Economic Outlook

CALAMOS INVESTMENTS

January 2017

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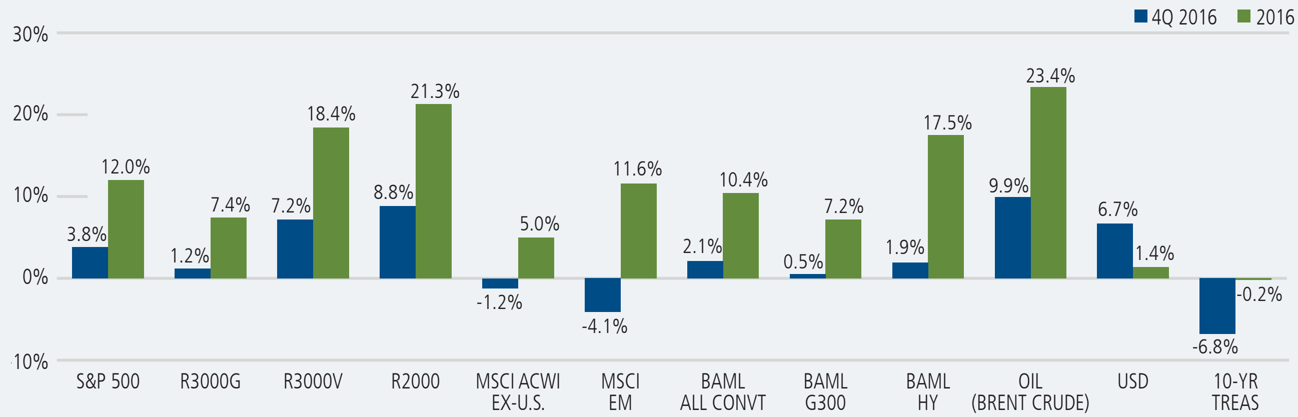
Entering 2017, we are increasingly optimistic about the prospects for the U.S. and global economies. Fundamentals are improving, with higher GDP growth and increasing inflation expectations set against still-accommodative monetary policy and a move toward fiscal stimulus. That said, the economy and markets are not the same. Investors have already pinned high hopes on the Trump administration's ability to ramp up U.S. growth and corporate profits (Figure 1), but the markets may well have gotten ahead of themselves over the short term. Also, transforming election promises into policies won't happen overnight, and we expect volatility as policies are hammered out. Finally, many of the risks that dogged the markets in 2016 have not gone away, including global political uncertainties, coordination of central bank policies, the longer-term impact of Brexit and other populist movements, and turmoil in the Middle East.

United States

U.S. economic fundamentals improved notably over the past year. Recessionary pressures abated and growth is likely to be stronger in 2017 than 2016. Trends in manufacturing data, consumer confidence, housing and auto sales are positive, and we expect deregulation to contribute to productivity gains. Inflation is likely to move moderately higher, but not to levels that are beyond

FIGURE 1. GLOBAL ASSET CLASS PERFORMANCE, 4Q AND 2016

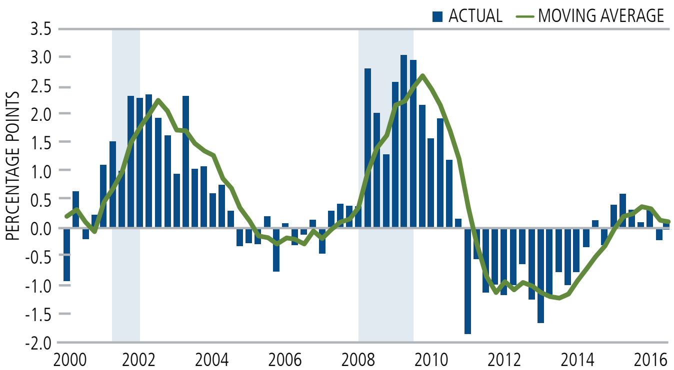
During the fourth quarter, investors flocked to cyclical and value oriented equities. Reflecting increased confidence in the U.S. economy's prospects, small caps outpaced large caps. Outside the U.S., global equities—particularly emerging markets—gave back some of the ground gained during the third quarter. Within fixed income, high yield slowed its pace while the 10-year Treasury slid steeply.



