORMANCE

FIGURE 11A. DEVELOPED ECONOMIES, 1945–1971

Total Nominal Returns
S&P 500 Index: up 463% cumulatively (6.4% annualized)
Long-Term U.S. Govt. Bonds: up 67% cumulatively (1.9% annualized)

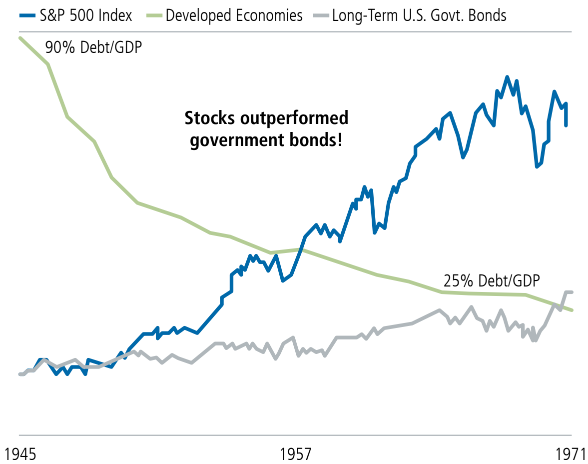
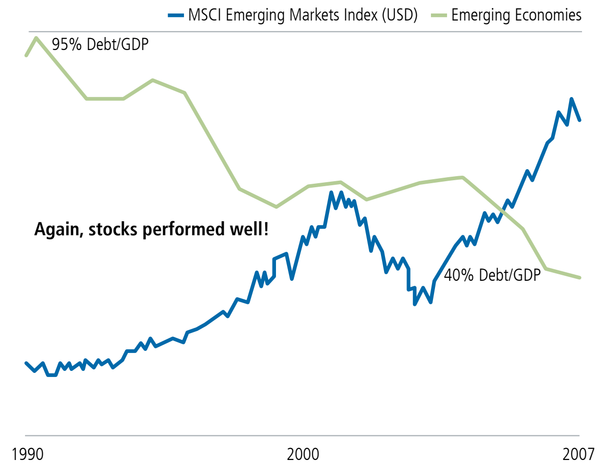


FIGURE 11B. EMERGING ECONOMIES, 1990–2007

Total Nominal Returns
MSCI EM Index: up 326% cumulatively (8.4% annualized)



Past performance is no guarantee of future results.
Source: Reinhart & Rogoff, Robert Schiller, Bloomberg and Ibbotson

The debt deleveraging cycle that began in 1945 and ended around 1970 also occurred while the global economy and equity markets performed well (Figure 11). Likewise, the emerging markets' debt deleveraging cycle of the 1980s provided a backdrop for reasonably strong real equity returns in the MSCI Emerging Markets Index during the 1990s.

Emerging markets are on a secular growth path, at levels much higher than the developed world's growth path, which has been on a secular slide since 1995 (Figure 12). The world is changing quickly. These changes are unsettling at times, and they are uneven and unfair. Yet, in a few years, we believe these changes can be the backbone of a new equity bull market.

The new secular bull market requires fiscal sanity, on a global scale

Emerging markets have the potential to fuel the entire world's growth over the next decade. However, we are still linked together as a single global financial and trade community. Correlations can go to 1.0 on the downside should another systemic shock occur. We believe only a reasonably healthy developed world recovery with a debt deleveraging backdrop will allow the emerging markets to provide support for an expanding global economy.

We firmly believe that the governments of developed countries cannot spend and tax themselves out of their crises! To us, Keynesian economics is a long-term prescription for financial ruin. The only reason government debt and deficit spending policies can persist for such long periods is because governments can print money. Of course, the U.S.

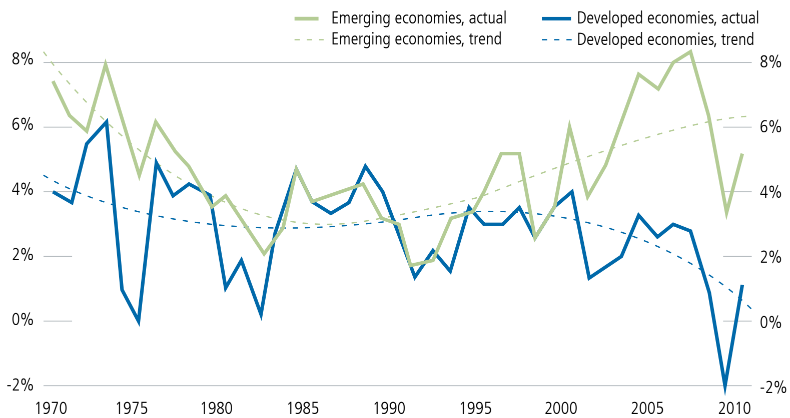
has an additional edge as the world's reserve currency and home to the most liquid financial markets. But even with these advantages, a limit exists to our profligacy. It is very possible to continue on with debt and deficit spending and manipulation of interest rates and asset markets, but we believe the results will surely be very slow growth and lack of wealth creation, as we have seen in Japan over the past 20 years. Japan's debt-to-GDP has climbed to more than 220%, with no solution in sight. This has resulted in virtually no wealth creation, stifled growth and debt levels that we believe at some point will create a sovereign crisis. Unless policies reverse soon, only luck and the goodwill of neighbors can bail out economies on this track.

