High Yield Market Review and Outlook, February 2015

BY JEREMY HUGHES, CFA, SVP AND CO-PORTFOLIO MANAGER AND CHRIS LANGS, CFA, SVP AND CO-PORTFOLIO MANAGER

Market Environment

The U.S. high yield bond market, as represented by the BofA Merrill Lynch High Yield Index, generated a 0.69% return in January due mainly to robust retail inflows and a significant decline in U.S. Treasury yields. Although the European Central Bank's (ECB's) announcement of quantitative easing was widely expected, European sovereign yields dropped, with the yield of the German 10-year sovereign bond falling to 0.30%. These declines put pressure on U.S. Treasury yields, and the 5-year yield closed the month at 1.16%, down from 1.65% at year end.

High yield fund flows turned positive following the ECB announcement, and $3 billion of inflows helped to offset $10 billion of outflows in December. In January, new issuance recovered as $22 billion of issuance more than doubled December's anemic issuance. Spreads widened by 21 basis points during the month to +534 basis points over comparable Treasurys, as high yield lagged the Treasury rally. The yield to worst declined by 20 basis points to 6.45%, still well above the all-time lows of 4.85% set in June of 2014. The average dollar price increased to $99.5 in January, up from $98.9 in December.

With January's market improvement driven mainly by the rally in interest rates, bonds with lower credit qualities underperformed for the seventh consecutive month, continuing the risk-off sentiment of 2014. The CCC and below segment generated a -0.53% return for the month, while the BB and B credit quality tiers returned 1.24% and 0.50%, respectively. According to Moody's Investors Service, the U.S. issuer-weighted trailing 12-month default rate ended December at 1.9%. The ratings agency is forecasting one-year forward default rates to start inching higher and to reach 2.8% in December of 2015.

Hypothetical Scenarios

Below, we present four scenarios that illustrate forecasted one-year returns for the U.S. high yield bond market in varying market environments. The scenarios examine changes in default rates, recovery rates, spreads, and Treasury yields to depict forecasted returns for the overall U.S. high yield market. These returns do not represent actual performance, are not guaranteed, and serve only to illustrate possible total returns for changes in the four variables. An investor's actual performance may differ dramatically from these forecasts depending on many factors.

Scenario 1: In this scenario, the economy continues to expand quicker than expected, leading to unchanged defaults (1.9%), while recoveries maintain long-term averages (40%). With an improving economy, spreads tighten to +400 basis points in this scenario but are offset by 5-year Treasury rates rising to 2.00% as the first Fed rate hike occurs late in the year. In this bullish scenario, the high yield market generates a hypothetical total return of 7.7% over the next 12 months.

Scenario 2: Default rates are in line with Moody's projections (2.8%), and recovery rates maintain long-term averages (40%). In this scenario, moderate U.S. economic growth is offset by slowing global growth, specifically from Europe

High Yield Market Review and Outlook

BofA ML U.S. HIGH YIELD INDEX

CHARACTERISTICS AT 1/31/2015

Price	$99.48
Duration	4.08 yrs
Spread to Worst	534 bps
Yield to Worst	6.45%
Current Yield	6.93%
5-Yr U.S. Treasury Yield	1.16%

HYPOTHETICAL OUTCOMES

AT 1/31/2016

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Default Rate	1.90%	2.80%	2.80%	4.00%
Expected Recovery	40%	40%	40%	35%
Spread Change (bps)	-134	-59	-34	+216
5-Yr U.S. Treasury Yield Change (bps)	+84	+34	+109	-16
% Chg from Defaults	-1.13%	-1.67%	-1.67%	-2.58%
% Chg from Spreads	5.47%	2.41%	1.39%	-8.81%
% Chg from 5-Yr U.S. Treasury Yield	-3.43%	-1.39%	-4.45%	0.65%
Expected Current Yield	6.80%	6.74%	6.74%	6.65%
Hypothetical Return	**7.71%**	**6.09%**	**2.01%**	**-4.09%**

Returns do not represent actual performance, are not guaranteed, and serve only to illustrate possible total returns for changes in the four variables. An investor's actual performance may differ dramatically from these forecasts depending on many factors.

and China where interest rates remain low, causing the Fed to forestall the first rate hike into 2016. The yield of the 5-year Treasury increases by 34 basis points to 1.5% and spreads tighten by 59 basis points to +475. This scenario generates a hypothetical return of 6.1% for the next 12 months.

