Phineus Long/Short Strategy

CALAMOS INVESTMENTS

Market Overview

Global equities rebounded sharply in Q1 as financial markets celebrated the suspension of the Fed's agenda of monetary normalization, supplemented by similar initiatives in China. This monetary inflection combined with an imminent truce in U.S.-China trade tensions drove a price recovery from the December lows that is extraordinary by historical standards. The S&P 500 Index rose 13.7% in Q1, while the MSCI Europe and MSCI Asia Pacific Indices rose 10.7% and 9.7% respectively in U.S. dollar terms.

The rapid and forceful reversal from monetary normalization to neutrality by the U.S. Federal Reserve was in response to the market turmoil of late 2018. Policymakers were unnerved not just by gathering weakness of economies abroad, but by the effective shutdown of U.S. credit markets in December. This turmoil compelled a "monetary truce," which allows the more optimistic investor to believe that the worldwide slowdown in economic activity has been adequately discounted.

While sentiment around U.S. economic activity has improved through Q1, our view is that the data is more consistent with stabilization than a broad-based recovery. Economic growth remains the crux of the question.

There is a tendency in our industry to assume that economic trends will validate the prior performance of financial markets, as the latter are better leading indicators than most forecasters. But markets can overshoot and anticipate fundamental outcomes that are less conclusive than implied by price alone. For example, the severe Q4 sell-off appears to have incorrectly anticipated the risk of U.S. recession in 2019.

Much of the upgraded U.S. setting reflects recent employment data, where momentum appears resilient. Outside of this, the picture is mixed. Most business surveys and capex intentions in particular have stalled from the robust pace of 2018. We believe U.S. firms did not anticipate the unfolding global slowdown and are struggling to maintain margins amidst higher labor costs, sticky interest expense and the reversal of global supply chains.

Investors have welcomed signs of more moderate growth because it sustains their belief in "Goldilocks" expansion: not too hot, not too cold and aligned with an accommodative Fed. The consensus assumes the Fed's agenda to normalize U.S. monetary policy is not just suspended—it has ended, with no further rate hikes anticipated through 2020. The comprehensive nature of this reversal message has merited celebration, though the context of the Q4 collapse should not be overlooked.

Periods of "Fed neutrality"—where the Fed pauses to assess the impact of prior tightening—have historically proven ephemeral. More often, they have foreseen a recession and embarked on an eventual and full-scale easing cycle, or they have pre-emptively eased (such as 1995 and 1998) and, thus, extended the economic

FIGURE 1. PHINEUS LONG/SHORT STRATEGY RETURNS

	QTR ENDING 3/31/19	1-YEAR	3-YEAR	5-YEAR	10-YEAR	SINCE INCEPTION (6/1/02)
Phineus Long/Short Composite						
Gross of Fees	3.80%	-2.83%	8.46%	6.37%	13.59%	12.81%
Net of Fees	3.48	-4.03	7.11	4.95	12.00	11.19
MSCI World Index	12.64	4.61	11.31	7.38	13.01	7.38
S&P 500 Index	13.65	9.50	13.51	10.91	15.92	8.15
HFRI Equity Hedge (Total) Index	7.92	-0.08	6.83	3.61	6.48	5.02

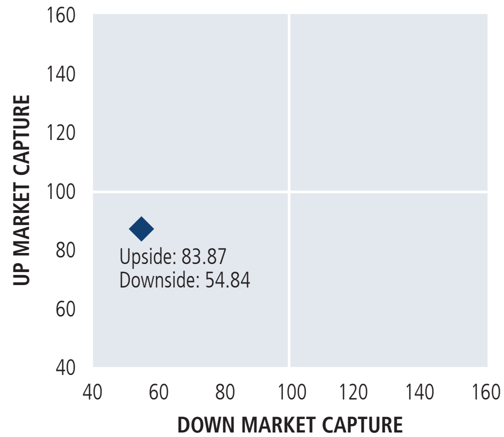
Source: Calamos Advisors LLC
Past performance is no guarantee of future results.
Data as of 3/31/19.

