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Climbing the Wall of Worry October 2012

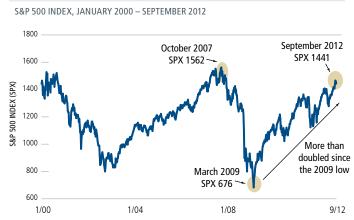
BY JOHN P. CALAMOS, SR. CEO AND GLOBAL CO-CIO

As the adage goes, "every bull market has to climb a wall of worry." In the third quarter, investors were in a bullish frame of mind, despite uncertainties related to global monetary and government policies. The S&P 500 Index reached highs not seen since October of 2007 (Figure 1), as investors responded favorably to good corporate earnings, better housing data in the U.S., the announcement of QE3 and the European Central Bank's (ECB's) unlimited debt buy-back program.

Within the S&P 500 Index, all sectors except utilities advanced. In sharp contrast to the first and second

quarters of 2012, "risk-on, risk-off" trends were muted, with no pronounced disparities between reflation and defensive sectors (Figure 2). The equity rally was broadbased geographically as well (Figure 3, page 3). Although concerns about the Chinese economy mounted, emerging markets on the whole demonstrated resiliency and performed well. European equities also advanced, as ECB commitments appear to have mitigated the tail risks of a near-term euro zone debt default. Meanwhile, within the credit markets, government securities were lackluster in a global low rate environment. As investors sought yield, high-yield bonds held up far better.

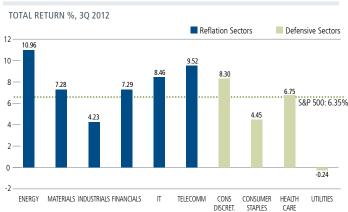
FIGURE 1. EQUITY MARKET BOUNCING OFF NEW POST-RECESSION HIGHS



Past performance is no guarantee of future results.

Source: Bloomberg. The S&P 500 Index is considered generally representative of the U.S. large-cap stock market.

FIGURE 2. SECTOR PERFORMANCE, S&P 500 INDEX



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

SUMMARY: GLOBAL OUTLOOK AND INVESTMENT OPPORTUNITIES

GLOBAL OUTLOOK

Financial markets will likely remain choppy due to elevated levels of global political uncertainty. The U.S. presidential election, the fiscal cliff and tension in the euro zone should contribute to vacillations in financial markets.

The U.S. economy looks set to maintain a slow growth track. Even with recent gains, job levels remain discouraging; and government debt levels are troublingly high. Nonetheless, we are seeing more favorable indicators, including consumer resiliency, healthy corporate balance sheets and profits, and improvements in the auto industry. Signs of stabilization in the housing market are especially encouraging.

China and other emerging markets can continue to make significant contributions to global growth.

While not discounting the slowdown that has occurred thus far in China, growth is continuing at a respectable clip, in absolute terms and relative to other countries. The secular trends related to China and other emerging markets, such as the rise in consumer income and increased middle class consumption, can help emerging markets weather a period of slower growth.

The euro zone faces significant headwinds. ECB intervention quells many near-term solvency issues but the structural issues are more intractable. Volatility should remain high as the situation in Spain looks increasingly dire and as stronger euro members grow frustrated with paying for the debts of less solvent neighbors.

A stronger economic recovery will likely remain elusive without increased commitment to pro-growth policies and more appropriate levels of regulation. Despite massive liquidity injections, the velocity of money has collapsed, and the sensitivity of equities to Fed intervention has decreased. Facing a raft of regulations, banks are largely unwilling to lend to small businesses—the engine of economic growth. Meanwhile, instead of hiring and making capital expenditures, corporations are sitting on large piles of cash as they wait for clarity on regulations and taxes.

INVESTMENT OPPORTUNITIES

Global secular themes provide growth opportunities. Secular themes can continue to provide a "wind in the sails" for companies around the world, even if economic growth slows globally. The most important of these trends relate to consumer strength in emerging markets, global demand for technology innovations, and infrastructure build out.

