

Market Review
and Outlook

Second Quarter 2008



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If you're not confused, you don't know what's going on

Economic pressures and volatility continued to batter the global markets during the second quarter. We saw the most severe June stock market decline in generations, a disconcerting echo to January of 2008. Perhaps even more discouraging, the June sell-off represented a test of March lows and signaled that the worst may not be over. Oil prices rose above \$140 per barrel, deepening pessimism among consumers and business. In the United States, spending is down as consumers have changed their driving and spending habits (finally), as the high prices of energy, food and gasoline take their toll. Business margins are showing signs of correcting while growth forecasts are being revised down.

Inflation has increased around the globe. This poses a significant threat to global expansion, which requires low interest rates and capital to mend the credit crisis sparked by the 2007 housing bust. Meanwhile, banks and insurance companies around the world are attempting to rebuild their balance sheets while asset write-downs seem to be spiraling out of control.

To some, the landscape may look intimidating, because it is fraught with uncertainty, changes and new challenges. Success will depend on adaptation, as it has throughout the evolution of the global economy. Consider the insights of Charles Darwin. Although he is cited for popularizing the idea of "survival of the fittest," it was adaptability that Darwin believed mattered most to survival. In his 1859 book, *On the Origin of Species*, he wrote, "It is not the strongest of the species that survives, nor the most intelligent, but the ones most responsive to change."

Just as in the natural world, business competitiveness calls for a high degree of adaptability to changing markets, competitors and consumer behavior. Being "the fittest" may allow more time to learn to adapt, but it does not guarantee success in adapting to change. Managing money successfully is no different. The ability to adapt is more important than being correct with a forecast. Our business is to lay out an investment thesis and then challenge the thesis as new information is revealed amid the noise of a volatile market. As we have done many times in the past thirty years, we will adapt to new threats and opportunities in an effort to gain understanding and build wealth for our clients.

Emerging Nations, Emerging Issues

Developed nations are struggling to grow amid strong headwinds, including declining credit availability and a banking crisis. Inflationary pressures increasingly limit the feasibility of further money growth and liquidity injections. Meanwhile, emerging nations are growing rapidly but inflation is accelerating even more as commodity prices reach extended levels (see Figure 1, page 2). Although the end of a credit cycle is typically deflationary, the landscape looks different this time around as inflationary pressures in energy and commodities markets seem to have offset deflationary forces.

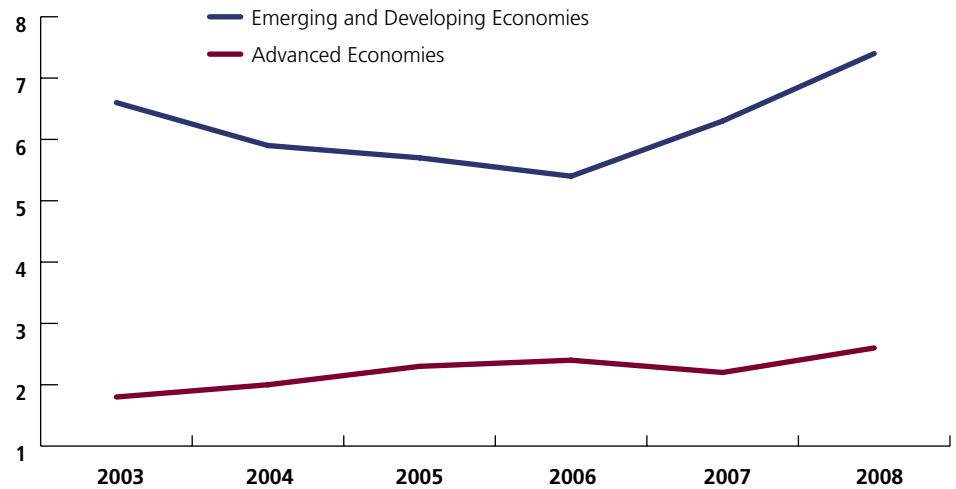
"Although our near-term outlook on the economy is less optimistic than at points past, we remain positive on the long-term potential for the global economy. We expect that the expansion of democracy and progress will continue, opening new doors to wealth for individuals all over the world."

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Past performance is no guarantee of future results.

Figure 1. Inflation Rate, Average Consumer Prices (Annual Percent Change)

While inflation has risen around the world, inflationary pressures are far more pronounced in emerging and developing economies.



© IMF, 2008. Source: World Economic Outlook (April 2008).