FIGURE 2. SINCE INCEPTION RISK/REWARD CHARACTERISTICS

	CALAMOS PHINEUS LONG/SHORT COMPOSITE	MSCI WORLD INDEX
Annualized Alpha	7.81%	N/A
Beta	0.71	1.00
Standard Deviation	16.33%	14.88%
Information Ratio	0.41	N/A
Sharpe Ratio	0.71	0.41
Sortino Ratio	1.32	0.58
Upside Semivariance	17.14%	9.85%
Downside Semivariance	6.22%	8.98%

Past performance does not guarantee or indicate future results.
Source: Calamos Advisors LLC

FIGURE 3. SINCE INCEPTION UP/DOWN CAPTURE VS. MSCI WORLD INDEX



Past performance does not guarantee or indicate future results. Portfolios are managed according to their respective strategies which may differ significantly in terms of security holdings, industry weightings, and asset allocation from those of the benchmark(s). Portfolio performance, characteristics and volatility may differ from the benchmark(s) shown.
Source: Calamos Advisors LLC
Data as of 3/31/19.

cycle. We expect financial markets to rejoin this debate between May and early autumn. The ongoing flattening of the U.S. Treasury yield curve could be the alibi for the Fed to preemptively ease in H2 of 2019.

In addition to this inflection in monetary sentiment, investors have been encouraged by abating trade tensions between the U.S. and China. While some deal appears imminent, as neither side desires escalating to a more strategic and costly confrontation, the trade resolution should be viewed more as a truce than a full conclusion of the issues at stake. In particular, the mechanisms regarding how to monitor and enforce China's compliance could prove problematic, as could overseeing the longer-term competition across key technological industries.

We question whether this U.S.-China deal will lead to a resumption of trade activity and a revival of global economic growth. Trump seems highly committed to the reversal of global supply chains in favor of more regional economic blocs in order to boost long-term investment in U.S. manufacturing. For this reason, we struggle to believe the eventual deal can be comprehensively positive for sentiment. Once Trump claims victory over China, the trade squeeze will be turned upon Europe.

The resurgence of Chinese equities in Q1 played much the same role in encouraging investors to assume that global output and trade will shortly revive. The scale of Chinese stimulus in January was impressive and helped underpin signs of stabilization after a shaky Q4. Nonetheless, many indicators remain consistent with weak demand; none of China's most important trading partners (Germany, Korea and Japan) are mirroring any notable pickup. As we write this note, the Politburo has revealed there will be an adjusted, slower pace of stimulus going forward.

Amidst all of these headlines induced by policymakers, we should not overlook that market volatility has a fundamental source: U.S. earnings releases have highlighted a sharp deceleration from last year's tax-induced bumper growth. We expect a steady wave of forecast downgrades in sales and profit margins across all of the major markets into autumn. In the context of this deterioration, the obvious question is whether the structural forces driving last year's contraction in liquidity have been genuinely reversed.

Putting all of this together, the market's performance in Q1 should be judged as a "rebound, not revival"—rebound from the turmoil of late 2018 rather than a revival of the bull market in risk assets. This distinction is captured by the dichotomy between the worlds of equity and credit and their respective

FIGURE 4. SECTOR WEIGHTINGS (%)

	LONG	SHORT	GROSS	NET	MSCI WORLD INDEX
Communication Services	9.4	-0.1	9.5	9.3	8.3
Consumer Discretionary	9.9	-0.2	10.1	9.7	10.4
Consumer Staples	2.0	0.0	2.0	2.0	8.6
Energy	2.2	0.0	2.2	2.2	6.0
Financials	29.7	0.0	29.7	29.7	15.6
Health Care	12.2	-0.1	12.3	12.1	12.8
Industrials	13.0	0.0	13.0	13.0	11.1
Information Technology	4.4	-3.1	7.5	1.3	15.9
Materials	2.1	0.0	2.1	2.1	4.6
Real Estate	0.0	0.0	0.0	0.0	3.3
Utilities	0.0	0.0	0.0	0.0	3.3
Other	3.9	-81.1	84.9	-77.2	0.0
TOTAL	**88.8**	**-84.6**	**173.4**	**4.2**	**100.0**

Numbers may not add up due to rounding. Sector weightings based on percentage of total account and are subject to change. Sector weightings exclude cash or cash equivalents. Source: Calamos Advisors LLC. Data as of 3/31/19.

