Investment Commentary

CALAMOS INVESTMENTS

High Yield Market Review and Outlook, January 2017

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Market Environment

The U.S. high yield bond market, as represented by the BofA Merrill Lynch U.S. High Yield Index, returned 1.97% in December. This gain more than offset November's decline, which was the first negative monthly return since January 2016. For the year 2016, the high yield market returned 17.49%, the third best year over the past 20, surpassed only by 2003 (when the markets recovered from the WorldCom fraud) and 2009 (when the U.S. economy emerged from the Great Recession).

High yield spreads tightened by 41 basis points to end the year at 439 basis points over comparable Treasury bonds, which is nearly 450 basis points tighter than the market lows in mid-February and more than 250 basis points tighter than year-end 2015. Following the U.S. election and the second hike of the rate-tightening cycle the Fed began in 2015, Treasury yields moved to levels not seen since 2011. The 5-year Treasury ended 2016 at 1.93%, after trading at 1.76% to begin the year. Presently, the market is pricing in two rate hikes in 2017.

High yield mutual funds experienced net inflows of $6.4 billion during December, bringing year-to-date net inflows to $6.9 billion and marking the first full year of inflows since 2012. New issue activity was fairly robust during what is typically a slow season, with $19 billion of new deals pricing during the month. For the year, new issuance totaled $286 billion, just shy of the $293 billion total in 2015. The yield to worst declined 40 basis points, closing at 6.17%, the lowest month-end reading since May of 2015. The average dollar price increased to $99.6 in December, up from $98.1 in November.

For the entire month of December, oil traded at above $50, supported by the OPEC agreement to cut production and more optimistic global growth expectations. Against this backdrop, the oil service (+6.0%) and exploration and production (+3.6%) industries outperformed for the month. Financial services (+2.3%) and healthcare (+2.2%) also outperformed, while retail (+1.0%), consumer goods (+1.0%), and utilities (+1.0%) lagged.

Lower-quality high yield outperformed higher-quality with the CCC and below tier outperforming for the tenth month in a row. The BB quality tier underperformed with a 1.43% return, while the B tier and the CCC and below tier returned 2.03% and 3.75%, respectively. For the full year, the CCC and below tier was up 36.46%, outpacing both the BB tier (13.22%) and the B tier (16.94%). According to J.P. Morgan, the U.S. high yield default rate including distressed exchanges ended 2016 at 3.98%, up from 2.94% a year prior. However, excluding energy and metals/mining, J.P. Morgan calculates defaults at just 0.68% for 2016.

Hypothetical Scenarios

On the following pages, 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.

BAML U.S. HIGH YIELD INDEX (H0A0)

CHARACTERISTICS AT 12/31/16

Price	$99.60
Duration	4.0 years
Spread to Worst	439 bps
Yield to Worst	6.17%
Current Yield	6.55%
5-Yr U.S. Treasury Yield	1.93%

HYPOTHETICAL OUTCOMES

AT 12/31/17

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Default Rate	3.0%	4.5%	4.5%	7.5%
Expected Recovery	40%	35%	35%	25%
Spread Change (bps)	-89	11	36	361
5-Yr U.S. Treasury Yield Change (bps)	32	-18	57	-93
% Chg from Defaults	-1.79%	-2.91%	-2.91%	-5.60%
% Chg from Spreads	3.52%	-0.43%	-1.42%	-14.26%
% Chg from 5-Yr U.S. Treasury Yield	-1.26%	0.71%	-2.25%	3.67%
Expected Current Yield	6.35%	6.26%	6.26%	6.06%
Hypothetical Return	**6.8%**	**3.6%**	**-0.3%**	**-10.1%**

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Scenario 1: In this scenario, the global economy expands quicker than expected, leading to lower defaults (3%) and better recoveries (40%) than current readings. With an improving economy and higher commodity prices, spreads tighten to 350 basis points, equal to the tightest levels in 2014. This tightening is offset by 5-year Treasury rates rising to 2.25% as Fed messaging continues to indicate that the central bank is likely to take a patient course, incresing rates twice over the next year. In this bullish scenario, the high yield market generates a hypothetical total return of 6.8% over the next 12 months.