Scenario 3: Defaults and recovery rates are the same as Scenario 2, but 5-year Treasury rates ratchet up to 2.25% as wage inflation finally emerges and the Fed becomes more vigilant about inflation (initially raising rates in mid-2015). Spreads tighten moderately by 34 basis points to 500 basis points with an improving U.S. economy. In this scenario, the carry return more than offsets the loss from defaults and interest rate increases to generate a hypothetical return of 2.0%, which would generate positive excess returns over Treasurys with comparable maturities.

Scenario 4: In our worst case scenario, the economy does not expand as expected and default rates tick higher to 4.0%, while recovery rates decline to 35%. Lower oil prices send shocks through the high yield market as likely energy bond default expectations increase for 2016 when hedges run off and liquidity becomes more challenging. Spreads widen significantly to 750 basis points and 5-year Treasury rates rally back to 1.0%. In this scenario, the hypothetical return would be -4.1%.

Outlook

Uncertainties surrounding global growth, oil prices, and interest rates are likely to persist through 2015, leading to heightened volatility across asset classes. Despite global headwinds, we expect continued U.S. economic expansion. This U.S. growth and the Federal Reserve's "patient" approach to raising short-term rates should provide support to the high yield asset class.

Oil prices, euro zone turmoil, and Chinese growth are three headwinds we are watching especially closely. Given that energy bonds account for roughly 15% of the high yield market, oil prices can have a dramatic impact on the asset class. While we don't expect a material increase in energy bond defaults in 2015,

2016 could be a different story as hedges roll off and liquidity becomes more challenging for the industry.

Our view on Treasury rates remains unchanged. Barring major economic disruptions, we believe the Fed will forestall its first rate hike until at least mid-2015, with measured future rate hikes. We believe that this approach, recently announced quantitative easing in the euro zone, and benign inflation expectations will keep long-end rates from backing up materially as non-U.S. central banks offset the lower demand for Treasurys with the end of QE3. In high yield, we expect a continued increase in liquidity premiums and plateauing fundamentals, which should prevent material spread tightening, despite the lack of viable fixed income alternatives. Security selection will be paramount as default rates slowly begin to inch higher and credit differentiation becomes more prevalent. Despite these challenges, we believe the high yield asset class represents an attractive option for risk-tolerant fixed income investors.

The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice. The information in this report should not be considered a recommendation to purchase or sell any particular security.

The BofA Merrill Lynch U.S. High Yield Index is an unmanaged index of U.S. high yield debt securities. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect any fees, expenses or sales charges. Investors cannot invest directly in an index.

Investments in high-yield securities include interest rate risk and credit risk. Outside the U.S., this presentation is directed only at professional/sophisticated investors and it is for their exclusive use and information. This document should not be shown to or given to retail investors.

Duration is a measure of interest rate sensitivity, with higher duration indicating greater sensitivity to changes in interest rates. Spread to worst is a measure of the variation of returns within a specific market or between different markets, comparing the best and worst performer. Yield to worst is the lowest potential yield of a bond, absent default. Quantitative easing refers to central bank bond buying activities.

CALAMOS®

Calamos Advisors LLC
2020 Calamos Court | Naperville, IL 60563-2787
800.582.6959 | calamos.com | caminfo@calamos.com

© 2015 Calamos Investments LLC. All Rights Reserved. Calamos® and Calamos Investments® are registered trademarks of Calamos Investments LLC.

HYMKTCOM 17037 0215M C