FIGURE 5. REGIONAL ALLOCATION (%)

	LONG	SHORT	GROSS	NET	MSCI WORLD INDEX
North America	82.9	-84.6	167.5	-1.7	64.1
Europe	5.9	0.0	5.9	5.9	22.9
Asia/Pacific	0.0	0.0	0.0	0.0	12.6
Middle East/Africa	0.0	0.0	0.0	0.0	0.2
Caribbean	0.0	0.0	0.0	0.0	0.1
Latin America	0.0	0.0	0.0	0.0	0.1
	88.8	**-84.6**	**173.4**	**4.2**	**100.0**

Regional weightings are based on security's region of domicile. Numbers may not add up due to rounding. Source: Calamos Advisors LLC. Data as of 3/31/19.

assessment of the outlook. As one example: the flattening of the U.S. Treasury curve has been arrested since December, but it has not reversed as one would hope with a risk revival.

Equities are discounting a degree of improvement in economic activity commencing this summer and extending through 2020. This outcome is in line with past U.S. election cycles and assumes managements can rapidly adjust their business models for slower growth ahead. Credit markets anticipate a prolonged period of slower growth, though they are agnostic about recession. If credit markets are correct, equities have limited upside. If credit markets are wrong, the implication is renewed upward pressure on U.S. interest rates.

The lesson of 2018 is that the 3% threshold for shorter-dated U.S. dollar rates is the ceiling, regardless of Fed projections. Prolonged capital subsidization has reduced the rate thresholds for financial stress, which is why the U.S. yield curve remains stubbornly flat. Entering 2019, the Fed has aggressively encouraged an overshoot to the downside of U.S. dollar yields. Any improvement in the global business cycle amidst full employment in the U.S. should produce an upward displacement of the entire Treasury curve.

Positively, economic recession in the U.S. is unlikely in 2019 and probably 2020. Our central forecast is that global activity will muddle through, largely supported by the resilience of Western consumer incomes. However, some mix of mild recession or financial crisis could be an accidental by-product of what we (later) describe as a transition to a different economic setting. We are acutely sensitive to this scenario, while remaining open to the higher likelihood of a softer landing.

Turning to Europe, investors have finally embraced the stagnant economic outlook that seems to be the continent's destiny in coming years. Sadly, the

ECB is becoming Japanese in the sense of "QE forever" with the associated malaise and decline in productivity. The failure to resolve Brexit will weigh upon the entire region, but we are intrigued by the longer-term upside for Sterling-based assets. Global investors appear structurally underweight the latter, while UK cash flow yields are compelling. Contrary to the common dogma, we believe the productivity upside for Britain is greater outside than inside the EU.

There is widening consensus that the strength of the U.S. dollar has reached its limits. This assumes the Fed has done its tightening cycle, which has been an underpinning of dollar strength. We question how much weakness in the U.S. dollar can unfold as long as the U.S. economy remains a relative source of strength, even if it too is slowing. Until we see circumstances where the Fed begins to panic and ease aggressively, we are skeptical that U.S. dollar weakness will emerge in force.

The negative case for the U.S. dollar is straightforward, although it may take time to emerge. The world is overinvested in U.S. dollar-denominated assets at a time when the rate differentials in favor of the dollar could be peaking. But this view is debatable given the mediocre outlook in much of the non-U.S. world. We believe real weakness in the U.S. dollar must await further pressure on risk assets, partly because the world expects America to respond with reflation, sooner or later as it always does.