Scenario 2: Default rates are in line with current estimates and long-term averages (4.5%), and recovery rates improve from recent levels (35%). In this scenario, moderate U.S. economic growth is offset by slowing global growth and sovereign rates remaining low due to quantitative easing policies. Against this backdrop, the Fed raises rates more slowly than expected to avoid strengthening the U.S. dollar too abruptly. Commodity prices continue to move moderately higher. The yield of the 5-year Treasury decreases to 1.75% and spreads widen by 11 basis points to 450, 100 basis points below long-term averages. This scenario generates a hypothetical return of 3.6% over the next 12 months.

Scenario 3: Defaults and recovery rates are the same as Scenario 2, but 5-year Treasury rates ratchet up to 2.5% as wage inflation finally emerges; consumers begin spending more of their wealth; fiscal spending kicks in; and the Fed either becomes more vigilant about inflation, suggesting more methodical rate hikes, or the market perceives the Fed to be behind the curve in its rate hikes, leading to higher inflationary expectations. Spreads widen modestly by 36 basis points to 475 basis points as a stronger U.S. economy is offset by fears of even higher interest rates. In this scenario, the return from carry almost offsets the loss from defaults and higher interest rates to generate a hypothetical return of -0.3%, which would generate sizeable excess returns over Treasurys with comparable maturities.

Scenario 4: In our worst case scenario, the global economic slowdown intensifies as the new U.S. administration struggles to enact changes, heightening recession fears. Default rates move higher to 7.5%, while recovery rates maintain their current 25%. In this scenario, a global slowdown leads to a retracement of oil prices, and investor appetite for risk wanes, which causes many issuers without access to capital to restructure or file bankruptcy. Spreads widen to 800 basis points as market liquidity becomes more challenged and 5-year Treasury rates rally back to 1.00%. Another round of U.S. quantitative easing is contemplated, which temporarily places a floor on how low risk assets fall. In this bear case scenario, the hypothetical return would be -10.1%.

Outlook

A recovery in oil prices and an insatiable demand for yield were two key factors that helped propel the high yield asset class to a return of 17.49% in 2016, its third best year over the past two decades. With oil prices comfortably above $50 at year end following the OPEC production agreement, many energy issuers have addressed their liquidity concerns by either raising capital in the financial markets or by restructuring their balance sheets. This should limit the amount of defaults from energy issuers going forward.

From a demand standpoint, high yield investors were especially attracted to the asset class in 2016 when more than $12 trillion of global debt (roughly 25% of the outstanding supply) yielded less than 0%. However, given the increase in global rates, the "reach for yield" that was so pervasive throughout 2016 is likely to be much less of a technical driving force for the high yield asset class in 2017. As prospects for global growth improved and the Fed raised rates for a second time in this current tightening cycle, the amount of negative-yielding bonds has dropped to $4 trillion, with just $2 trillion in maturities greater than two years. At year end, the Bloomberg Barclays Global Aggregate Index was generating $260 billion more in income than it was at mid-year, an increase greater than the income generated by the entire U.S. high yield market annually.

Following the post-election risk rally, high yield ended the year at a 6.17% yield to worst, +439 basis points over comparable Treasurys, with an average dollar price of $99.6. This compares to 20-year averages of 9.13%, +579 basis points, and $94.4, respectively. The market has high hopes for the new administration's pro-growth policies and has already priced in a great deal of the potential upside of an improving U.S. economy. While default rates likely trend lower, there still is reason for concern as more than 40% of CCC issuers have been unable to access the capital markets over the past three years. Defaults will almost certainly be lower in the energy sector but are likely to pick up in other industries. With the combination of weaker relative technicals and spreads well below long-run averages, we expect the upside and corresponding price appreciation potential to be limited for the high yield asset class in the next year. Instead, we expect more of a coupon-like return for 2017 with more volatility than in 2016. Despite these headwinds for the asset class, we believe better-than-coupon returns are not out of reach during 2017 for active managers who employ a rigorous bottom-up security selection process.

High Yield Market Review and Outlook

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The **BofA Merrill Lynch U.S. High Yield Index** is an unmanaged index of U.S. high yield debt securities. The **Bloomberg Barclays Global Aggregate Index** is a broad measure of global investment grade debt, and includes developed and emerging market issues. 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.

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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.

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