Phineus Long/Short Strategy

CALAMOS INVESTMENTS

Market Overview

Global equities enjoyed a positive but volatile quarter as investor sentiment was buffeted by a whirlwind of trade-related news centered on the worlds' two-largest economies. At the same time, the Federal Reserve produced a "dovish surprise," signaling its willingness to ease policy and cut rates under the alibi of trade uncertainty and underwhelming inflation. The S&P 500 Index rose 4.30% in the quarter, while the MSCI Europe and MSCI Asia Pacific Indices rose 2.70% and 0.15% respectively in U.S. dollar terms.

Trade conflict has been front and center. After hopes for "the deal of the century," China retreated from negotiations in May and Trump responded with more tariffs. China's hardened position echoed the widening awareness amongst its elites that this would not be a deal they could "sign and ignore." Given the issues at stake, we see a truce at best in what promises to be a long and drawn out affair. The mechanisms regarding how to monitor and enforce China's compliance are almost unresolvable, as is overseeing the longer-term competition across key technological industries.

The motive for some sort of deal is that neither side desires escalation to a more strategic and costly confrontation that inflicts damage to their own interests. In Osaka, Trump and Xi achieved a face-saving compromise that both could sell to their domestic audiences, agreeing to postpone any further disputes. For Trump, tariff uncertainty is his best guarantee that the Fed will deliver on lower interest rates. China's purpose is to gain time through conciliation. More broadly, trade conflict is no longer a purely Trump-Xi matter. Reflecting trade imbalances and income inequality at home, the U.S. is no longer willing to absorb excess savings and insufficient demand abroad.

The old theme of "global growth led by China" was inextricably linked to the Pacific supply chains which are being unwound. Huawei is the poster child of China's problems in the tech sector. Direct investment flows and corporate announcements imply China's technological development and supply industries have started to suffer. At the same time, China's debt cycle is extreme and trade confrontation is limiting its options for managing its debt and demographic challenges. Internally, President Xi has been weakened by his failure to manage the trade talks, which may explain why economic reforms have stalled. Time will play to the U.S. advantage.

Trade politics are reinforcing the enduring recession across the global producer industries of manufacturing and commodities. These are areas we continue to avoid and trade and export data in the quarter emphasized the "recession-like" climate. We have long argued that economists have been too quick to ignore the costs of global integration, both social and economic. The uneven distributional effects of globalization across the Western world is leading to a fragmentation of the international order into competing

FIGURE 1. PHINEUS LONG/SHORT STRATEGY RETURNS

	QTR ENDING 6/30/19	1-YEAR	3-YEAR	5-YEAR	10-YEAR	SINCE INCEPTION (6/1/02)
Phineus Long/Short Composite						
Gross of Fees	2.57%	1.01%	11.09%	7.70%	9.93%	12.78%
Net of Fees	2.25	-0.24	9.73	6.27	8.39	11.17
MSCI World Index	4.20	6.94	12.39	7.20	11.33	7.53
S&P 500 Index	4.30	10.42	14.19	10.71	14.70	8.29
HFRI Equity Hedge (Total) Index	1.72	0.44	6.83	3.46	5.39	5.02

Source: Calamos Advisors LLC
Past performance is no guarantee of future results.
Data as of 6/30/19.

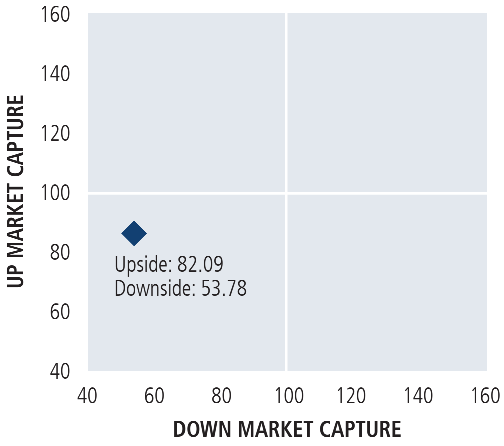
Phineus Long/Short Strategy

FIGURE 2. SINCE INCEPTION RISK/REWARD CHARACTERISTICS

	CALAMOS PHINEUS LONG/SHORT COMPOSITE	MSCI WORLD INDEX
Annualized Alpha	7.78%	N/A
Beta	0.69	1.00
Standard Deviation	16.21%	14.93%
Information Ratio	0.40	N/A
Sharpe Ratio	0.71	0.42
Sortino Ratio	1.32	0.59
Upside Semivariance	16.91%	9.98%
Downside Semivariance	6.13%	9.00%

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 6/30/19.

economic, financial and technological regimes. Donald Trump is a symptom rather than a cause.

