

Economic Review and Outlook

CALAMOS®

JOHN P. CALAMOS, SR.

Chairman, CEO & Co-CIO

NICK P. CALAMOS, CFA

President of Investments & Co-CIO

IN THIS COMMENTARY

- > We review the past year and revisit our 2010 outlook.
- > We believe risk levels are above average, but equity valuations are below normal. As a result, the risk/reward characteristics of equities appear to us to be reasonable on the whole.
- > The global economy is in a tug of war. Emerging markets with decent balance sheets are on one side and overextended and profligate developed markets on the other. Emerging markets are focused on slowing asset inflation, while developed markets are seeking to reflate assets.
- > These global imbalances must be addressed to sow the seeds of lasting economic prosperity. We believe free trade and fiscal responsibility will be essential.
- > In our portfolios, we are emphasizing growth-oriented businesses with global presence.

In 2010, financial markets extended their 2009 rebound and provided some relief to market participants. Amid signs that the global economy was recovering slowly, U.S. equity markets did well on the whole, as did European markets, apart from the beleaguered PIIGS nations.* China lagged, amid concerns about rising reserve requirements, tighter credit and asset inflation. Even as markets generally improved, anxiety remained high, fueled by concerns about the long-term impact of quantitative easing and currency devaluation.

As we look to 2011, we believe that risk levels remain elevated by many measures. Yet, on the other hand, our analysis indicates that the equities of developed markets are inexpensive on the whole, particularly growth-oriented businesses with global presence. While emerging markets are more expensive, they are growing rapidly and in our view, not at extreme valuation levels. We believe that there are many reasons to be excited about the prospects ahead.

Yet, while we see the rise of emerging markets as a powerful and exciting force for change, we believe that caution is warranted in terms of how we participate. Financially strapped developed nations and increasingly prosperous emerging markets may find themselves facing different, even oppositional, challenges. Ultimately, these challenges are intertwined, so addressing global imbalances in currency, trade, and debt will be essential for a global secular bull market.

A LOOK BACK

In our January 2010 commentary, "Hair-of-the-Dog" Economic Policies or Buying Time to Heal?", we shared our view of what 2010 might hold:

We believe the economy is in recovery mode, as evidenced by recent economic data and financial market indicators. We expect further improvement in the next year, and see good potential for reasonable equity market returns. On the whole, corporate profits appear to be in good shape, balance sheets are healthy and corporate operating leverage offers the potential for dramatic improvement. ... We believe the market won't experience a price-to-earnings expansion, but should be buoyed by strong growth in earnings. ... Along with

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Past performance is no guarantee of future results.

MAY LOSE VALUE | NO BANK GUARANTEE

*Portugal, Ireland, Italy, Greece and Spain

inventory restocking, corporate capital investment may help pave the road to near-term prosperity in the economy and equity markets for 2010.

Our outlook for good corporate profits and reasonable equity market returns was okay, albeit a bit too conservative. Equity returns in the United States were better than reasonable, while corporate profits continued to be strong.

Our analysis indicates that the equities of developed markets are inexpensive on the whole, particularly growth-oriented businesses with global presence.

We went on to say: “Given a more measured pace of economic recovery with ongoing pressures, we also expect potentially significant disparities between winners and losers.” Our view was that the markets would focus on quality, but this was not the case. To our surprise, correlations among industry groups and sectors were very high in 2010.

We also wrote that we believed the “U.S. dollar’s decline against the yen and the euro was largely over” and that the dollar would “decline against store-of-value currencies and gold, and decline against commodity currencies and emerging market currencies in general.” Our concerns for Europe and the euro were on target, but the yen continued to appreciate against the dollar. By and large, our other expectations played out as we expected. Gold and commodities performed very well, as did the currencies of store-of-value countries (for example, Switzerland, Sweden, Singapore) and commodity countries (Brazil, South Africa, Norway, Canada, New Zealand, Australia).

We stated that:

We are very excited about large-cap growth opportunities in the United States ... We also see the technology sector capturing a leadership role in the next decade. Such resurgence could provide a powerful tailwind to the Nasdaq Composite Index over the next decade. In addition to technology, we are also favoring commodities, agriculture and energy.

The Nasdaq surged in 2010, as did the commodity and materials sectors. We were also cautiously optimistic about emerging market equities:

From the broadest perspective, emerging markets may be ahead of themselves, given the strong rally and currency strength of last year. The emerging markets look compelling as a group, but individually there is political and country risk. As a result, we prefer to be well diversified in this asset class. We will likely reduce some exposure based on short-term gains and add to our exposure on weakness.

We did in fact reduce our exposure on strength, but still remained overweighted relative to respective benchmarks. On the whole, emerging markets performed well in 2010 (with China a notable exception). Overall, our emerging market positions benefited those of our portfolios that can hold emerging market companies.

2010 SURPRISES

We were surprised by the strength of U.S. consumer discretionary stocks in 2010. Although we remained overweight in the internet retail sector, we stayed underweight in the traditional retail and restaurant stocks because we believed the country had a significant capacity surplus in these groups. However, these companies—at least the publicly traded ones—proved more adaptable than we predicted. As listed companies maintained access to capital

or had better balance sheets than smaller competitors, mom-and-pop stores and restaurants shrank or went out of business, leaving the customers to the larger competitors.

We were surprised about how quickly high-yield issuers were able to refinance and how quickly the high-yield market snapped back to average and even below-average pricing and terms. The other big surprise was that U.S. large-cap stocks lagged U.S. small-cap stocks; while high beta outperformed low beta. This was the opposite of what we expected. While still well behind equity markets, the bond markets in the U.S. and most of Europe performed well and slightly above our expectations.

2011 OUTLOOK

Over the past decades, the end of high inflation, the cessation of the Cold War, disinflation and lower interest rates provided a generally strong backdrop to the bond and stock markets—of course, with the expected ebbs and flows of economic and market cycles. However, when we consider the imbalances and policy extremes in the global economy, risk levels appear higher to us now.

