

Market Review and Outlook

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Although these recent months have been extremely difficult, we encourage investors to not give up on the longer-term opportunities that we believe exist in the global marketplace.

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Past performance is no guarantee of future results.

In the final weeks of the first quarter, the markets' broke out of their precipitous downward slide and gave way to a strong rebound. While welcomed, the magnitude and duration of the upswing remain the focus of much analysis—and much apprehension. Is this just a bear market rally or the start of a new bull market? Has the economy reached a stabilization point or are we many months away from a recovery?

We have seen positive signs over the past few months. In our view, the first quarter bounce in the equity markets now suggests that a recession is likely, not a depression. Credit markets, though strained, have begun functioning more normally. Corporate net debt levels are very reasonable. The move to ease mark-to-market accounting is another step in the right direction—though much more could be done on that front.

Other positive developments include:

- > Housing starts have shown indications of reaching a short-term bottom and mortgage applications have rebounded sharply (see Figure 1)
- > Low interest rates have stimulated mortgage refinancing and housing sales
- > The new issue debt markets are showing signs of life (see Figure 2)
- > Cyclical sectors are outperforming the more stable sectors in the equity markets, as the technology, financials and the cyclical/stable charts on pages 2 and 3 indicate (see Figures 3, 4, 5)
- > The manufacturing side of the economy is showing some recent strength, with three consecutive months of improvements (see Figure 6)
- > After collapsing in 2008, global trade has recently turned up (see Figure 7)

Overall, the Fed's short-term fix is taking hold and markets appear to be responding. The government stimulus package will also contribute to the rebound, even if the longer-term solution still avoids our grasp. Additionally, the Federal Reserve and Treasury Department have made it abundantly clear that they will continue to provide all the capital necessary to ensure a deflationary bust does not take hold. Record global fiscal stimulus has added to the "shock and awe" of the G20's response.

It appears that the financial crisis is on the mend and business activity is at least better than it was. Liquidity is improving and the banking industry is bottoming. Banks have shown an increased willingness to lend to each other, as indicated by a declining TED spread (see Figure 8). Credit is available, even if it is not growing at the rate that the political class wants. In general, then, the credit and banking system is functioning but not at the "normal" level that would indicate the crisis has passed. Unemployment and bankruptcy rates will likely continue to rise over the next 12 months, but it is important to remember that these have historically been lagging indicators.

Consumer balance sheets—better than many think?

Consumers have experienced a horrendous collapse in net worth, as the financial market and housing markets delivered a one-two punch. Yet, the consumer's balance sheet is not in as bad shape as the media would like us to believe. Certainly, consumers need to increase savings and reduce debt, but we believe the debt reduction can be easily managed with a few years of fiscal restraint. Consumer debt-to-income is about 130%, versus around 90% in the 1990s. However, most of the debt build is in mortgage debt and interest rates are lower now than in the 1990s, so the debt service has become more reasonable.

Average household net-worth-to-income has declined from over 620% to 460%. This is a devastating hit and savings will increase to fill this gap. The data suggests the average household has a debt-to-net-worth level of about 28%, which is not alarming at all. (Debt-to-income of 130% and net worth to income of 460% implies debt-to-net-worth of $130/460 = 28\%$.) This does not mean that some households are not struggling or have not overextended themselves, but it does suggest a more rational household debt level and the possibility that a debt bubble is not going to burst or is even present in most sectors of the economy. Finally, with the housing price collapse and the low mortgage rates, housing affordability is at the most attractive level in at least a generation.

Deciphering the warning signs. The stock market is generally recognized as a leading economic indicator. However, as we have noted in the past, the financial markets now also have the potential to cause a recession, not just warn us of the pending slowdown. This changed dynamic is due to the financial market's leverage and size. As we noted in our August 2007 commentary, "Re-Pricing Credit Risk":

The volatility in markets is a function of the leverage in the markets, the complexity of the derivative structures, and of who has the exposure. When you're leveraged six-to-one or seven-to-one, and the market moves against you, many options go out the door and survival mode sets in.