Positioning and Portfolio Changes

In our view, the 2018 to 2020 period represents a liquidity-driven deflation of financial prices in the context of a global cyclical slowdown. While the Fed's pivot represents insurance against the more deleterious risks, we believe the economic slowdown is still underestimated by investors and will be more apparent in corporate releases through the middle quarters of 2019.

This interpretation has biased our long selections towards more resilient areas of the equity world. At the margin, it implies more U.S. versus non-U.S.; it supports our bias towards the Western consumer rather than the global producer industries.

Our sense is that this slowdown can avoid an outright recession in the U.S., largely due to the resilience of consumer incomes. Nonetheless, we are entering a vulnerable phase and markets will struggle over the correct "valuation" applied to late-cycle equities. For this reason, the steady recovery in U.S. equities through Q1 was used to reduce net exposure and preserve the year-to-date gains.

Into April, the Fund's long and short exposure is roughly balanced; positioning shifts are largely occurring at the industry and stock level. For example, the Fund has modestly reduced its exposure to U.S. financials where the group's beta implies some vulnerability to "late-cycle" perception. That said, valuations are compelling and fundamentals are solid, which explains their impressive bounce after the December lows. Core longs here include **JP Morgan, Bank of America (3.3%)** and **Morgan Stanley (4.0%)**.

Technology has been a tactical source of alpha in recent months, but crowded positioning is a concern; according to some data, investor positioning in software is near multi-year highs. Equally, the industry is exposed to maturing corporate profitability, which implies weaker tech capex. **Facebook (5.0%)** and **Google (4.1%)** remain core longs partly because they sell into markets (via advertising) more dependent upon the health of the consumer than corporates.

The Fund added modestly to its health care positioning **Humana (1.5%)**, though we prefer diversified companies such as **Johnson & Johnson (2.4%)** and **LabCorp (3.2%)** rather than traditional pharmaceuticals. Drug pricing remains vulnerable to a variety of political clouds and little of the health care food chain will emerge unscathed from the secular spending pressures that are an outcome of demographic realities. We view the group as a defensive rather than a genuine growth class. We remain highly selective in other defensive areas such as consumer staples, where valuations are high after the 2018 turmoil across markets. We are focused on discretionary names such as **McDonald's (2.5%)**, which is in the middle innings of a multi-year turnaround as it shifts to an asset-light franchise model. **Wal-Mart (2.0%)** was added as a staple-like opportunity benefiting from the resilience of the Western consumer.

With regard to our industrials positions **Honeywell (1.3%)**, **Emerson Electric (2.1%)** as well as the military/defense positions **Harris (1.3%)** and ***Raytheon (2.5%)***, we emphasize businesses less exposed to the very different economic landscape abroad. The portfolio has tactically adjusted its exposure to airlines, where **Delta Airlines (3.0%)** remains our preferred long and **Air Lease (1.0%)** is an attractively valued contrary play on global travel demand.

Emerging markets remain uncompelling despite their valuation attraction. The rise of "global growth led by China" has been inextricably linked to the Pacific supply chains which are being unwound. China's debt cycle is extreme, while the confrontation with the U.S. is substantial and limiting the options of policymakers. Recent fiscal initiatives have been more modest than prior episodes, and we continue to avoid the region.

The reappraisal of the outlook for USD interest rates is usually the signal to upgrade EM risk assets. Yet, MSCI Asia Pacific underperformed in Q1 despite the Fed's pivot, confirming our disbelief in a sustained EM cycle. With globalization in retreat, these economies will struggle to compete for capital. We think investors have not incorporated this risk into their long-term expectations for GDP and earnings growth across much of the EM world.