We have noted in the past that just as the “Great Recession” was not normal, the recovery has not been normal either. When we consider the current environment, risk levels are still elevated because many key monetary, fiscal and market factors are not normal. The extreme factors we see include the extended period of near-zero short-term rates, the ballooning of the Fed’s balance sheet (Figure 1), an explosion in total debt to GDP in the G3, the near-exponential move in gold prices (Figure 2), the historically

FIGURE 1. FEDERAL RESERVE BALANCE SHEET: TOTAL ASSETS

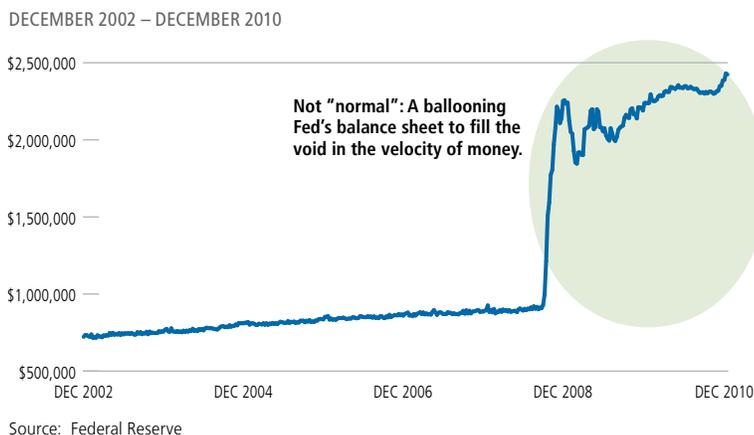


FIGURE 2. GOLD PRICES

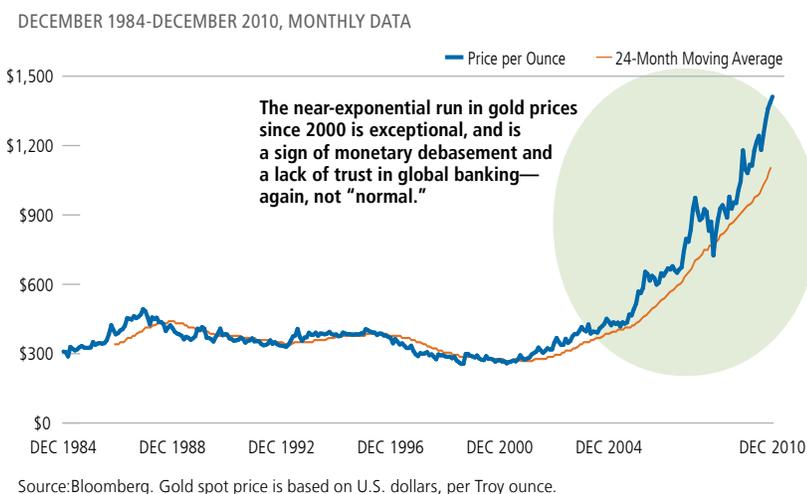


FIGURE 3. 10-YEAR TREASURY BOND, REALIZED VOLATILITY

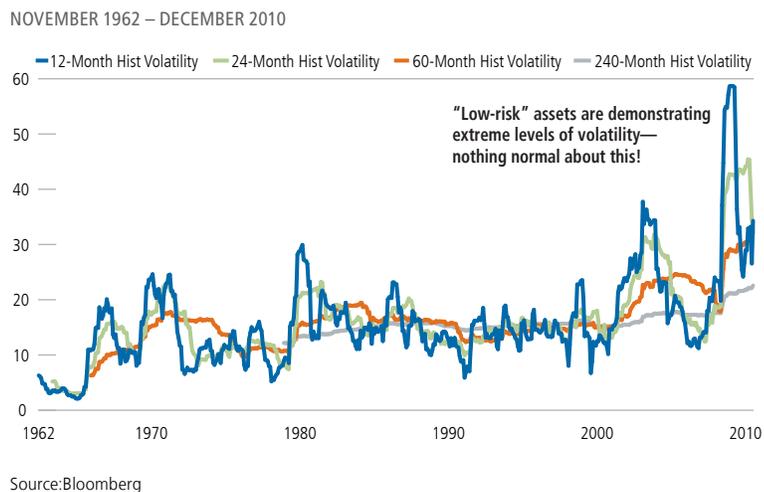
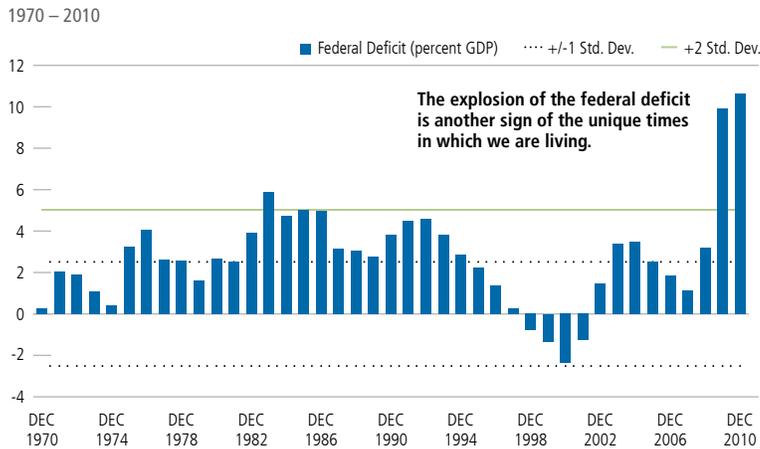
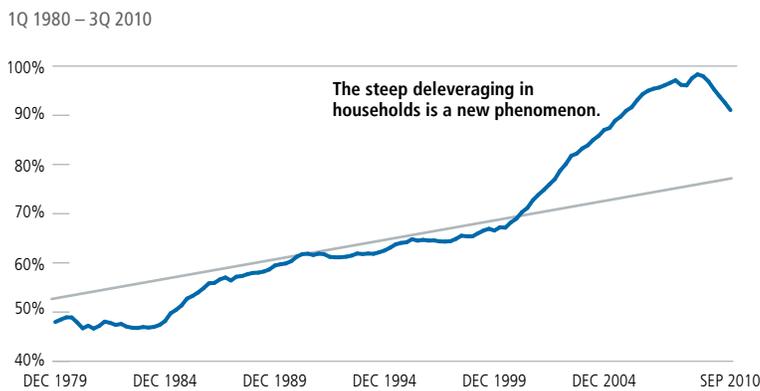


FIGURE 4. U.S. FEDERAL DEFICIT, AS A % OF GDP



Sources: Treasurydirect.gov (federal deficit data) and Bureau of Economic Analysis (GDP).