The expectations implied in emerging-market equity valuations and most prognosticators' forecasts are that developed markets will slow while emerging economies continue to expand. Two factors are cited in support of the view that emerging economies will escape the slowdown. The first is the strength of the commodity markets. The second is that most major emerging-market countries are no longer creditors with debts in foreign currencies, but lenders that have kept their debt financed in local currency.

“Although a portion of current commodity price increases is a function of new demand at the margin, much of the increases appear to be the result of monetary excess.”

However, the topic of commodity market strength begs two questions: first, to what extent are commodity price moves attributable to inflation caused by U.S. dollar devaluation; and second, why has current demand impacted prices so quickly and sharply? In their recent white paper, “This Time is Different: A Panoramic View of Eight Centuries of Financial Crises,” Professors Reinhart and Rogoff¹ put forth an interesting argument as to what we might expect and why the current thinking about emerging markets may be flawed. They find that emerging countries typically fall into crises because of declining commodity prices and global credit tightening emanating from a center country credit crisis. The United States is the center country today and commodity prices are very high. Reinhart and Rogoff also dispel the myth that “this time will be different” because emerging countries today are reliant on domestic debt markets and have borrowed in local currency. The professors' findings show that many emerging markets have crashed with a domestic debt-financing regime.

Much of the world is awash in U.S. dollars and global banks have reserves bursting at the seams. Witness the large sovereign wealth investment funds that are searching the world to find investment opportunities with dollar holdings. Global demand for oil is down from a year ago, but oil prices have increased more than 90% from June 30, 2007 through June 30, 2008—so something is amiss. On the surface, the China growth story is a compelling reason for rising oil prices, but China's expansion did not sneak up on the world suddenly; China has been growing at a 10% plus growth rate for 25 years. Rational expectations would assume that the markets had many years to adjust to the growth reality of China, causing market prices to adjust along the way, not just in the twenty-third and twenty-fourth years of the expansion. Many global businesses saw China's potential and invested much earlier, so why wouldn't the commodity markets adjust to the change over time?

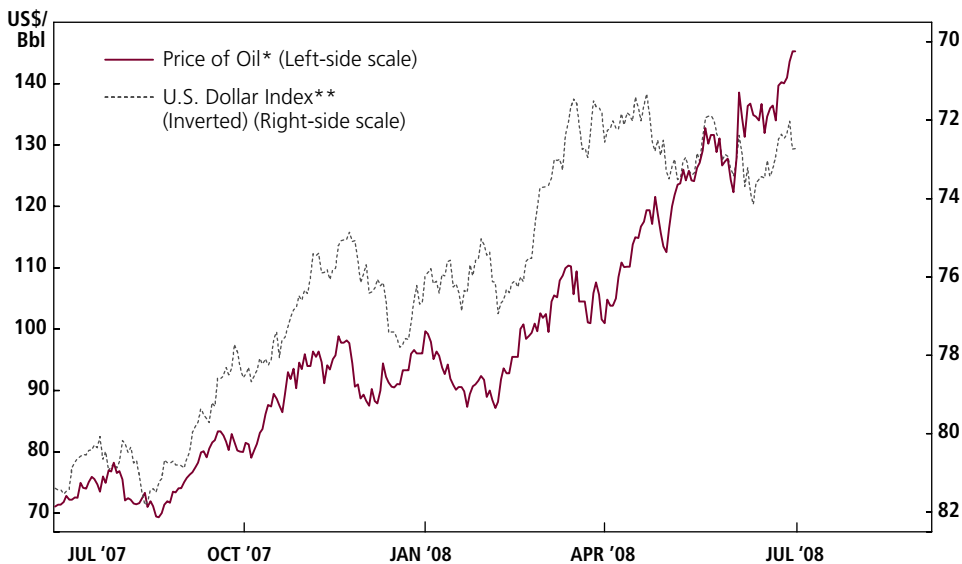
As we have discussed in the past, consider what happened to commodity prices coming out of World War II. Globally, the demand for commodities was tremendous. Most of Europe's and Japan's infrastructures were decimated and had to be rebuilt, while the United States had to retool its manufacturing base for a peace-time economy. Meanwhile, there was the domestic demand of huge highway projects, suburban sprawl, two-car families with air conditioners, multiple color televisions and eventually computers. And, the global population soared—from 2.1 billion at the end of World War II to 6.1 billion now.

Applying the popular logic of today, one would expect that these levels of demand would have driven commodity prices to exceptionally high levels. Yet, the opposite happened: Real commodity prices declined dramatically in the face of this incredible global infrastructure build-out and population explosion. This suggests that demand alone is not the driver of today's soaring commodity and fuel prices. Although a portion of current commodity price increases is a function of new demand at the margin, much of the increases appear to be the result of monetary excess. This excess money creates asset bubbles and, ultimately, inflated prices for goods and services. As Milton Friedman put it, inflation is caused by "too much money chasing too few goods."