The other flash point in the quarter has been the capitulation by the Federal Reserve, signaling that its prior framework to normalize interest rates is dead. Trump has provided Chairman Powell with a masterclass in political manipulation: engineering his capitulation as prelude to a resumption of trade negotiations. This shift at the Fed is more remarkable given the absence of stress in corporate credit, the resilience of U.S. employment and rising budget deficits. There is no longer any pretense of moral hazard across the central bank community. The Fed has the back of investors.

One dilemma at the Fed is highlighted by the contrast between the prolonged weakening across the global producer industries versus the relative health and resilience of the Western consumer and the U.S. consumer in particular. The absence of pressure upon household finances and consumer confidence is why we think U.S. recession is avoidable. In any case, some stress in corporate credit must be prelude to transform the "soft landing" into an authentic U.S. recession. The latter is probably beyond the Presidential election in 2020, and not in the next 12 months.

We expect 50 bps of rate cuts through the summer as the Fed implements some insurance for the expansion. It is highly unusual for the fed funds rate (2.5%) to be above the U.S. 2-year Treasury yield (~1.85%) for any extended period. Financial conditions would almost certainly tighten if the Fed proves reluctant to act. The harder question is whether Fed action marks the pricing climax of the highest quality, most-secure financial assets, beginning with longer-dated Treasures. If not, and bond yields extend their decline into autumn, recession anxiety will almost certainly overwhelm the effects of central bank subsidization.

In our view, the Fed tightening cycle of 2016 through 2018 has sowed the seeds of a meaningful slowdown. The mid-cycle pauses of 2012 and 2016 were not preceded by a Fed tightening cycle and, thus, the risks today seem greater. Neither of those prior slowdowns were preceded by today's yield curve inversion. Slowing nominal GDP into early 2020 is the headwind for the earnings outlook. While U.S. GDP for Q2 was better than feared – 2.1% versus the 1.8% forecast – the internals were highly skewed. Excluding government spending at a 5% pace, private sector GDP in Q2 ran just 1.3%.

On a positive note, data relating to the U.S. consumer has pointed to resiliency. Personal consumption advanced an impressive 4.3% in Q2. Some of this was boosted by rising borrowing and a material decline in savings, so the swing variable will be sustainability of income growth. As layoffs gradually mount, the Goldilocks

 All portfolio positioning and sector information is for a representative portfolio. Please see the last page for additional information.

Phineus Long/Short Strategy

FIGURE 4. SECTOR WEIGHTINGS (%)

	LONG	SHORT	GROSS	NET	MSCI WORLD INDEX
Communication Services	11.9	0.0	11.9	11.9	8.3
Consumer Discretionary	7.7	-0.7	8.4	7.0	10.5
Consumer Staples	2.4	0.0	2.4	2.4	8.5
Energy	2.2	0.0	2.2	2.2	5.7
Financials	27.8	-1.4	29.2	26.4	15.8
Health Care	15.4	0.0	15.4	15.4	12.6
Industrials	17.8	-4.5	22.3	13.3	11.2
Information Technology	5.6	0.0	5.6	5.6	16.3
Materials	2.0	0.0	2.0	2.0	4.6
Real Estate	0.0	0.0	0.0	0.0	3.2
Utilities	0.0	0.0	0.0	0.0	3.3
Other	4.1	-83.8	87.8	-79.7	0.0
TOTAL	**96.9**	**-90.3**	**187.3**	**6.6**	**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 6/30/19.

thesis could become "a little too cold." Since 2018, business investment has weakened and the debate is how this filters into hiring. We have seen pockets of consumption weakness in declining retail auto sales, building materials, hotel occupancy and even Netflix's subscriber base.

The earnings environment has deteriorated through the first half of 2019. Earnings revisions in January were the worst of the current cycle, and corporate reports in April revealed Q1 profit growth as flattish (+0.3%). The consensus for Q2 imply a similar outcome, although breadth is worse with 8 of 11 sectors seeing negative growth. Analysts are calling for a modest decline in Q2 earnings on revenue growth of 3.8%. To some extent, the roll-off effect of the corporate tax cut has complicated comparisons. Forward EBIT has decelerated to year-over-year growth of less than 1%.