FIGURE 5. U.S. HOUSEHOLD DEBT, AS A % OF NOMINAL GDP



Sources: Federal Reserve Flow of Funds release (debt), Bloomberg (GDP).

unusual volatility of government bonds (Figure 3), the federal deficit (Figure 4), state and local government deficits, and the rapidly expanding role of emerging economies as a global growth driver. The magnitude of U.S. household debt deleveraging is also extreme (Figure 5). The aggregation of a multitude of factors at extremes increases the probability of extreme outcomes and the volatility in economies and markets. Moreover, the old road maps may not be as helpful in guiding policymakers and investors.

Inflation Remains a Key Concern

We will be monitoring global inflationary pressures closely. China’s Premier Wen Jiabao and the U.S. Federal Reserve Chairman Ben Bernanke have both assured the world that they can control inflation. China’s assurances focus on controlling asset bubbles and inflation without disrupting growth and money flows. The U.S. has advanced the view that the expansion of the Fed’s balance sheet and a near-zero fed funds rate will not cause inflation. If inflation were to occur, it could be handled with 100% confidence and in 15 minutes, as Bernanke announced in December on “60 Minutes.”

We believe that there are many reasons to be excited about the prospects ahead.

Of course, inflation is not just inflation in the Consumer Price Index. In fact, most of us would welcome deflation in the CPI—except for the Fed. Inflation occurs in many ways as excess currency finds its way to real estate, stocks, bonds, commodities and other investments. The Fed has created inflation, just not in the CPI. As we have seen time and time again, inflation in assets can be more damaging than inflation in consumer prices—especially if the assets are also levered with debt and cheap financing.

We do see prices rising dramatically in oil, gold, silver, agriculture goods, health care, education, taxes, legal fees, accounting fees, permits and user fees ... the list goes on. But, to adapt a Groucho Marx saying: “Who are you going to believe? The Fed or your own lying eyes?” If you

ignore history, there's nothing to be concerned about. On the other hand, there are abundant historical examples of governments getting these adjustments wrong—and often by a significant degree.

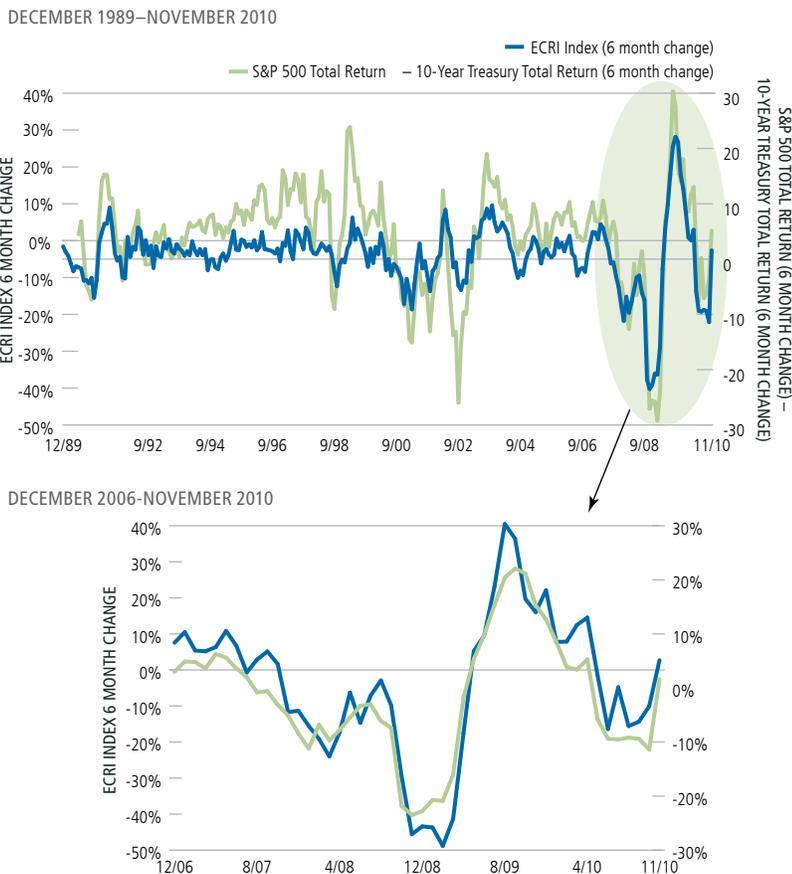
For China, the inflation quandary is complicated by what the United States might do next. As the U.S. economy picks up strength, the Fed and Congress can pursue a more normal rate of interest and (we hope!) a more prudent fiscal spending approach. This would likely relieve pressure on China and other emerging markets to issue more of their own currencies to offset the U.S. currency devaluation.

There's also an interesting paradox for the stock market. If global liquidity is reined in and the Fed moves to a more normal interest rate environment, the equity market, commodities and energy prices will likely decline. The stock markets love liquidity, as studies and experience support. The removal of liquidity in the U.S. and China would show the extent of "non-economic" asset appreciation that has occurred, but we believe it would also be an important step in setting the stage for the next bull market in equities.