> The near-term growth path is not clear, but we have seen improvements in many areas.

Compare this to Canada, an example of fiscal austerity. Figure 13 illustrates the relationship between wealth creation and reduced deficit spending and debts. As debt decreased, equity markets gained. Similarly, Figure 14 charts the inverse relationship between U.S. government spending and the historical performance of the U.S. equity market.

In fact, the developed world debt crisis following WWII quickly subsided with the rapid decline in deficit spending, low interest rates and defaults, along with pro-growth fiscal policies and healthy consumer balance sheets. Equity markets boomed during this deleveraging cycle, as they

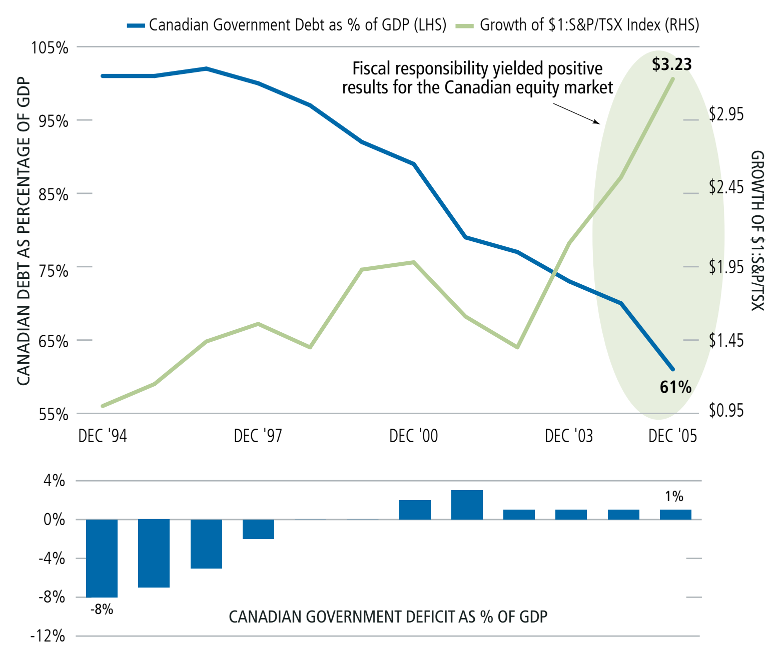
FIGURE 12. TREND REAL GDP GROWTH RATES HAVE BEEN DECOUPLING



Source: George Magnus, *Uprising: Will Emerging Markets Shape or Shake the World Economy?*, page 172, John Wiley & Sons, 2010

FIGURE 13. CANADIAN GOVERNMENT DEBT AS A % OF GDP VS. GROWTH OF $1, S&P/TORONTO STOCK EXCHANGE INDEX

1994-2005, ALL DATA IN US $



Source: Bloomberg. The S&P/Toronto Stock Exchange (TSX) Composite Index tracks the performance of the largest companies in the Toronto Stock Exchange, based on market capitalization.

did in Canada and in the emerging markets during their debt deleveraging cycles. So, history has shown that equity markets and economies boom when governments achieve fiscal sanity—not when they grow their presence and impose fiscal hardship on future generations. *It's about the wealth creation, Stupid!* It's not about wealth redistribution or fairness. We believe opportunity and jobs are what many working-age adults want, not guaranteed security and government handouts.