Optimistically, the trough of this earnings deceleration could occur in Q3, yet any H2 rebound will be constrained and less than the consensus is anticipated. If economic data remains sluggish, consensus S&P500 estimates are materially too high for both the second half of 2019 and probably 2020. While investors look to Fed easing as a reason to ignore the deterioration in corporate fundamentals, history implies that "insurance cuts" only pay out for investors if they translate into sustainability of the earnings cycle.

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. In contrast, we believe the V-shaped recovery in equities in H1 must confront an L-shaped pattern in earnings for the remainder of 2019. While sentiment around U.S. economic activity could stabilize, we are wary of dismissing the downside risks. The unambiguous message of yield curve inversion is that policy settings have been too tight.

This leads to the conclusion that financial markets have reached the frontier between global slowdown on the one hand and a recession in the West on the other. Enthusiasm for rate cuts by the Fed is understandable—it allows the optimistic to assume that global slowdown has been discounted and will prove limited in duration. We are less convinced, but acknowledge that some sort of "soft landing" is likely. In our view, the market's performance in H1 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.

Positioning and Portfolio Changes

While the S&P500 is flirting with new highs for the third time in the past 18 months, sector and style leadership has been decidedly defensive, with bond proxies and high-quality stocks disproportionately contributing to benchmark performance. This is consistent with our thesis of rising economic vulnerability and broadening disappointments in capital spending and business surveys.

While the Fed's pivot is insurance against the more deleterious risks, the economic slowdown is still underestimated by investors and will be more apparent in corporate releases into early 2020. This interpretation has biased our long selections toward more resilient areas of the equity world. At the margin, it has implied more U.S. versus non-U.S. equities. It supports our bias toward the Western consumer rather than the global producer industries. It supports our bias in favor of quality rather than high beta or high cyclicality.

Quality is generally defined as companies with a higher return on capital, lower leverage and lower earnings variability. Today's setting has favored defensive stocks and secular growers that exhibit higher quality characteristics. The conundrum is that these sectors have outperformed markedly over the past year and investors have embraced a more cautious outlook; positioning in defensives is crowded and momentum is elevated. In addition, some of the leadership will fail if the U.S. economy slips into recession.

To reflect the macro uncertainties as well as the risk of overcrowded positioning, our company positioning is balanced across style and sector factors. Similarly, the portfolio's long and short exposures have been roughly balanced, which is consistent with our view that equities are "going nowhere" amid rising fundamental vulnerabilities. Positioning shifts in the past quarter have occurred primarily at the sector and stock level.

In financials, we cut more internationally exposed names and added a partial sector-wide hedge. Having tempered our long exposure, we view financials as a good contrary exposure to the possibility that bond prices will climax through the summer. We have added marginally to higher quality growth areas such as payment service providers like FIS (1.4%).* The group's beta suggests that it is susceptible to the perception of "late-cycle," but we believe that valuations are compelling and fundamentals solid. Core longs here include JPMorgan (4.1%), Bank of America (3.6%) and Morgan Stanley (4.4%).

In Technology, we are concerned about valuations, crowded positioning and the reality that many of these names are still cyclical and thus, less defensive than assumed. According to data that we monitor, investor positioning in software is near decade highs, while many names are trading at valuations not seen since the 1990s. The extraordinary leadership of tech-related profitability is climaxing, which implies weaker tech capex in coming years. We prefer communication services such as Facebook (4.7%) and Alphabet (4.0%) partly because they are less exposed to trade or the semi cycle; and partly because they sell into markets (via advertising) more dependent upon the health of the consumer rather than corporate capex. The portfolio closed its short position in semiconductors in early May and added a long position.

The portfolio added selectively to health care through several existing positions such as Humana (2.4%),* Pfizer (2.1%)* and Medtronic (2.3%).* Apart from Pfizer we prefer diversified companies such as Johnson & Johnson (2.0%)*and health services companies like LabCorp (3.5%)* to traditional pharmaceuticals. One exception is Alexion (2.5%)* in biotech which will be better insulated from political pressures as an orphan drug maker. We view health care overall as defensive rather than a genuine growth area. 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 remain highly selective in other defensive sectors such as consumer staples, where valuations are high relative to their earnings prospects and our lone holding is Walmart (2.2%),* a core holding that benefits from the resilience of the Western consumer; Walmart is levering its SG&A investments and delivering EBIT growth for the first time in years. We hold McDonald's (2.7%)* for similar reasons, which is delivering strong sales comparisons as its productivity investments show results; we expect the company to enjoy considerable EBIT margin expansion over the next two years. We have no direct exposure in other defensive sectors including utilities and real estate.