Short-Term Bullish, Nonetheless

Despite the elevated levels of risk that we see, we are maintaining our "short-term bullish" stance, as we have over the past two years. Short-term market momentum and liquidity have been very strong. Typically, these are important legs for a rising market. We see other positives including reasonably attractive valuations in developed world equities, improvements in bank credit overall, greater stabilization in the U.S. housing market and increased mortgage lending on

FIGURE 6. S&P 500 TOTAL RETURN, LESS 10-YEAR TREASURY VS. ECRI INDEX



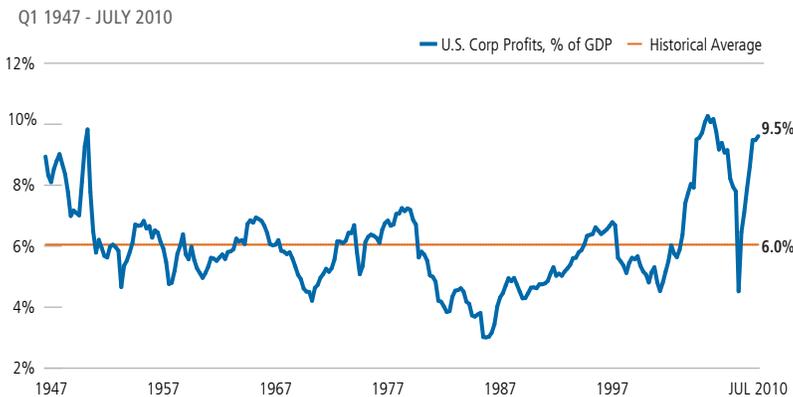
Source: Bloomberg. The S&P 500 Index is generally considered representative of the U.S. stock market. The ECRI Weekly Leading Index is a measure of leading economic indicators.

the back of low interest rates. Global trade is at a new high, and emerging market equities and commodity prices have been expanding rapidly again.

We've seen favorable signs in two key economic indicators that have had very good track records of predicting the economy and even the equity markets, specifically the Conference Board's Composite Index of Leading Economic Indicators* and the ECRI Index, which we show in Figure 6. Additionally, corporate profit margins are high (Figure 7), and many corporations have abundant cash stockpiles and strong balance sheets.

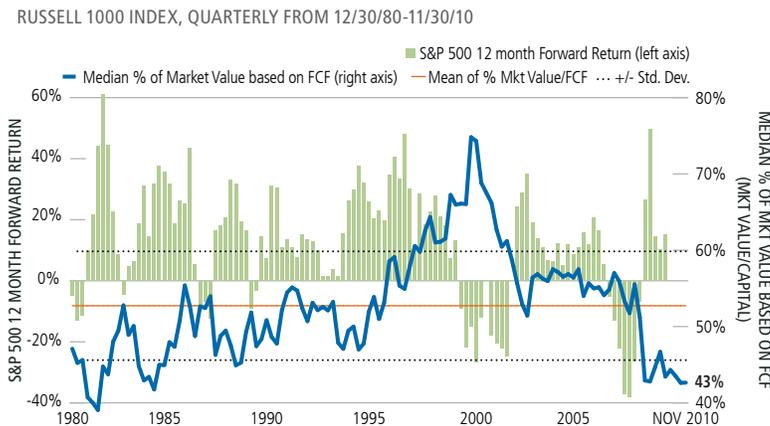
*A monthly index consisting of 10 components that seeks to predict the direction of the economy.

FIGURE 7. U.S. AFTER-TAX CORPORATE PROFITS, AS A PERCENTAGE OF U.S. GDP (\$)



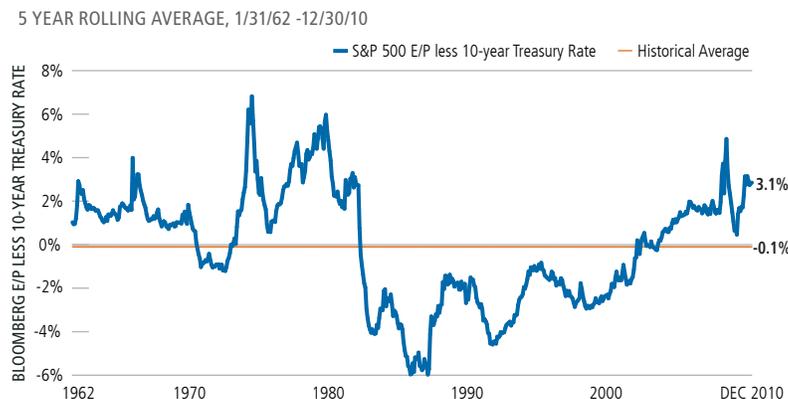
Source: Federal Reserve Bank of St. Louis.

FIGURE 8. CALAMOS ECONOMIC PROFIT MODEL: MEDIAN % OF MARKET VALUE BASED ON FUTURE CASH FLOWS (FCF)



Sources: Calamos Advisors LLC, Model Station and Federal Reserve Bank of St. Louis. The Russell 1000 Index is considered generally representative of the U.S. large-cap equity market.

FIGURE 9. S&P 500 INDEX EARNINGS-TO-PRICE RATIO, LESS 10-YEAR TREASURY RATE



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

Of course, the current high corporate profit margins may be viewed as a double-edged sword. It is positive that corporate profits are so high, but profits are a mean-reverting measure. The long-term mean is 6% of GDP, as compared to 9.5% today. However, in our valuation models, we normalize earnings to avoid overpaying for peak earnings, and by our measures, the market is still attractive.

We believe stock market valuation levels are attractive by a number of measures.

As we have discussed, we believe that risk levels remain elevated. However, many of these risks seem to be priced into the U.S. equity market already. Indeed, we believe stock market valuation levels are attractive by a number of measures. Since 1980, about 53% of stock market values can be attributed to future value creation. However, despite high return on invested capital and low capital costs, the market today is assuming only 43% of its value is from future value creation—more than a full standard deviation below the norm (Figure 8). By this measure, the market is more than 20% undervalued.

We also see compelling opportunities today when we consider the stock market equity risk premium, which measures the return premium available to equity investors relative to a government bond rate or a corporate bond rate. In Figure 9, we show the S&P 500 Index's average earning yield, less the 10-year U.S. Treasury bond rate, which we've selected as a proxy for a lower-risk rate. By this measure, the stock market has not been this inexpensive since 1980, apart

from the 2009 trough. Here again, current levels indicate an undervaluation of more than 20%.

2011: A TUG OF WAR

During the Great Recession, China was a major source of global liquidity. As a percentage of GDP, its fiscal stimulus package was larger than the U.S. package. In 2010, approximately two-thirds of global GDP growth came from emerging market economies (Figure 10).