In Europe, there is no political visibility and equities are virtually uninvestible until these markets become much cheaper. Sponsors of European integration are paralyzed by a defensive and doctrinaire mentality, taking refuge in the culture wars against liberalism. Europe's combination of budgetary austerity coupled with monetary subsidization is following a Japan-like trajectory. Europe has been reduced to the protector of a stagnant status quo.

Outlook

What explains the uncommon reversal of fortunes into 2019? More than anything, it reflects the comprehensive capitulation by the U.S. Federal Reserve and the message that central banks have the back of investors.

Through the course of 2018, investors came to realize that central bank policy was no longer aligned with the post-2008 cycle of financial asset price inflation. The latter was the derivative of the Fed's extensive policies of capital subsidization: the suppression of U.S. interest rates, credit risk and, thus, the corporate cost of capital. We characterize these policies as the monetary equivalent of opioids. **Into 2019, the performance of equities has been remarkable. Naturally, we should ask whether these gains foreshadow an improving economic cycle and the revival of the bull market in risk assets. Our interpretation is more nuanced.**

By releasing its financial squeeze, the Fed confirms the end of monetary restriction, and investors have rejoiced. But equally, we have learned that the withdrawal of the monetary drugs is starkly difficult. The Fed has not just suspended its agenda of monetary normalization—it has abandoned it. We have witnessed the sober reality that prolonged application of capital subsidies creates dependency.

The message of the past six months, as exhibited by the schizophrenic swing between recession fear and recovery optimism, is that the behavior of risk assets virtually defines financial conditions and confidence across the U.S. economy. In effect, the Fed has committed itself to be the manager of global risk assets.

Policymakers are now prisoners of the very inflation in financial asset prices that they created. While some argue the Fed is more concerned about the risks of recession than they are willing to admit, our perspective lies in the Fed's own fallibility as demonstrated by its unconventional policies. Capital subsidization has created economic and social costs that are associated with permanent dependency.

The apprehension surrounding these costs, which include the encouragement of excessive indebtedness, explains the rare display of disarray at the Federal Reserve. In our view, this reflects genuine fear of policy error and the politicization of the institution itself. Financial markets understand the direction of policy bias at the Fed because the threshold of pain is low.

Conventional wisdom is that central banks can manage financial markets and even have a duty to manage them in order to 'benefit the economy'. The rise of new schools of thought, such as Modern Monetary Theory (MMT), are manifestations of the decline of belief in free markets and the abandonment of anchors. All of this can be traced back to the hyper activism of central banks and their commitment to support asset prices.

Of course, central banks can suppress financial volatility and support 'market liquidity', which has been the theme in 2019. But there are still absolute anchors relating to rate levels, balance sheet structures and the productive allocation of capital. As Hyman Minsky, the famed economist noted, "The more stable things remain, the more unstable they will be when crisis occurs; success breeds a disregard of the possibility of failure."

Investors are comforted by the absence of the familiar end-cycle dynamic of rising inflation and monetary restriction. Yet, the last two recessions in the West were not the consequence of inflation as traditionally defined: they were the consequence of instability produced by different forms of asset price inflation. In Minsky terms, investors are confusing the ascendancy of financial assets in 2019 with stability.

For this reason, central banks appear to be displacing problems rather than addressing them. Financial markets have calmed decisively since December in response to central bank assurances. Yet, the inversion of the most widely monitored versions of the U.S. Treasury yield curve has amplified perceptions of late-cycle vulnerability. These vulnerabilities combined with increased leverage have reduced the threshold for financial stress.

The strategic question is whether "Fed neutrality" is enough. Does the pivot by the central banks halt the downturn in the global business cycle and remove the risk that this downturn could be prelude to recession?

Slower U.S. growth seems inevitable due to the fading influence of the Trump tax bill and the structural recession across the global producer industries. There are pockets of late-cycle exhaustion in key areas of consumer demand such as housing and autos. The risk of outright U.S. recession remains low because employment markets are firm, though some slackening has also emerged here. For example, monthly U.S. payrolls averaged 40,000 less per month in Q1 versus the prior quarter.