Overall, equities remain the most compelling asset class. Valuations remain attractive, especially those of growth-oriented equities. The spread between the average earnings yield of the companies in the S&P 500 Index and the 10-year U.S. Treasury further supports the case for equities. While interest rates are likely to remain low for the near term, inflation is still a risk—and one that equities can provide a hedge against.

Mid-grade corporate issues maintain their appeal. In a low-rate environment, opportunities in the government bond market have greatly diminished, but the most speculative credits may not offer appropriate compensation for their attendant risks. For income-oriented investors, mid-grade corporate credits may provide attractive risk/reward characteristics.

Bull markets do not announce themselves, and market turns can only be seen clearly in hindsight. This is an environment that requires patience and long-term, global perspective. An understanding of the cointegration of global economies is essential, as is active fundamental research.

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Outlook

In the months ahead, we believe that elevated levels of political uncertainty globally will cause high levels of market volatility around the world. Aggressive intervention by central banks has boosted the markets, but as we will discuss at greater length, it is still too soon to know how sustainable that boost will be. The markets may have already priced in much of the easing already.

Overall, we believe the U.S. economy is positioned to continue on its slow growth track. Even with

recent positive reports, unemployment levels remain discouraging, as do high levels of government debt. However, businesses have improved their balance sheets and have plenty of cash on hand. Corporate profits have remained intact. Manufacturing data has been mixed, but the comprehensive ISM Index has most recently moved in an encouraging direction (Figure 4). The auto industry has demonstrated notable strides.

Perhaps more significantly, consumers have proven relatively resilient as home prices have risen and the

FIGURE 3. RISK ASSETS ADVANCE



Past performance is no guarantee of future results.

Source: Lipper, Inc., Mellon Analytical Solutions, LLC, JP Morgan. The MSCI World Index is a market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America, Europe and Asia Pacific regions. The MSCI Emerging Markets Index is a free float adjusted market capitalization index cited as a measure of the performance of emerging market equities. MSCI Europe Index is a market capitalization weighted index composed of companies representative of the market structure of Europe. The Credit Suisse High Yield Index is considered generally representative of the U.S. high yield market.

FIGURE 4. OVERALL IMPROVEMENTS IN U.S. MANUFACTURING



Source: Federal Reserve Bank of St. Louis. ISM Manufacturing Index tracks manufacturing in the U.S. economy. A value above 50 suggests expansion within the manufacturing economy.

FIGURE 5. U.S. HOUSEHOLDS CONTINUE DELEVERAGING

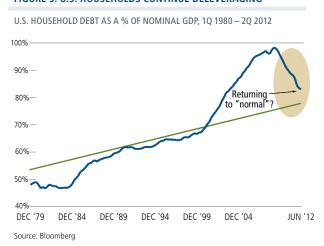
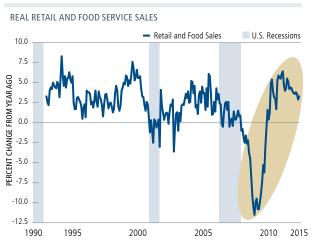


FIGURE 6. U.S. CONSUMER SPENDING HAS INCREASED



Source: Federal Reserve Bank of St. Louis

S&P 500 Index has gained 30%. We've seen ongoing progress in consumer household deleveraging as well as increases in consumer confidence and spending (Figures 5 and 6).

Indeed, signs of a more broad-based recovery in the housing market are especially welcomed news (Figure 7). Rising home prices are an integral component of the wealth effect, and in turn, a catalyst for increased consumer confidence and spending. Longer-term, a recovery in the housing market should also help replace jobs that were lost when the sector imploded.

FIGURE 7. HOUSING MARKET ON THE UPSWING



FIGURE 8. MANUFACTURING SLOWDOWN IN CHINA



China: Will Trains, Planes and Automobiles Be Enough?

Concerns about China's ability to drive global economic growth are intensifying as PMI data has touched levels indicative of economic contraction (Figure 8). The country has seen seven consecutive quarters of declining gross domestic product growth. A year ago, the government's focus was on containing inflation, even at the cost of curtailing GDP growth. While China has shifted from a tightening mode to an accommodative stance over the past year, the concern is that the government may have waited too long, underestimating the impact of a significant slowdown in export demand from the euro zone, which represents nearly one-fifth of China's export market.