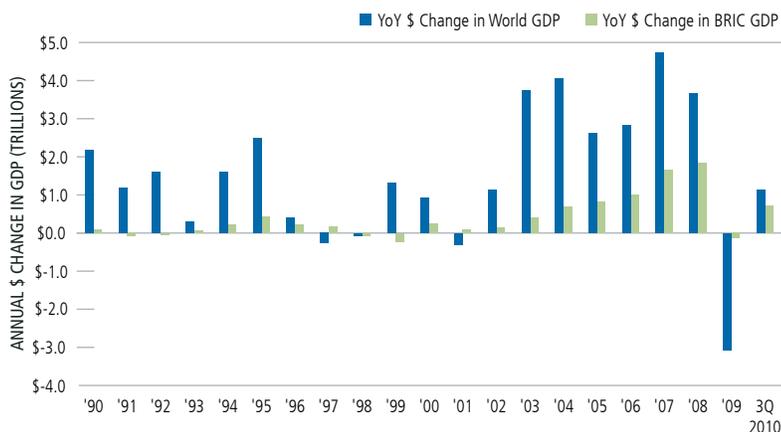
We believe that China and other emerging markets will demonstrate their continued importance to the global economy in 2011. However, we see something more complicated than a straightforward growth story. We expect an interesting dynamic as emerging market economies contend with inflation concerns and hot money flows. Dispersions in global growth rates and policy directions will send opposing messages to market participants.

Indeed, we see an extremely consequential tug of war. On one side, the developed world is attempting to reflate assets tied to massive amounts of debt as they hope to avoid the unwinding of the debt cycle. On the other side, emerging economies are attempting to deflate assets or at least considerably slow the growth in asset inflation while they pursue tighter monetary policies.

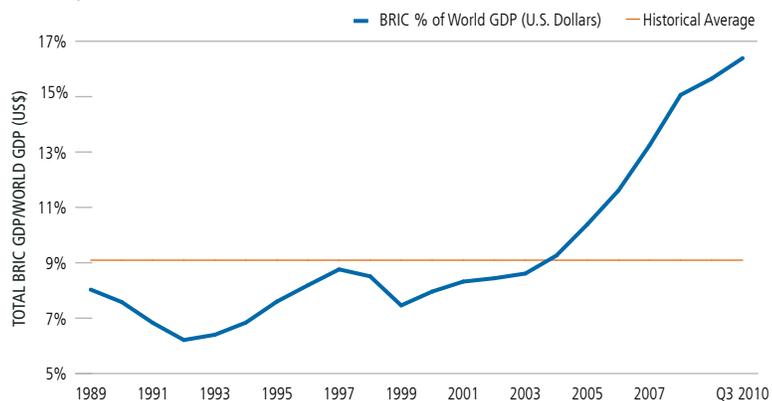
The OECD countries are broke or near broke; there are few traditional Keynesian fiscal options left to them. Monetary policy options are also quickly dwindling, as evidenced by the global outcry against the U.S. Fed's QE 2.0 policy and the U.S. bond market's quick reversal of course.

FIGURE 10. EMERGING MARKETS (BRIC COUNTRIES)* AND WORLD GDP

10A. EMERGING MARKETS ARE CONTRIBUTING MORE TO WORLD GDP GROWTH
1990–Q3 2010



10B. EMERGING MARKETS' SHARE OF WORLD GDP
1989 – Q3 2010



Source: Bloomberg. * BRIC nations are Brazil, Russia, India and China.

The United States has chosen the Keynesian stimulus model combined with a loose monetary policy. It's been a continuation of the past 50 years—inject monetary liquidity and ramp up deficit spending to offset weaknesses in production and capital spending. Over the past few years, we've seen this approach on steroids (although perhaps recent changes in Congress may change this somewhat). We believe the long-term implications of this policy include a weaker dollar, unsustainable debt and deficits and ultimately higher inflation and higher capital costs.

The Eurozone is in a similar expansionary monetary policy mode as it attempts to support insolvent economies and struggling banks, such as those in Spain and Ireland. There have also been fiscal austerity measures, which strike us as a weak effort relative to what the PIIGS need. (We expect near-term pain and a flight of some of European Union members.) Japan has also indicated another need for currency intervention to reduce the strength of the yen relative to the dollar.

Meanwhile, the BRICs—primarily China, Brazil and India—have different priorities. They are focused on restraining the potentially disruptive effects of huge liquidity flows. (Consider China: large minimum wage hikes, housing inflation, M2 up 5% and bank credit up 60% since the end of 2008.) Their worries include concerns about overheating economies, property market bubbles, hot money flows and U.S. exporting inflation. They are tightening credit and banking reserve requirements and taxing hot money flows.

FIGURE 11. GROWTH OF \$1: MSCI EMERGING MARKETS INDEX AND S&P 500 INDEX



Source: Bloomberg

TUG OF WAR

EMERGING MARKETS WORK TO SLOW ASSET INFLATION

In 2010, China repeatedly raised interest rates and reserve requirements.

China eased capital controls on Chinese exporters' foreign currency earnings as of January 2, 2011, thus allowing capital to remain overseas and reducing pressure on inflation.

Brazil and South Korea tax bond investments for foreign investors.

India and Malaysia raise interest rates.

G3 ATTEMPTS TO INFLATE ASSETS

Federal Reserve embarks on QE 2.0 and signals willingness for QE 3.0.

Eurozone bails out European Union banks, Greece and Ireland.

Japan intervenes in currency market, attempting to halt yen appreciation.

For the most part, their fiscal policies remain stimulative because of their strong balance sheets and trade balances. If emerging market economies cannot tame money flows and inflation continues to heat up, we expect more aggressive capital controls, interest rate hikes and increased reserve requirements. We believe this would result in slower global growth in the following few quarters.

What could this mean for investors in 2011? In our view, the Fed's move to a near-zero short-term rate and its quantitative easing has caused some global inflation problems and malinvestment, which could contribute to a new bubble in emerging markets and commodities—a view echoed by a number of market strategists over the past year. If the Fed moves to QE 3.0, then we believe it is likely that commodities, energy and emerging market equities may perform well. If the Fed does not initiate QE 3.0, then we believe the U.S. equity market may be more attractive in 2011 than commodities, gold and some of the emerging markets.