The corporate earnings cycle is symptomatic of these late-cycle dynamics. In December, investors effectively "priced in" an earnings recession for 2019. Profit growth has quickly turned negligible in Q1 (~ 0%) and the second derivative of growth is what matters now. Cost structures may be too high for slower sales and profits, which usually elicits cost-cutting. These costs can be the hardest to cut: admin costs, depreciation of existing assets and debt service.

Compared to the rest of the world, the U.S. slowdown is recent and still modest. While Europe can avoid recession due to the resilience of domestic demand, GDP growth in Euroland seems unlikely to exceed 1% in 2019 and the political setting remains unfriendly to investors. The silver lining could be an authentic ("no deal") Brexit, but the British political class has never believed in this. Here and once again, fear of economic disruption is the defining characteristic of Western policymakers due to apprehension of social repercussions.

The outlook for China is more opaque. Chinese policymakers are aiming for stabilization and the nascent signs here are positive. Yet, deleveraging remains the strategic priority because excessive credit growth is perceived as the longer term threat. Real GDP has likely stabilized after last year's doldrums, but the absence of any recovery in nominal GDP growth implies little benefit for the rest of the world. China faces considerable challenges in coming years: the old theme of "global growth led by China" is over.

An era of transition: 2018 to 2020

The post-2008 bull market ended in October of last year. Our definition of "end" is not based upon the price behavior of the major equity benchmarks, but upon the driving logic of financial asset price inflation spurred by central bank policies of the past decade. This era is climaxing now: 2018 – 2020 should be viewed as one phase of a more extended transition from the investment environment of capital subsidization.

The challenge for investors is that this transition period is unlikely to correspond to the conventional perception of a bull or bear cycle. Instead, we expect a climate of rising financial instability, social and political fragmentation, and gathering evidence of late-cycle exhaustion. We see the S&P 500 Index range bound between the December lows of 2400 and the former highs around 3000.

Slower U.S. growth has been welcomed because it maintains the liquidity environment and a low cost of debt. The Fed is committed to avoiding the turmoil of late 2018. This persistence limits the downside for risk assets, as does the absence of familiar end-cycle logic of rising inflation and monetary restriction. As long as U.S. recession is avoided, we do not anticipate a severe bear move because the Powell "fear threshold" has been demarked.

Phineus Long/Short Strategy

Equally, we see the upside potential for equities as limited. Stronger U.S. growth would almost certainly prove disruptive for credit markets and, thus, would revive the monetary constraint for equities. Business investment is generally slowing, while U.S. corporate profitability is peaking. More generally, equities are grappling with a future of less capital subsidization, higher labor costs, higher interest rates and a diminished contribution of globalization to corporate profitability.

Investors should expect multiple reversals of trend perception in coming years. 2018 was the downward reversal of trend – it was not sustained. Similarly, today's gathering perception of an upward trend in risk assets is unlikely to be sustained. This framework of "neither bull nor bear" implies a tactical approach to equity exposure. When corrections occur, they are likely to be rapid as investors again fear trend reversal.

Conclusion

Our assumption is that global growth will remain sluggish through this year and into 2020, but avoid any traumatic debacle. This is good news for parts of the global landscape that are priced for mediocre growth, but creates challenges for components of the U.S. equity world that are priced for superior profitability. U.S. earnings are unlikely to grow in 2019, which implies that equities prices are sanguine relative to the downside risks.

We do not believe the wait-and-see neutrality of the Federal Reserve is sufficient to restore the bull market in risk assets. The challenge is not just the cyclical slowdown in global growth, but the declining effectiveness of monetary stimulus for the economic cycle. Markets will add their opinion to this debate between now and early autumn. The dispersion of views among investors is wide, but conviction attached to these views appears low.

Reflecting all of this, we are cautious about adding risk with U.S. markets back near all-time highs. We aim for healthy absolute returns in 2019 without forcing our clients to assume either the bullish or bearish side of these arguments.

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