Certainly, this data demands attention. However, we should not overlook the broader and longer-term economic trends. Although economic expansion has slowed, the growth prospects of the Chinese economy remain compelling on an absolute basis and the more so on a relative basis, with gross domestic product growth still projected to exceed 7%. The government has announced a massive infrastructure build-out, including subway systems, waterways, highways, ports, airplanes, and power plants. The impacts of China's more accommodative stance will take time to ripple through the Chinese and global economies.

I recently came across a commentary I wrote in December 1992, "After the Election: Where to From Here?" This commentary included the passage:

The concept of supply-side economics, which spurred the record U.S. job creation during the 1980s, is now being adopted in countries all over the world, among them Chile, Mexico, Malaysia, Taiwan, Korea and even China, among others. These nations view supply-side economics as a means to create a strong middle class and raise the overall standard of living. ... Given this worldwide trend, the investment opportunities are as great now as for any time in history. And when one considers the pent-up demand created as emerging nations grow and prosper, the opportunities are exciting as well.

These were fledgling trends in 1992, and since then, China and other emerging markets have come tremendously far. Barring extraordinary geopolitical events or extreme social unrest, this secular progress and momentum should be able to withstand ebbs and flows, as we have seen in the U.S. economy throughout its history.

The average household income in China has soared by more than 300% over the past 10 years,* and the wealth effect among Chinese consumers is growing in strength. According to a McKinsey & Company study published in October 2011, well over half of surveyed Chinese consumers anticipated a rise in income during 2011, a marked upswing from 39% in 2010 (Figure 9). About one-third reported upgrading to more expensive products, while 60% said they were buying more or more frequently. We believe this rising confidence and spending, on such a massive scale, can provide tremendous growth opportunities to companies worldwide (Figure 9), while also helping to reshape the Chinese economy.

The growing role of the consumer in China requires that we re-evaluate the relative importance we assign to manufacturing sectors versus consumer sectors. Many look at China as an industrial powerhouse, and as such, heavily weight industrial data in their assessment of the health of the Chinese economy. However, as the Chinese consumer attains greater wealth and access to services (such as education and health care), we expect data from

consumer sectors to be increasingly telling measures of the Chinese economy.

A Long Road Ahead for the Euro Zone

As we noted, the ECB's pledge to support troubled euro zone countries has alleviated many near-term solvency concerns. However, the structural problems have not gone away. Debt levels are stratospheric in too many countries. The ECB has taken on a massive amount of assets relative to GDP, outpacing the Fed by a wide margin (Figure 10). Unwinding this level of intervention could be an extremely complex undertaking. While consumer confidence is

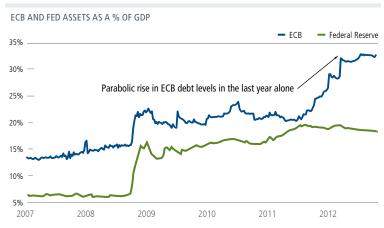
FIGURE 9. CHINA'S CONSUMERS: A DRIVING FORCE FOR ECONOMIC GROWTH

% OF RESPONDENTS EXPECTING THEIR HOUSEHOLD INCOME TO INCREASE IN THE COMING YEAR



Source: McKinsey & Company, McKinsey Consumer & Shopper Insights, "2011 Annual Chinese Consumer Study: The New Frontiers of Growth," by Yuval Atsmon, Max Magni, Molly Liu, Lihua Li, October 2011, using data from McKinsey Insights China - Annual Chinese Consumer Studies (2009-2011); Online Benchmark Survey (2011)

FIGURE 10. ECB BALANCE SHEET REVEALS DEPTH OF EURO ZONE DEBT CRISIS



Source: CLSA Asia Pacific Markets, "Greed and Fear," Christopher Wood, April 27, 2012.