GLOBAL IMBALANCES MUST BE ADDRESSED

The Great Recession occurred ultimately because of great global imbalances—in debt, trade, savings, demographics and consumption. Today, a few governments are focusing on correcting imbalances to stimulate lasting economic growth. Unfortunately, many other governments are attempting to fight the rebalancing tide and what we see as an inevitable need for changes.

These changes will require significant shifts and a will that we have not often seen from governments and populations. We believe that G3 debt imbalances can only be improved with spending constraints. Trade imbalances require true floating-rate regimes and free trade. Savings imbalances can be improved via normal market-clearing interest rates for savers in the G3 and trade deficit improvement in the United States. We believe demographic imbalances can be improved through better immigration policy—for example, a more market-driven approach that allows talented individuals to move more readily to countries where their expertise and knowledge can contribute to economic growth. The consumption imbalance in the emerging economies can be improved via floating exchange rates that cut into the mercantilist policies of their governments and more open capital flows. We believe that the unfunded pension, social security and Medicare liabilities will be addressed with broken promises, new taxes, means testing, extended age requirements, health care rationing and productivity and technological advancements.

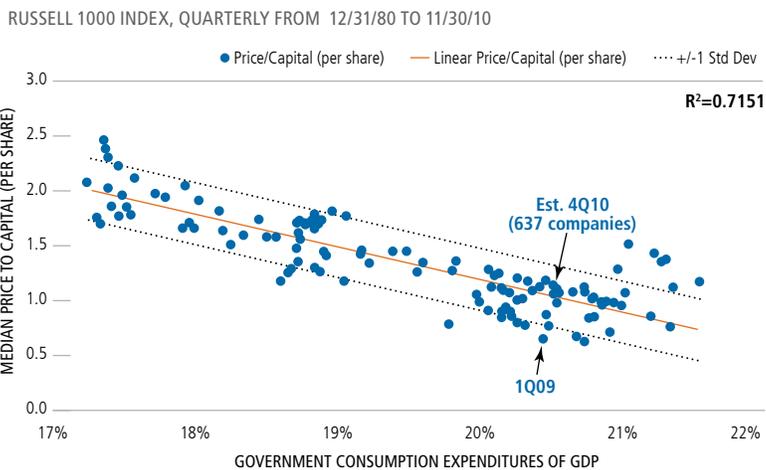
If policies in the United States continue on the current path, we believe the next crisis may be a flight out of the dollar

until interest rates rise to entice investors back. How do we know when the reserve tanks are full of dollars? What we do know is that historically extended periods of interest rates held below the “normal” market clearing rate have often preceded crises and bubbles. The U.S. may continue with its near-zero short-term interest rates and quantitative easing policies until a meaningful improvement in unemployment occurs or the economy sustains a high level of growth. Quantitative easing and the negative real yield on short-term government bonds are strategies that appear to be aimed directly at the mercantilist emerging market policies. Thus, in our view, these strategies are effectively a weapon in the trade wars.

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From our vantage point, among G3 politicians, the mismanagement of government finances has led to assertions that the “only” answer to slow growth and large deficits is more and larger government. This may be a politically expedient way of allocating capital and resources, but it appears backward to us and directly opposed to the way financial markets work. The election in the U.S. has the potential to change the path, but we are in the “trust but verify” camp. In our view, Washington has a way of catching even the best free market advocates in its vortex of power and influence, funded by the U.S. taxpayers’ checkbook. The free capital markets give more capital to companies or countries that earn higher returns, while capital flows

FIGURE 12. MEDIAN PRICE TO CAPITAL VS. FEDERAL PORTION OF GDP



Source: Calamos Advisors LLC, Model Station and the Federal Reserve Bank of St. Louis.

away from those that mismanage it. Investment banks seem immune to this reality, while politicians seem to be blind to it.

The size and cost of government has been a very significant influence on the financial markets in the last few years. Figure 12 supports the view that the size of government has an inverse relationship with capital values, or better said, wealth. So, although the political class fails to see the large government “solution” as the problem, the capital market pricing mechanism indicates otherwise.

We believe it is apparent now that Alan Greenspan mistakenly treated good deflation resulting from supply-side driven global competition (that is, lower prices born from increased efficiencies and productivity) as bad deflation (a collapse in asset values or business profits collapse). When the Consumer Price Index showed signs of deflation, Greenspan responded with an excess of liquidity and low debt costs. This led to abundant cheap capital, which financed the housing bubble, and ironically unleashed the “bad” deflation he was worried about.

THE NEXT STAGE IN THE GLOBAL FINANCIAL MARKET CYCLE

We believe that investors should read as much as they can about the currency markets, the history of financial crises, and how nations have emerged from these problems. We are experiencing the aftermath of the bursting of the worst type of asset bubble: a highly leveraged, bank-financed bubble in unproductive assets (housing). We are still left with empty homes, insolvent banks and workers with skills that won’t be needed for years. In contrast, the technology and telecommunications bubble of 1999 and early 2000 was primarily equity financed and to some extent was focused in productive assets. The tech-telecom bubble left assets that have benefited businesses over the past decade, including a global network of fiber optic cable, productivity-enhancing software, and capital equipment that has improved communication and internet access.

We reiterate the expectation we set forth two years ago: a slow healing process until the housing markets clear excess inventory, banks’ balance sheets are stabilized and debt levels are reduced. We need to see normalized interest rates, not the near-zero rates that cause mal-investment. We also need fiscal policy that addresses our mountains of debt and reduces the size of government. Debt and deficits are a mathematical reality, not a difference in political theory. We believe it is time to address excess debt and spending because the current levels are not conducive for sustained economic health.