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

FIGURE 2. U.S. FISCAL POLICY HAS HINDERED GDP IN RECENT YEARS

HUTCHINS CENTER'S FISCAL IMPACT MEASURE (FIM), CONTRIBUTION OF FISCAL POLICY TO REAL GDP GROWTH



Source: Hutchins Center calculations based on BEA data (https://www.brookings.edu/interactives/the-fiscal-barometer/). As defined by the Hutchins Center, the FIM "is a gauge of the contribution of federal, state, and local fiscal policy to near-term changes in the gross domestic product, the tally of all the goods and services produced in the economy. It includes both the direct effects of government purchases as well as the more indirect effects of government taxes and government transfers. When FIM is positive, the government is contributing to real GDP growth, and when it is negative, it is subtracting from it." (Source: https://www.brookings.edu/research/the-hutchins-centers-fiscal-impact-measure)

control. The Federal Reserve doesn't appear in a hurry to raise rates dramatically. Currently, our base case is two rate increases for 2017, noting that historically, the Fed has tended to foreshadow more activity than it has delivered.

Over recent years, fiscal policy has not provided a tailwind to GDP growth (Figure 2). With the U.S. presidential election behind us, we expect pro-business fiscal policy can provide a stronger catalyst for sustainable expansion over the next several years. We anticipate that reduced regulation and new tax policies, once implemented, can drive growth in the corporate sector and encourage responsible risk taking with capital.

Trump's policies have not yet been set forth in detail, but the reflation trade looks set to continue. Over recent months, we have increased our positioning in cyclical growth names (such as industrials, materials and energy), while still maintaining secular growth exposure. We see growing opportunities in financials, where rising long-term interest rates and the potential for less regulation provide tailwinds. Within technology, we have increased our emphasis on cyclical growth areas, but still own traditional high-growth names within the sector.

Although we believe that 2017 is setting up to be a better year for the U.S. economy, our outlook for the equity market is more cautious. Given the post-election strength in equities, we would not be surprised to see a pause or pullback as investors digest the first few months of the new administration. President-elect Trump's comments have raised concerns of protectionist policies and trade wars, and these fears could stoke volatility in the market. Also, the strong dollar may also take some wind out of the sails of U.S. multinationals. Reflecting these concerns, we have remained attentive to quality and valuation as we have added names poised to deliver a better opportunity set in a higher-growth economy.

Global and International

In our global and international strategies, we seek companies that provide increased cyclical growth exposure while still offering the sustainable fundamentals we require, such as catalysts for improved margins, profits and earnings. This tilt has led us to energy, industrials and financials. In contrast, we are underweight staples, telecommunications and utilities. We continue to find opportunities in technology but have shifted some secular growth exposure in favor of increased cyclical growth.

From a regional perspective, we currently favor the United States, in line with our view that fiscal policy, reduced regulation and new tax policies can boost economic growth. We have invested in U.S.-domiciled companies and non-U.S. companies with significant revenue exposure to the U.S., such as exporters domiciled in the euro zone and, to a lesser extent, Japan. Our overall positioning in the euro zone reflects a more cautious view informed by mixed data. We are encouraged by improving economic fundamentals, stimulative monetary conditions, and reasonable equity valuations. These positives are tempered by concerns over the continuing effectiveness of ECB monetary policy, political uncertainties, the rise of nationalist movements, the path of Brexit, and the long-term sustainability of the euro. Meanwhile, economic conditions in Japan are more challenged, with Abenomics having yielded only mixed results. Weak growth and deflationary pressures persist, but monetary conditions are highly accommodative and valuations are supportive. In regard to positioning, we have found bottom-up opportunities in companies with improving capital allocations and growth potential.

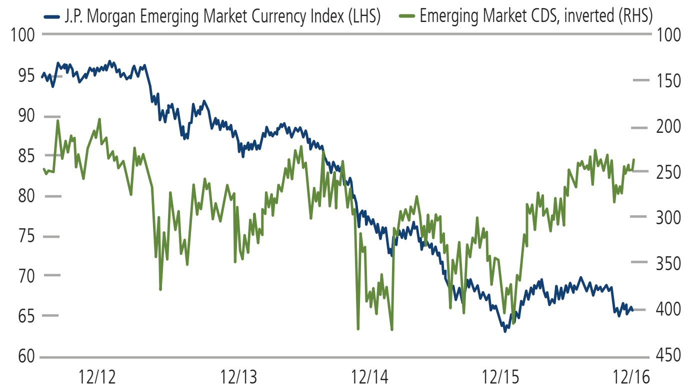
Emerging markets have faced added pressure since the U.S. elections, and we are monitoring the potential impacts of the stronger dollar, rising U.S. interest rates, and policy developments. Of note, while emerging market currencies have weakened more recently on the back of dollar strength, credit default swaps (CDS) have improved (Figure 3), likely because better global growth prospects reduce the perceived credit risk in emerging markets. If emerging market CDS continue to improve and stabilize at these levels, we should see emerging market currencies begin to improve as well, which would be a positive tailwind for emerging market equities in 2017.