^{*}Financial Times, "Chinese appear content with their lot despite slower growth," Simon Rabinovitch.

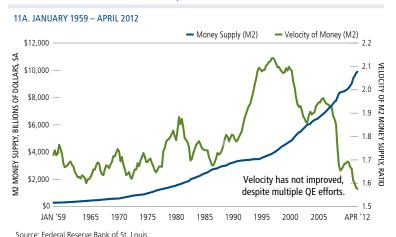
rising rapidly in China and has been resilient in the U.S., consumers in countries such as the U.K. and France are pessimistic about their prospects (Figure 9).

Money is not getting where it needs to go to stimulate economic growth and wealth creation. Instead, cash is on the sidelines.

With painful—and violently protested—austerity plans in debt-burdened nations, the euro zone will remain politically volatile, particularly as frustrations mount in stronger countries about footing the bill for what some view as indiscriminant spending. Greece has been the focal point of the debt crisis, but relatively speaking, could be a fly in the ointment compared with Spain, the fourth largest economy in the euro zone. The ECB can't control these political crosscurrents; these are issues that will also work through the ballot boxes across the euro zone, for years to come.

Given this backdrop, we cannot entirely rule out the possibility that the composition of the euro zone changes.

FIGURE 11. SOARING MONEY SUPPLY, PLUMMETING VELOCITY



In a global environment of muted growth, the fall-out could be devastating for Europe (one of the lessons learned from the Lehman crisis). The U.S. and Asia would be a step removed, but the impact would be far from inconsequential.

Quantitative Easing: The Right Medicine?

While the markets rallied in the wake of the QE3 announcement, we remain cautious about the implications of massive, extended quantitative easing. QE is focused on the symptoms, but has fallen short of being a cure. Many of the theoretical impacts of quantitative easing have been elusive. In the U.S., job growth continues to be lackluster when weighed against the scope of QE efforts undertaken. Smaller businesses face persistent hurdles as banks keep the purse strings tight. Large companies have benefited from low rates and have accumulated capital, but they are not spending it. Mortgage rates are low but out of reach for many consumers.

Figure 11 illustrates a root cause of the problem. While money supply has soared, the velocity of money has not. The monetarist equation developed by Irving Fischer states that MV = PQ, where M represents the nominal quantity of money; V represents the velocity of money; P represents the price level for financial assets, real estate, commodities and product pricing; and Q represents the amount of all transactions. The Fed is pumping M into the system to increase P and Q. However, the Fed can't control V on its own. With no V, the M gathers dust, which is what we see today. Money is not getting where it needs to go to stimulate economic growth and wealth creation. Instead, cash is on the sidelines—in banks' coffers and on large corporations' balance sheets, not in circulation.

With so much M in the system, there can also be dangers when money does start to move. Massive liquidity injections can fuel inflation—that is, a rise in P. Notably, inflationary pressures moved upward on the heels of the QE3 announcement. Despite the Fed's commitment to keeping interest rates low through 2015, and the general consensus is inflation will remain contained near-term, we believe that the risk is still out there. With such massive infusions of cash globally, the Fed and the ECB are in uncharted waters, and it may be difficult to unwind this level of monetary stimulus.

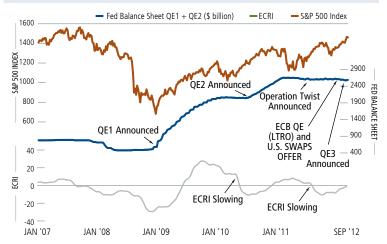
Moreover, inflation risk is not solely correlated to monetary policy. For example, a rise in commodity prices could also fuel inflation. This is not a near-term concern, but given a highly charged geopolitical landscape, this could happen even if global demand remains more measured.

The Fed's bond-buying spree and commitment to keeping interest rates low through 2015 is a strategy to incent investors to move into riskier assets. However, multiple rounds of easing have not resulted in meaningful wealth creation, and market participants no longer view quantitative easing as a panacea. Figure 12 shows that the impact of quantitative easing on the equity markets has lessened, in terms of both duration and magnitude.