The global monetary regime has gone through two major changes over the past 55 years. To us, it appears global imbalances may be laying the foundation for the third

THE WAY OUT? LESSONS FROM CANADA

We believe Canada provides a model that other countries could emulate. *The Canadian Century: Moving Out of America's Shadow*, by Brian Lee Crowley, Jason Clemens and Niels Veldhuis,* is an excellent roadmap of how to dig out from a debt crisis. The book explains that in 1993, the Canadian government represented 53% of its economy, with soaring debt and deficits that look like Greece today. Federal and province debt levels were 120% of GDP and interest costs consumed 33% and 20% of annual federal and province revenue, respectively. (Today, in the U.S., debt to GDP is at 80%, with 60% federal debt and 20% state debt, ignoring the present value of unfunded liabilities in Social Security and Medicare.) The economy was sinking under the debt weight and interest costs were rising, as markets expected Canada to follow Mexico's collapse.

The Canadian currency collapse ushered in some dramatic changes to the socialist agenda. A weaker currency did support exports and helped growth, but it was a swift fiscal austerity program that made the difference. Government spending at the federal level was cut 8.8% over two years; province spending was also cut by a similar amount. Federal employment was reduced 14% in two years while federal spending to the provinces fell 14%. Province spending was controlled by requiring provinces to finance 50% of program

funding to be financed by the province, with a province alone deciding how the money was spent.

Some tax hikes occurred, but spending cuts were more than four times the size of tax increases. The one significant tax hike was the addition of a value-added tax to supposedly pay for tax cuts. Meanwhile, corporate tax rates were cut by a third and corporate capital taxes were abolished. Taxes on personal income and capital gains taxes were reduced. During the next decade, the poverty rate also declined 30%.

Could you imagine recommending this series of tax reductions, spending cuts, federal and state government payroll reductions today in the U.S.? Compared to Canada's aggressive—and successful—actions, last month's bipartisan deficit plan strikes us as a feeble attempt at fiscal austerity. The new U.S. plan is to reduce the debt growth level by half by 2020. Where are the statesmen in our Congress?

Before a currency crisis or inflation-induced interest-rate hike forces the U.S. Congress to get real with our fiscal position and direction, we believe Congress should pursue the path laid out by Canada. Canada has a model we need to import. Forget gold and oil—import fiscal discipline.

*Key Porter Books, 2010

change. The first monetary regime lasted about 25 years and it went out with a bang!

The current monetary regime is less structured, with some floating rate and some fixed-rate currencies. We believe the most important factors are the euro pact and the U.S.

– China fixed-rate regime. The euro currency bloc is under intense pressure—clearly illustrating the problem of having multiple fiscal policies tied to a single monetary policy. In effect, countries have outsourced monetary policy to the European Central Bank and issued debt in a currency that they cannot manage. Countries are operating under a fixed

exchange-rate system within the currency bloc and are not experiencing the pain of the inflexible policy. However, the sovereign debt crises of 2010 and the specter of more on the horizon are bringing the perils of the approach into focus. We would expect further breakdown and a smaller currency bloc within the next few years as the PIIGS struggle to adjust to collapsing wealth without a monetary mechanism to help ease some pain. We believe fixed exchange-rate systems like the euro bloc are too rigid and eventually collapse.

While remaining attentive to the risks in the markets, we find much to be excited about.

The U.S.-China currency pact, dubbed “Bretton Woods II” because of its similarities to Bretton Woods, is also under political and economic stress. China’s currency is pegged to the dollar at an undervalued exchange rate. This allows China to export products to U.S. consumers at low costs. China builds its productive capital base and employs people, and in return, the U.S. receives very cheap financing to fuel our huge deficits and spending appetite. We also benefit from low-cost import products. To us, China’s currency approach is a mercantilist policy aimed at boosting exports to spur Chinese economic growth and is an affront to open trade.

This relationship may have been more equally beneficial in the past, but has become more complicated over the past few years. The U.S.-China relationship is now strained by a weak dollar and China’s poor return on investment on the huge amount of dollar reserves it holds. Meanwhile, U.S. politicians blame China’s undervalued currency for high

U.S. unemployment and the potential demise of the U.S. manufacturing base. Unfortunately, we may need China more than China needs us at this point. When you owe someone as much money as we owe China, we are not in a great position to demand changes. Should China demand higher interest rates to offset the dollar debasement caused by quantitative easing and the Fed’s low interest rate policies, then our highly levered economy could be vulnerable to another economic crisis, as most U.S. government debt is financed with short-term bonds.

China is already reducing its dependency on exports to the U.S. and its use of dollars in some foreign exchange transactions. The monetary regime between the U.S. and China can migrate slowly over time, which we believe could avoid a full-blown crisis—or not. To some extent, this is dependent on our respect for China’s holdings and the dollar’s value. We see this as an important stress point to monitor and one to hedge against now.

OUR POSITIONING

As investment managers, our responsibility is to take a realistic view of the global marketplace, with its attendant risks as well as its opportunities. While remaining attentive to the risks in the markets, we find much to be excited about. As we’ve said in the past, the flipside of volatility is opportunity.

When we survey the current environment, we see tremendous secular investment opportunities. We believe we have been able to invest in highly desirable companies, without paying a premium compared to the average stock. Specifically, we are emphasizing financially strong growth-oriented companies

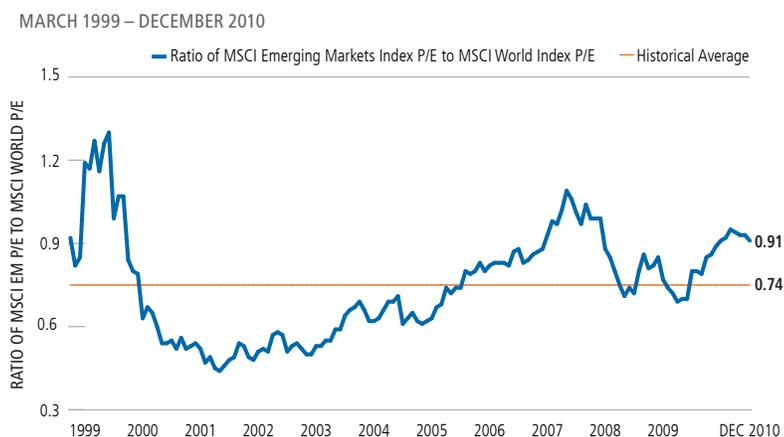
with global presence, in terms of market access, management know-how, distribution and/or brands, and capital access. We are investing in global economic growth driven by capital spending and infrastructure build-out.