In consumer discretionary we are focused on names that are more defensive or in the early-to-middle innings of turnarounds such as Lowes (1.3%)* and MGM Resorts (1.9%).* We are avoiding the automakers on the view that auto sales face numerous structural headwinds. Early in the quarter, the portfolio added Disney (2.0%),* which is transforming its business to a direct-to-consumer subscription model; this implies a larger proportion of its earnings profile can be directly controlled rather than dependent on the renewal of multi-year agreements.

Industrials was a significant source of alpha again in Q2, led by L3Harris (2.4%)* as well as Delta Airlines (3.2%) and Air Lease (1.2%).* We emphasize businesses less exposed to the very different economic landscape abroad. We still like Raytheon (2.9%),* which has large exposure to key growth areas in the defense space and the industrial-like tech company First Solar (2.6%);* the latter continues to benefit from trade policy and has good visibility due to a multi-year order backlog. The portfolio has tactically adjusted its exposure to airlines, where we saw an opportunity to add to United Continental (3.3%) after its relative underperformance.

Given the lateness of the U.S. expansion and the varied headwinds overseas, we are maintaining a sector hedge on a portion of our industrials exposure. In materials our focus has been on industrial gas names such as Air Products (2.0%),* which are rerating higher given their defensive characteristics and improved pricing as a result of consolidation. In Energy we remain underweight with a preference for the major integrated producers like Exxon (2.0%).* We continually review the energy space for opportunities, but have hesitated to act so far.

The reappraisal of the outlook for USD interest rates is usually the signal to upgrade EM risk assets. Yet, MSCI Asia Pacific underperformed again in Q2. This confirms 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 the entrenched political risk into their long-term expectations for GDP and earnings growth across much of the EM world. We continue to avoid the region.

What is there left to say about Europe? 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. That said, we are intrigued by the possibility of "hard Brexit" in late October, which could create a long-term opportunity for Sterling-based assets. Conceptually, releasing the UK economy from the anti-growth political structure of the European Union could be a major turning point.

Outlook

What explains the extraordinary recovery in U.S. equities through the first half of 2019? This reversal of fortune is more striking in the context of rising economic and earnings vulnerability. Naturally, we should ask whether these gains foreshadow a global economic upturn and the sustained revival of risk assets. Our interpretation is more nuanced.

The End of Central Bank Supremacy

The Fed's comprehensive capitulation has been the dominant feature of 2019. The Federal Reserve remains the single greatest influence upon the value of global financial assets. Anticipation of Fed easing combined with the collapse of bond yields have been interpreted as the triumph of "QE Forever." Happily, investors have been trained to extrapolate what has been the defining feature of the post-2008 era. And yet, we are witnessing the beginning of the end of central bank supremacy.

In 2018, we learned that the withdrawal of the monetary drugs is starkly difficult because prolonged application of capital subsidies creates dependencies. Today, the Federal Reserve is doubling down on a policy mode that is visibly failing in Europe and Japan. Within the institution itself, the FOMC members are divided and without intellectual conviction, dictated to by financial markets and easy prey to political manipulation.

The implication is that the Federal Reserve has lost an aspect of its independence. There is a difference between the Fed working through markets versus following markets. Conventional wisdom is that the Fed can manage financial markets and even has 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.

Of course, central banks can suppress financial volatility and support liquidity, which has been the leading theme in 2019. But there are still absolute anchors relating to rate levels, balance sheet structures and the productive allocation of capital. By "absolute," we refer to the reality that asset prices must eventually be supported by future economic and earnings returns. Asset prices that rise solely as the consequence of lower discount rates are stealing capital returns from the future.

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 the consequence of instability produced by different forms of asset price inflation.

The ascendancy of financial assets in 2019–2020 should not be confused with stability. Our decision to focus portfolio returns upon alpha, with negative or limited beta exposure, is consistent with this perspective.

QE Forever: Silver Bullet or Failing Ideology

The post-2008 bull market in equities was largely the derivative of the much larger and artificially derived bull market in fixed income. The leadership of the Fed and its unconventional policies played a decisive role in the cycle logic of the past decade. Ben Bernanke was bold, innovative and right: the U.S. system survived and prospered. At the end of this long and unusual paradigm, the major excesses are found predominantly in the fixed income rather than the equity world.

Investors have embraced this paradigm. With gathering signs of slowdown through 2019, the presumption is "QE Forever." For investors, the Fed's failure to complete its agenda of monetary normalization implies that the next recession will bring the resumption of quantitative easing (QE), with interest rates at the lower bound of modern financial history. This extrapolation is comforting because the initial post-2009 series of quantitative easing proved highly stimulative. Obviously, it has supported much higher equity prices, at least in the U.S.