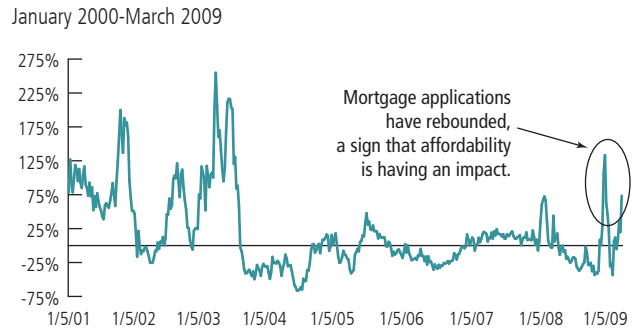
It is possible that the excess leverage in financial markets may have exaggerated the economic warning signs, resulting in a panic. Leverage exaggerates movements and may have created false signals for the markets about how bad bank and financial balance sheet deterioration actually will be.

Amid reasons for optimism, some cautionary notes.

Recent financial market performance may be implying that we will see positive GDP growth by the end of the year. However, it would be miraculous if we came this close to unwinding a debt bubble that took 25 years to build, stopped the implosion and were able to re-inflate the debt cycle again. We believe that the best-case scenario would be one of muted growth for the next five years or so, given that consumer balance sheet repair will probably take three to five years and the financial sector will be considerably smaller and less leveraged.

As we have outlined in the past, consumers save in relation to net worth. As net worth increases, savings decreases, and vice versa (see Figure 9). We believe consumer savings will

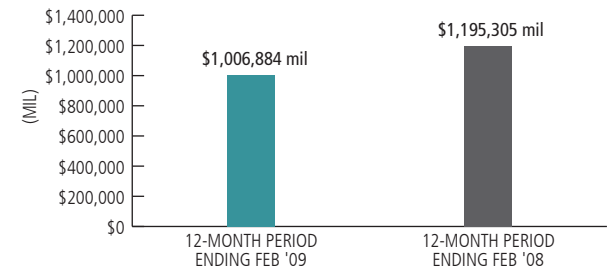
Figure 1. Mortgage Bankers Association Mortgage Applications Index (Year-Over-Year % Change)



Source: Bloomberg LP

Figure 2. U.S. Corporate Debt New Issue (\$ Value)

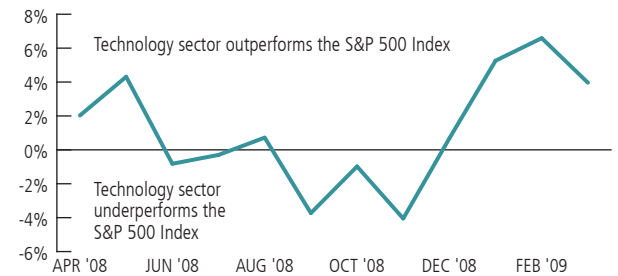
Year-over-year comparison.
New debt issue has fallen, year-over-year, but still remains respectable.



Source: Bloomberg LP

Figure 3. Technology Sector vs. the S&P 500 Index

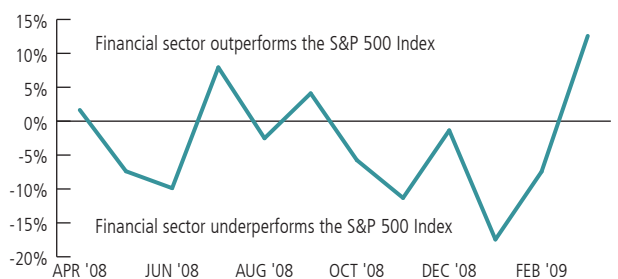
Monthly relative performance: April 2008-March 2009



Source: Factset. The technology sector is represented by technology stocks within the S&P 500 Index, which is considered to be representative of the U.S. stock market. Indexes are unmanaged, do not reflect fees, expenses or sales charges. It is not possible to invest directly in an index.