In contrast, we are biased against companies that are overly dependent on the G3 GDP growth and consumption, and those that are overly exposed to government debt burden or rising government regulations. We are avoiding G3 fixed-income investments that don't have an equity tie or that are not adjustable-rate. We favor hard currency countries and some emerging market sovereign debt, but believe equity valuations offer better return potential on the whole.

We believe the risk/reward characteristics in the bond markets are not compelling on the whole, and we would encourage most investors to maintain caution. However, if GDP growth remains subpar, it is quite possible that interest rates and inflation would keep bonds from falling. In general and over the long run, government bond interest rates have tended to mirror sustainable GDP growth. But at some point, continued debt build-up and servicing costs would take precedence, interest rates would rise above GDP growth, fueling a collapse in the currency and bond markets. Japan may not be too many years away from such a crisis as that country's internal savings rate has dropped significantly. This may trigger the exceptionally high debt-to-GDP that would put Japan at the mercy of outsiders to purchase its debt at low rates.

While U.S. equities appear to be pricing in the risks in the market, we believe the case for emerging market equities may not be as strong in early 2011. As Figure 13 shows,

FIGURE 13. PRICE-TO-EARNINGS RATIO COMPARISON: MSCI EMERGING MARKETS INDEX RELATIVE TO MSCI WORLD INDEX



Source: Bloomberg. The MSCI Emerging Markets Index measures the equity market performance of 21 emerging markets. The MSCI World Index measures the performance of companies representative of the market structure of developed market countries in North America, Europe, and Asia/Pacific region.

valuations of emerging market equities relative to developed market equities have moved upward and are now above their long-term average. Additionally, as we discussed, many emerging market economies are attempting to slow asset growth and rein in liquidity; this may provide a near-term headwind. Given this, we would not be surprised to see the U.S., Europe and Japan outperform the emerging markets in the first half of 2011. This is not to say that the emerging market opportunity has diminished from a secular perspective—only that over the shorter term, we believe the opportunity set may be more concentrated on multinational companies providing goods and services to emerging markets.

Conclusion

We believe the fixed exchange-rate systems around the world are breaking, and they represent a significant portion of global GDP. The euro bloc and the U.S.-China peg are under pressure—and this has significant implications for

global trade and financial markets. This struggle can last for years, but we believe that the global imbalances in debt, trade, demographics and savings will work their way out in the currency markets and ultimately in continued wealth convergences between the emerging markets and the developed world. Let's hope that this convergence happens at far higher per capita levels than we see in the G3 today. We believe for this more favorable convergence to happen, we will need fiscal reality and productivity enhancements, along with an abandonment of inflation-stoking measures and what we see as government Ponzi schemes in the G3.

As we have discussed, many current G3 policies reflect those nations' efforts to keep their assets inflating to offset the mountains of debts and bad mortgages. But these easy money policies are causing the emerging markets to overheat and are contributing to asset inflation. This has led to emerging market policies that attempt to offset asset inflation and hot money flows into their countries. The Fed's decision to move forward with QE 2.0 caused reflation assets (commodities, equities and precious metals) to surge; it also caused emerging market countries to step up tighter monetary and credit controls. A "don't fight the Fed" policy favors further exposure to the G3 equity markets, but sends a cautionary message to emerging market equity buyers in the near term.

With the recent changes in the U.S. Congress, we believe the U.S. markets should get a boost from increased clarity regarding taxes, some health care costs and financial oversight. In our view, holding the line on taxes and tough talk about re-evaluating the health care bill—combined with corporations' large cash balances and a high degree

of liquidity thanks to the Fed—should provide the stimulus needed for a strong rebound in business capital investment and increased merger-and-acquisition activity. While this wouldn't spur employment, we believe it could lead to a surge in information technology and industrial spending in 2011. G3 equities—especially U.S. mid-cap and large-cap growth equities—are compelling to us.

We also believe it is possible that the S&P 500 Index could approach its all-time record levels during 2011, though we believe it is less likely that these highs will be breached for any sustained period. This is because, ultimately, we don't believe the markets are in a secular bull phase yet. We believe the next secular bull market will need to be built upon fiscal responsibility, the end of the welfare state economies, sound currency and supply-side driven productivity growth. There is work to be done on these fronts.

We believe the G3 bond markets still offer an ugly risk/reward profile and don't provide the "safety" that many investors may look to them for. Cash and adjustable rate bonds may be the only choice and of course, the current rate of interest is shockingly low.

However, the level of the S&P 500 Index—or any index, for that matter—is not our principal concern as active investment managers. We also believe that we can operate effectively even if the global markets are not in a secular bull market phase. We set our focus on seeking companies that are positioned to capitalize and adapt to the realities of the global economy. We encourage investors to take a similar approach. Risk is always present in the markets. But, we believe opportunity is there as well.

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 portfolio is expected to be more volatile than that of a U.S. only portfolio. These risks are generally intensified for investments in emerging markets.

Beta is a statistical measure of the relative volatility of a stock, fund, or other security in comparison with the market as a whole.

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.

Treasury Securities are bonds issued by the U.S. Treasury. They are the debt finance instruments of the Federal government, and are often referred to as "Treasurys."

OECD Countries are Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, The Netherlands, New Zealand, Norway, Poland, Portugal, South Korea, Spain, Sweden, Switzerland, Turkey, the U.K., and the U.S.

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

The Nasdaq Composite Index is a market value-weighted, technology-oriented index comprised of approximately 5,000 domestic and non-U.S.-based securities.

The Standard & Poor's 500 Stock Index (S&P 500) is an unmanaged index generally representative of the U.S. stock market.

The Russell 1000 Index consists of the 1,000 largest securities in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index. It is a large-cap, market-oriented index and is highly correlated with the S&P 500 Index.

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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Calamos International LLP
No1 Cornhill,
EC3V 3ND, London, UK
Te: +44 (0)20 3178 8841
Web: www.calamosglobal.com

Calamos International LLP is registered and approved by the Financial Services Authority.

CALAMOS®

Calamos Advisors LLC
2020 Calamos Court
Naperville, IL 60563-2787
800.582.6959
www.calamos.com

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