Red Carpet, Not Red Tape

How do we stimulate V in a way that leads to the right balance of P and Q? In large measure, quantitative easing is coming up short because of political uncertainties, burdensome regulations and disincentives for taking capital risks. Job growth comes from small businesses. But banks are not lending to small businesses because of regulation concerns. Heavy regulation discourages small

FIGURE 12. EQUITY MARKET SENSITIVITY TO FED INTERVENTION



Past performance is no guarantee of future results.

Source: Bloomberg, ECRI. The ECRI Weekly Leading Index is a measure of leading economic indicators.

business development, while increasing government expenses. Without clarity about the election, taxes and the fiscal cliff, large U.S. companies are choosing to sit on cash rather than spend, hire and grow.

Investors need to understand the impact of co-integration of all economies.

For us, the incomplete results of quantitative easing again underscore the need for more reasonable levels of government involvement in the economy and businesses. In today's global economy, aggressive intervention has not led to commensurate gains in jobs or personal income. Instead, sustained global growth requires a greater commitment to pro-business policies and less government intervention.

I recently travelled to Greece as a member of the Hellenic Initiative, a group of Greek American businesspeople formed to provide economic counsel to the Greek government. I returned from the trip encouraged about what I heard. Prime Minister Antonis Samaras recognized the need for Greece to "switch from being a country of red tape to one of a red carpet for investors." This is the mindset needed for economic growth—not only in Greece, but in the U.S. and throughout Europe. A strong private sector can set the stage for better wages, increased tax revenues and national prosperity. Rising government debt without rising personal income is a roadmap to economic stagnation.

When governments have allowed their borrowing to spiral out of control, inflating out of debt may be the

most expedient course. There's less risk to the status quo, and less immediate-term pain. However, as we have observed in the past, easing (ultimately currency debasement) is not a lasting solution. Equity markets can usually hold their own with inflation in the three to four percent range, as modest inflation can often support pricing power and earnings growth. However, if inflation moves higher, it can be a highly detrimental game changer. Market participants become more concerned about rising interest rates, which can result in earnings multiple compression.

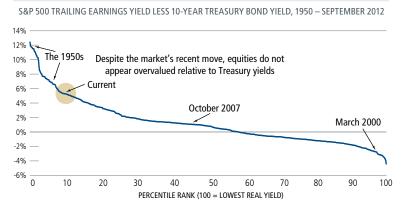
FIGURE 13. MARKET HIGHS AND P/E LOWS



Past performance is no guarantee of future results.

Source: Bloombera

FIGURE 14. EQUITY VALUATIONS: ATTRACTIVE VERSUS TREASURY YIELDS



Past performance is no guarantee of future results.

Source: Robert Shiller, Standard & Poor's, Corporate Reports, Empirical Research Partners Analysis. Capitalization-weighted data. Trailing earnings yield less 10-year Treasury yields.

Investment Opportunities in the Global Economy

The good news is that globalization is a long-term investment theme. The bad news is that what happens in Europe, China and the U.S. affects all investors. Investors need to understand the impact of co-integration of all economies. These evolving relationships are one area that our Investment Committee monitors with particular care to ensure that we are not assuming unintended risks.

Broadly, we feel the opportunities are most attractive for multinational companies, with geographically diversified revenue sources. We continue to believe that the sources of a company's revenues are far more important than where the company is headquartered. We are emphasizing companies that are participating in secular growth themes, particularly those related to the prosperity of emerging market consumers and continued demand for technology innovations. We also see opportunities in select commodity-oriented companies, which can be beneficiaries of global infrastructure build-out and also provide a hedge against inflation.

The Equity Markets. On an asset class level, our most constructive outlook is for equities. The earnings of many corporations have risen, but these increases are not reflected in prices. For the S&P 500 Index, price-to-earnings ratios have come down and are compelling versus historical levels (Figure 13).