Figure 4. Financial Sector vs. the S&P 500 Index

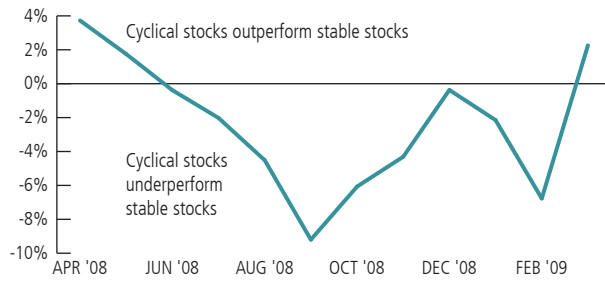
Monthly relative performance: April 2008-March 2009



Source: Factset. The financial sector is represented by financial stocks within the S&P 500 Index, which is considered to be representative of the U.S. stock market.

Figure 5. Cyclical vs. Stable Stocks

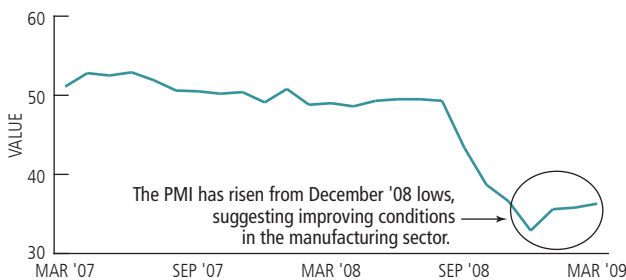
Monthly relative performance: April 2008-March 2009



Source: Factset. Stable stocks are measured by the S&P North American Consumer Index and cyclical stocks are measured by the S&P North American Cyclical Sector Index.

Figure 6. PMI Composite Index

March 2007-March 2009



Source: Bloomberg LP. The Institute of Supply Management's Purchasing Manager's Composite Index is an economic measure of the manufacturing sector that considers production level, new customer orders, supplier deliveries, inventories and employment.

Figure 7. Baltic Dry Index

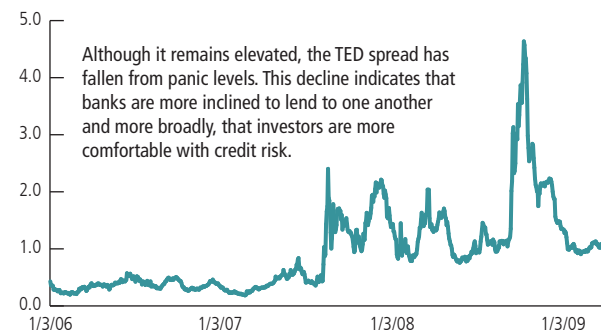
March 2006-March 2009



Source: Bloomberg. The Baltic Dry Index is a composite of the Baltic Capesize, Panamax, Handysize and Supermax indexes.

Figure 8. TED Spread

January 2006-March 2009



Source: Bloomberg LP. The TED spread measures the difference between the U.S. Treasury Bill rate and Libor.

likely move up to the 8 to 10% level, taking a big bite out of GDP. This, in turn, should result in reduced employment as businesses restructure to the lower level of sales.

The current drive to re-inflate the debt bubble through monetary and fiscal stimulus may stop the debt cycle from unwinding. But, this solution will likely result in higher inflation and higher interest rates in the future. This could result in another debt cycle collapse, and we may be back for round two. This may be the problem for another Congress and President, as we once again "kick the can" to the next administration, as we have done for decades with Social Security and Medicare.

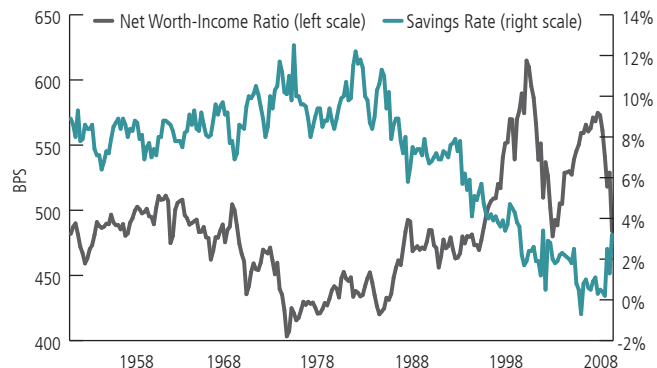
Additionally, even as we see signs of improved sentiment in the markets, participants by and large remain extremely short-term oriented—long-term secular themes and valuations continue to be ignored for near-term comfort and liquidity. Current equity valuations give companies virtually no credit for long-term sustainable cash flows. Bond prices indicate a very difficult economy going forward.