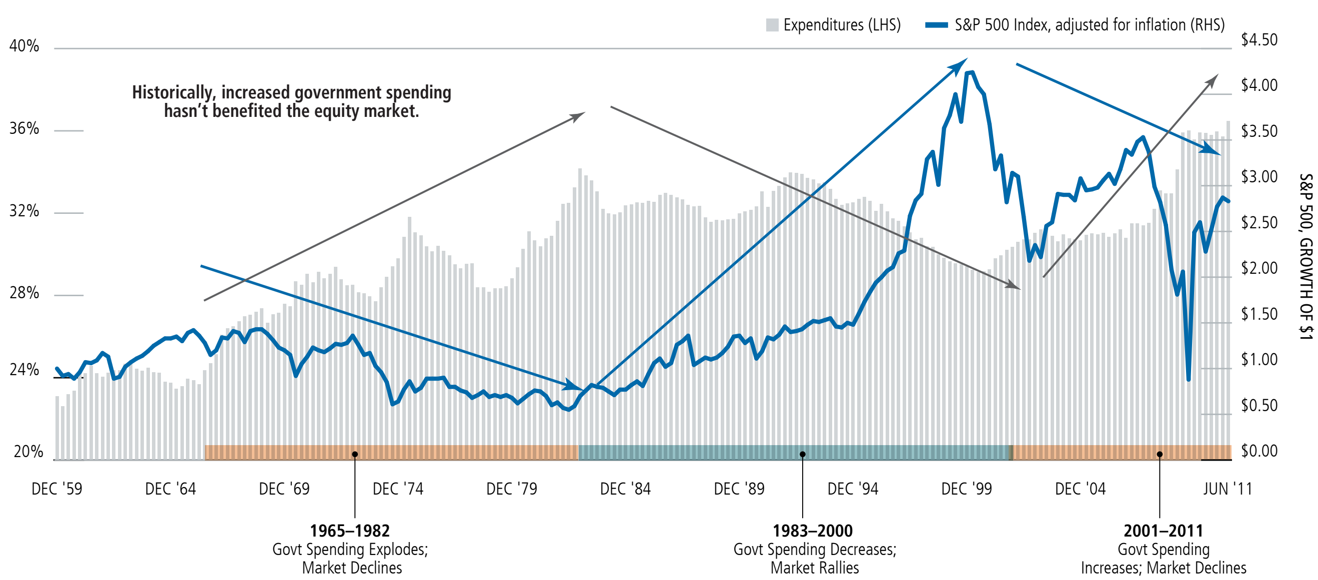
When does a new bull market begin? We believe a new bull market will be coincident with gains in economic freedoms (such as free trade, stable currency, reasonable taxation and reduced regulatory complexity), a more serious approach to debt deleveraging, greater signs of sustainable savings on a country level, and a clearing of the housing market. What appears obvious to us is that the economy and equity markets cannot get back into a sustained growth phase until the markets clear in a normal manner, unassisted by government. Only then can investors and businesspeople determine the true economic value of assets and expected after-tax and after-inflation return potential. Debt levels at the household level must drop to sustainable levels, household net worth must increase to more healthy levels and housing prices must find their own bottom. Finally, the government debt levels must decline, starting with an end to deficit spending on an operating basis with a real plan to reduce debt over the near term.

Conclusion

While we have many concerns about the global economy, we believe the healing process has begun. The near-term growth path is not clear, but we have seen improvements in many areas (the federal balance sheets of the U.S., Europe and Japan being notable exceptions). On the whole, consumers are deleveraging, U.S. banks have recapitalized, U.S. corporations with marginal balance sheets have been able

FIGURE 14. U.S. FEDERAL GOVERNMENT EXPENDITURES AS A % OF GDP AND EQUITY PERFORMANCE

1Q 1960 – 2Q 2011



Sources: Bureau of Economic Analysis, Bloomberg, Bureau of Labor Statistics.

to refinance and restructure debt, and homeowners with healthy balance sheets have had access to lower mortgage rates. Many private small businesses without access to capital have collapsed, clearing the market, albeit in a difficult fashion. State and local governments are addressing debts and deficits. M&A activity and slow growth is helping to rationalize overcapitalized infrastructure and production. Growth in emerging market economies has provided a buffer and even an engine of growth in many industries.

> Our view is that global growth companies—those with diversified revenues and without country bias—offer the best risk and return prospects, overall.

We believe that emerging markets can come to the rescue, at least for the next few years. The imbalances in the global economy can be unsettling, as we noted, but these same imbalances create opportunities for countries, companies and investors on a global scale. For example, the majority of the world does not have adequate access to food, clean water, health care and consumer goods. Meanwhile, the developed economies can produce more than they are able to consume. Anyone see a solution? The major focus of the U.S. and other developed markets should be in providing emerging markets with products at prices the emerging markets can afford. We believe excess global output can be absorbed quickly and more efficiently if we adopt a supply-side growth approach with the emerging markets. In our view, the worst possible scenario for global recovery is one that attacks free trade and focuses inwardly, repeating the mistakes of the Depression and collapsing the emerging economies into our debt and banking crisis.

Thus, we see significant opportunity for companies that are adapting to the global economy. Our view is that global growth companies—those with diversified revenues and without country bias—offer the best risk and return prospects, overall. Valuations remain particularly compelling for many growth equities according to a number of our measures, such as price-to-earnings ratios relative to value stocks and projected free cash flows.

Within our portfolios, we have sought companies we believe can benefit from U.S. manufacturing growth, capital spending in information technology, global infrastructure build out and the rise of emerging market consumers. We are avoiding companies tied to U.S. or European GDP growth and those that may be more affected by government debts and a confusing regulatory environment, such as financials, utilities and many areas of health care. Given the challenges we see in the global economy, we currently favor companies with higher-quality balance sheets, strong brands and experienced management.

We expect ongoing volatility as the global economy sorts through its intertwined challenges. Yet, we also expect continued opportunities to emerge. In this rapidly evolving environment, we believe our experience, global perspective and selective approach will drive and differentiate our results.

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