Figure 14 further supports the case for equities versus government bonds. Currently, the average earnings yield of the companies in the S&P 500 Index is about 500 basis points above the 10-year U.S. Treasury yield. This spread ranks in the top tenth percentile over 60 years, and is more attractive than at other past market highs, such as October 2007 and March 2000. By this measure, the equity markets do not look to be overvalued. Additionally, as we noted, there is a great deal of money sitting on the sidelines—money that we believe could move into motion quickly and help sustain an equity rally.

We believe that growth equities may be particularly well positioned. Typically, coming out of a recession, market participants remain fearful and short-term in their perspective, unable to look beyond the next quarter's earnings. Growth equities are often overlooked. But, historically, when markets have rallied rapidly, growth equities have often come back with particular strength.

The Fixed Income Markets. We believe that investors must approach the fixed income markets with a high degree of caution. In a low-rate environment where aggressive easing has become the global norm, the opportunities in the government bond market have rapidly dwindled. While the equity markets appear to us to have priced in rising interest rates, even a modest upward rate fluctuation could exact a heavy toll on government bonds.

However, we have found opportunities, primarily in the mid-grade tiers of the corporate bond market where we believe durations and yields to maturity are reasonable and can offset a potential increase in interest rates. This area of the fixed income market may be particularly compelling for the more conservative investor who seeks income potential but does not want to reach too far down the credit spectrum.

Conclusion

The global economy still faces headwinds, including many that are quite powerful. We expect that political volatility will remain a driving force in the global financial markets. The global economy may be in a period where economic cycles are far shorter than they were in the 1990s and 2000s, harkening back to the 1970s and 1980s. However, unlike the 1970s, we can now easily invest across global markets, capitalizing on an exponentially larger set of opportunities. As we noted, themes such as the rise of the emerging market middle class consumer, continued appetite for technology innovation and infrastructure build-out can provide a tailwind for select companies in periods of slower or uneven economic growth and choppy markets.

Vacillating markets can increase the temptation to market time, but we believe the futility—and dangers—of timing are as pronounced as ever. Timing increases the potential for being whipsawed by short-term volatility. Investors should be wary of making large, rapid-fire allocation shifts to try to capitalize on short-term bumps.

Instead, we believe investors should think globally and long-term. Many may wish to consider increasing allocations to risk assets, most notably equities, and not

discount the potential for an inflation surprise. As we noted, we believe that growth equities are especially undervalued as investors seem to be overlooking the longer-term merits of these companies.

Have we scaled the wall of worry, or will we look back at this rally as a false start? Bull markets don't announce themselves, and it is impossible to know if one has started until after the fact. So, this is a question that we won't pretend we can answer. But what we do know is this: We are in an environment that requires an active, disciplined approach, focused on individual company fundamentals and long-term global secular influences.

To quote again from our 1992 commentary,

While the election will presumably affect long-term trends, it hasn't changed our investment philosophy ... our view is that that successful investing is predicated on managing risk and adapting to change. The impact of government changes will not cause us to shift to cash, but to focus on newly created opportunities within [world economies].

Today, as then, we believe that these opportunities can serve as a compass for our long-term approach. We believe we are well equipped to adapt and change in response to the growth prospects we continue to see across the global economy.

ABOUT THE AUTHOR

John P. Calamos, Sr. is chairman, chief executive officer and global co-chief investment officer of the firm he founded in 1977, which he took public as Calamos Asset Management in 2004 (Nasdaq: CLMS). A recognized authority on convertible securities, he has pioneered investment strategies and techniques to help manage risk for major institutional and individual investors for more than 30 years.

Mr. Calamos received his undergraduate degree in Economics and M.B.A. in Finance from the Illinois Institute of Technology. He joined the United States Air Force after receiving his undergraduate degree, served as a combat pilot during the Vietnam War and ultimately earned the rank of Maior.

He has shared his expertise in two books, *Convertible Securities: The Latest Instruments, Portfolio Strategies, and Valuation Analysis* (McGraw-Hill, 1998) and *Investing in Convertible Securities: Your Complete Guide to the Risks and Rewards* (Longman Financial Services Publishing, 1988). He has also authored numerous articles in various financial journals and is a frequent guest on national financial networks including CNBC, Bloomberg TV and Fox Business Channel.

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