Selectivity remains key, as fundamentals vary. We see plenty of supportive developments but many unique challenges. Our current emerging market positioning favors companies with strong domestic demand and countries pursuing economic reforms. Commodity consumers are well represented in our portfolios, but commodity price stabilization and higher growth and inflation expectations provide a more hospitable macro landscape for commodity producers. From a country standpoint, we are constructive on India (see our post) and Mexico—as we believe both markets are positioned for a reversion to the mean after having been penalized unduly by shorter-term sentiment. We maintain a commitment to China; valuations have cheapened and we've seen a relative pick-up in economic data, particularly in regard to trends in discretionary consumer products. More opportunities have emerged in Russia as improved commodity pricing and the potential for less fractious foreign relations support better prospects for companies that meet our fundamental criteria.

Convertible Securities

In 2016, convertible securities captured a substantial measure of the equity market upside. Issuance was also healthy, with $77.2

FIGURE 3. EMERGING MARKET CDS TRENDS: FORESHADOWING EM CURRENCY IMPROVEMENTS?



Source: Macrobond

billion coming to market, led by the United States with $36.3 billion. Looking to 2017, convertible securities offer considerable potential in an environment characterized by economic growth, rising interest rates and upwardly moving, albeit volatile, equity markets. This is because convertibles have demonstrated greater resilience in periods of rising rates versus high-quality non-convertible debt. Also, a rising rate environment could spur increased issuance as companies seek to access the capital markets at lower borrowing costs.*

Within our convertible portfolios, we are favoring U.S. over non-U.S. names and finding more smaller-cap opportunities. While we continue to invest in secular growth companies, particularly within technology, we've increased cyclical exposure across sectors. We've built positions in energy, materials, and industrial companies that can benefit from infrastructure spending, deregulation and increased inflationary expectations. We've sought names we believe can capitalize on domestic energy independence, domestic manufacturing and a strong national defense. Consumer discretionary remains an important theme in our portfolios, but we have been highly vigilant to crosscurrents (for example, the likelihood of increased resistance to minimum wage legislation and greater focus on domestic manufacturing) and their impact on different segments of consumer activity.

*In exchange for the equity upside participation they offer, convertibles often have modestly lower coupons than non-convertible debt.

Fixed Income

After a prolonged period of historically low interest rates, the Fed has begun raising short-term rates and longer-term rates have started to move higher. While rates may drift higher over the first few months of the year, we believe fears of protracted long-term rate jumps may be overdone. Investors typically think of short-term rates and long-term rates rising in tandem, but in reality, parallel rate rises have been quite rare. In our view, longer-term rates are not likely to soar, as accommodative monetary policies and purchase programs from other global central banks help to keep U.S. long-term rates in check. Additionally, we believe long-term interest rates are unlikely to bottom until the next recession, which we see as an unlikely scenario for 2017.

As investors sort out the evolving dynamics in the bond markets, sentiment may overshoot or undershoot fundamentals, creating opportunities for active managers to capitalize on dislocations. With rising global interest rates, the "reach for yield" is likely to be less of a driving force for high yield than in 2016, and we expect more measured performance for the asset class as a whole. Although economic conditions are improving and defaults are likely to wane in the energy sector, we do not see this as a time to slacken our risk discipline. Nonetheless, we believe high yield presents compelling prospects. Like convertibles, high-yield issues are hybrids of stocks and high-quality bonds with more sensitivity to improvements in economic growth and equity markets and less vulnerability to interest rates than traditional fixed income.

Conclusion

In summary, our more constructive view of the economy is paired with a recognition that Main Street and Wall Street are not the same street. An improved economic backdrop and the likely direction of fiscal policy and interest rates support an increased tilt toward cyclical growth. However, the valuations of many stocks are stretched by a number of measures, and there are still macro risks in the global economy.

Absent a few brief spikes, volatility has been low over the past year. As fiscal policies evolve and interest rates rise in the U.S., investors should be prepared for periods of elevated short-term volatility, with equities pausing or giving back some of the gains amassed since the election. Ahead of potential turbulence, we encourage investors to remember the market doesn't generally move in a straight line, even during a longer-term upward trajectory. Given our view that there is a breadth of opportunity in the markets but volatility may ramp up, we believe the case remains strong for including risk-managed strategies (such as alternatives) alongside allocations to traditional asset classes. We are also likely to see increased performance dispersion among both sectors and securities, providing an environment that favors active 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. **Oil** is represented by current pipeline export quality Brent blend. **JP Morgan Emerging Market Currency Index** measures a group of emerging market currencies against the dollar. The **Citi Economic Surprise Indexes** are objective, quantitative measures of economic news that measure the difference between actual releases and the median of Bloomberg survey data. **Quantitative easing** refers to central bank bond buying activities. A **credit default swap** is a contract that gives the buyer the right to recoup the economic value of a decline in the value of the issuer's debt securities. **Alternative strategies** entail additional risks and may not be suitable for all investors.

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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