New realities for the financial services industry. Besieged on many fronts, the financial industry is in a depression that is dragging down the entire economy. We expect that the financial industry will shrink, and many jobs will be lost. This will have a large impact on the economy as unemployment increases in the service sector. On its own, the debt that financed the housing bubble would stretch the financial industry, but not break it. Unfortunately, the industry is also trying to come to grips with derivatives and credit swaps, and no one can be sure of the balance sheet impact these may have. To make matters worse, the commercial real estate market is now faltering and other consumer and business loan defaults are rising. Can the economy operate with a banking industry in shambles? Our view is that the financials will need many years to absorb the hit and that credit will not flow freely for the foreseeable future. Slow credit expansion, along with fiscally conservative consumers, will be an anchor on GDP growth for the next five years.

Figure 9. Personal Savings Rate and Ratio of Net Worth to Disposable Income

1951 Q4-2008 Q4

An inverse relationship exists between savings and net worth. In general, higher consumer net worth translates to a lower need for out-of-pocket savings, and vice versa.

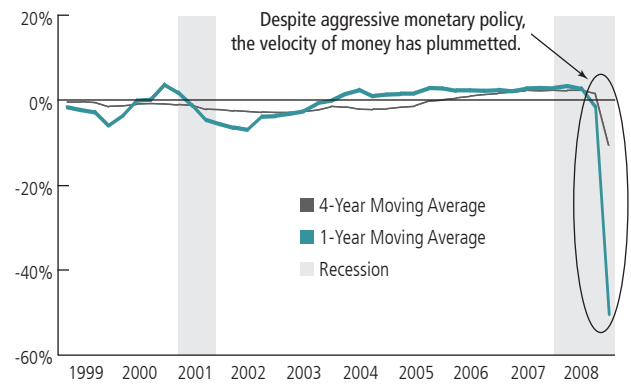


Sources: Personal savings and disposable income: Bureau of Economic Analysis (BEA); household net worth: Federal Reserve Board.

Lasting recovery requires revving the velocity of money.

Discussions of the current economic crisis often lead to comparisons with the Great Depression of the 1930s. The Depression was caused by excessive debt levels, and was made worse in some measure by restrictive monetary policy, trade policy, and restrictive fiscal policies. Today's "re-depression" is worse than a typical recession, but certainly not severe enough to qualify as a 1930s-type depression. The "re-depression" has been caused by excessive debt levels, excess leverage in the financial system and a collapse in the velocity of money. Therefore, a focus on stimulating velocity is essential to a successful recovery. The Fed has attempted to offset the collapse in velocity with incredible growth in its balance sheet and quantitative easing. As did the previous presidential administration, the current administration wants people to stimulate the velocity of money by returning to the spend-and-borrow ways of the past.

Figure 10. Monetary Base Velocity Growth



Source: Federal Reserve Bank of St. Louis, "Monetary Trends," April, 2009.

We believe that the market sell-off presents investors with exceptional long-term opportunities, with valuations near a generational low.

Since the velocity of money is driven by consumers' and businesses' willingness to transact, spenders must have the financial wherewithal to enter into transactions, confidence in the economy and their jobs/businesses, and also some incentive to part with their cash. Unfortunately, the current tide in Washington has been anti-business, pro-tax, and pro-regulation. There have also been counterproductive comments that smack of class warfare and a reneging on contracts. This is not a prescription for stimulating the "animal spirits" that encourage entrepreneurial risk taking. Yet, it is entrepreneurial spirit—not the spend-and-borrow syndrome—that offers the best prospects for creating lasting wealth and economic prosperity.