And yet, QE has failed notably in parts of the Developed world. In Europe, for example, the destruction of its sovereign bond market as an investible asset will produce unintended economic and social consequences, most of which will prove damaging. Both Europe and Japan have enjoyed more QE than the U.S., yet there is little sign of equity leadership anywhere outside of the U.S. With Draghi's latest "do what it takes" narrative, the eurozone seems condemned to Japanese-style negative interest rates and financial repression.

U.S. equity leadership of the past decade was never just about QE. It was the Fed's unconventional policies combined with sustained corporate profitability that defined the remarkable superiority of U.S. equities. QE on its own is not the panacea – or worse, it can lead to the slow destruction of capital markets.

The initial years of QE were effective because they raised asset prices and added to future returns—better future economic and earnings outcomes. This form of easing is approaching its limits because rates can't be lowered much more and the stimulatory impact becomes elusive at the end of a long expansion. QE could still bolster asset prices as investors allocate the excess liquidity, but these are rising price gains that drive down future nominal and real returns for the investor.

In 2019, investors have responded happily to the collapse in bond yields because they are paying more attention to the price gains that result from falling interest rates than the future falling rates of return on capital. Our concern is that today's returns are future returns that have been pulled forward by the "present value" effect. Investors should be wary of extrapolating the past six months of equity gains.

This begs questions about the future of U.S. corporate profitability and the extent to which its long superiority versus the rest of the world is climaxing. In our view, the earning stall of 2019 will not be easily reversed. Most leading indicators suggest today's backdrop is different from prior mid-cycle slowdowns. Earnings estimates for H2 are generally too high and the ongoing deterioration in global PMIs suggest the macro environment has downside risks. While the distance between yield curve inversion and recession can be extended, perceptions of "end-cycle" will stay entrenched.

Beyond these late-cycle dynamics, the secular tailwinds for U.S. earnings look increasingly exhausted. U.S. corporate profitability is climaxing, slowly and unevenly as companies confront a world of less capital subsidization, higher labor costs, higher leverage and thus, higher credit expense, and a diminished contribution from globalization. About one half of the excess returns for U.S. equities over the past 20 years has been driven by margin expansion. By our calculation, the S&P500 would be 40% lower today in the absence of this rising share of GDP to capital.

End of an Era: 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 cresting now. The years 2018 to 2020 should be viewed as one phase of a more extended transition from the investment environment of capital subsidization.

Identifying and navigating this paradigm shift will be critical for our clients. One challenge is that this transition is unlikely to correspond to the

Phineus Long/Short Strategy

conventional perception of a bull or bear cycle. 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.

Since early 2018, we have viewed the S&P 500 Index as range bound. Following the volatility of last autumn, we outlined a strategic range between the December lows of 2400 and the former highs of 3000. This multi-year period of consolidation is a reflection of rising cyclical vulnerability and climaxing secular U.S. profitability. As the S&P500 challenges the top of that range (again), we do not see the fundamental setting that could support a sustained breakout.

Conclusion

The message of the past six months, as exhibited by the schizophrenic swing between recession fear and the optimism of new highs for the S&P500, is that the behavior of risk assets virtually defines financial conditions and confidence across the U.S. economy. 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. The Fed has ensured that the correction in equities is more complex and extended than would otherwise be the case

Our assumption is that global growth will remain sluggish through this year and into 2020, but avoid any traumatic debacle. This is okay news for parts of the equity landscape that are priced for mediocre growth, but creates challenges for components that are priced for superior profitability. U.S. earnings are unlikely to grow in 2019, which implies investors are sanguine relative to the downside risks. The challenge is not just the cyclical slowdown in global output, but the declining effectiveness of monetary stimulus. 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.

We are cautious about adding risk with U.S. markets back near all-time highs. We are obstinate in our defensive attitude toward equity risk and sector and style positioning. While Fed rate action is an incremental positive, it is unlikely to overcome what we have broadly defined as late-cycle vulnerabilities. We aim for healthy absolute returns in 2019 without forcing our clients to assume either the bullish or bearish side of these arguments.

Calamos Advisors LLC
2020 Calamos Court
Naperville, IL 60563-2787
Attn: Compliance Officer

CALAMOS® INVESTMENTS

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

Calamos Investments LLP
62 Threadneedle Street | London, EC2R 8HP, UK
Tel: +44 (0)20 3744 7010 | www.calamos.com

8517 0619Q II