Changing Leadership, Long-Term Opportunities

Stock market corrections invariably result in market cleansing and new leadership. Although we cannot predict exactly when a lasting recovery will occur, we do believe that it will happen. As this crisis passes, asset values will rise, albeit with different winners and losers than in the past. Financials enjoyed incredible leadership in the bull market of 1982 through 2007. According to FactSet, the sector held a 17.6% weighting in the S&P 500 Index in December 2007, up from 7.5% in December 1990. Going forward, we expect that the financial sector will be a smaller portion of the economy than it was in the past decade.

We believe that the technology sector will again return to the leadership role that it lost a decade ago, carrying us forward in the new economy. Businesspeople will pay for

Regulation that supports not hinders, the markets

Much of the current economic problems can be traced to misguided policy and inappropriate regulation. For example, over recent years, many safeguards issued in the wake of the Great Depression were abandoned. The government repealed the uptick ban and rules separating investment banking and banking. Meanwhile, mark-to-market guidelines were re-instated, which added considerable fuel to the market sell-off. Regulations—or the lack thereof—favored some participants (for example, hedge funds) over others. Certainly, then, government plays a critical role in righting the economy's course and fostering future growth.

We believe that economic freedom leads to economic progress. Accordingly, government policy should encourage risk taking, investing and business, rather than penalizing these impulses through excessive taxation and regulation. We believe that several actions could go a long way to calm the markets and stabilize the economy. These include a repeal of mark-to-market regulations, and regulations that:

- > Re-institute the uptick rule
- > Require insurance-like reserve requirements for credit default swaps
- > Ensure that investment banks operate with bank leverage requirements
- > Provide increased oversight of hedge funds
- > Establish capital requirements for housing agencies (e.g., Fannie Mae and Freddie Mac) that are "logical" and in line with banks

productivity enhancements, and we are still in the early stages of this technology revolution. Innovation in biotechnology, nanotechnology, wireless technology, better energy sources and many presently unknown areas will provide the job creation and growth for the future.

When the global economies get back on track, we expect that businesses with a global reach and low cost production will prosper as the emerging economies continue to grow their middle classes. We have sought to participate in this long-term secular trend by investing in large-cap growth companies that offer excellent brand awareness and are positioned to benefit from pent-up demand in these markets. Today, many of these stocks are available at what we believe are great bargains.

We believe that large-cap growth should once again lead in the new bull market. We also expect to see agriculture and related areas do well as consumers around the globe increase consumption and commodity prices rebound. We are excited about some of the emerging economies that have kept their financial houses largely in order and should be in a strong position to prosper in the future. These include China, Brazil and Turkey.

Around the world, there are near-term infrastructure, energy and utility needs to be addressed. We are carefully evaluating companies positioned to benefit from this trend, as we expect them to be leaders in the next bull market.

Conclusion

Although these recent months have been extremely difficult, we encourage investors to not give up on the longer-term opportunities that we believe exist in the global marketplace. As we noted, the markets have historically been a leading indicator of economic recovery. Even if the March rally does not sustain itself, we believe that the markets will move forward before market participants are comfortable emotionally and before all the economic solutions are clear. Historically, bull markets have typically started when the news is just “less bad,” not when the news is all positive.

That said, we remain cautious and prepared for future volatility. Until we have the benefit of hindsight, it is impossible to predict when the bear has returned to his cave. We believe that a bull market cycle will be largely predicated on conditions in the financial sector. It would very difficult for a bull market to begin as long as the financial sector remains mired in a depression.

We believe that the market sell-off presents investors with exceptional long-term opportunities, with valuations near a generational low. Investing is all about discipline, finding value, timing and discomfort. If you are comfortable, be careful—conditions will likely change. If you are not comfortable, you are probably positioned well for the future. Unfortunately, proper investing requires being in a state of discomfort. Successful investors invest when others fear the market, and fear the market when others love it.

We continue to draw confidence from the lessons of history, and from our decades of experience investing through bull and bear markets. As always, our investment discipline is focused on capitalizing on the fear and opportunity in the market through proprietary research and long-term perspective. Our portfolios reflect our emphasis on fundamentals and identification of long-term secular themes; as such, we believe that we are well positioned for the road ahead, with all of its twists and turns.

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