We are also seeing exponential price increases in non-productive assets that are not governed by free markets and have inelastic supply curves. (Inelastic supply curves are those which are relatively long in duration. For example, new oil supplies take a number of years to bring to market and agriculture takes a full year.) The global oil and agriculture markets are subject to heavy government intervention, trade tariffs and cartels that disrupt the normal pricing mechanism. Add the inelastic short-term supply curves to this socialist pricing schema and you have a recipe for hoarding and unclear market-pricing feedback. Moreover, large hedge funds and investment community participation have become an increasingly important influence. This involvement is no minor issue because, until quite recently, the world value of the outstanding commodity pools was very small within the context of the global financial markets; and major investment flows have a dramatic impact on prices. Today, statistics suggest that as much as two-thirds of all oil contracts are purchased by investor-speculators, as opposed to end users attempting to hedge their input costs.

Figure 2. Oil Prices and the U.S. Dollar are Closely Linked

As the graph below shows, weak U.S. dollar policy is inflationary.



* West Texas Intermediate ** Index versus 6 major currencies, source: NYMEX

Source: BCA Research. © BCA Research 2008.

Monetary Excess: What Can We Expect?

The current global monetary regime is most like the Bretton Woods Agreement that was put in place after World War II. As discussed in the 2003 white paper, "An Essay on the Revived Bretton Woods System,"² a strong parallel exists between the current United States – China monetary regime and the Bretton Woods agreement.

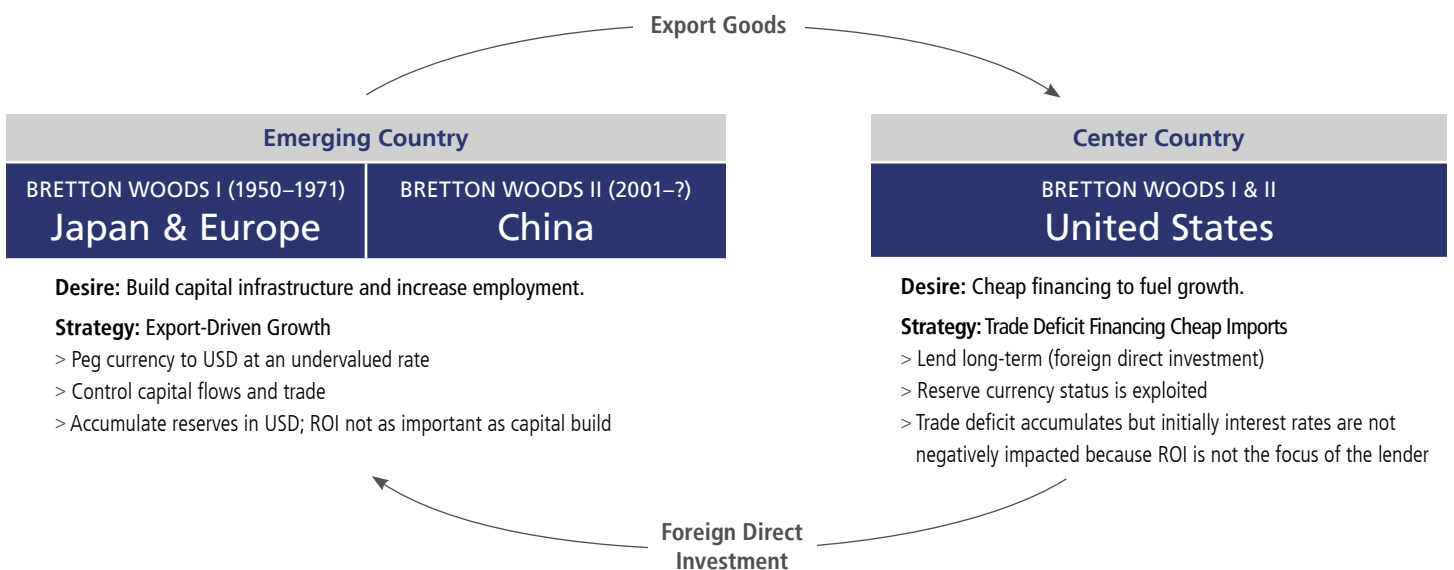
In the Bretton Woods agreement (BWI), the center country was the United States and the peripherals were Europe and Japan. In the new monetary regime, which we'll call "Bretton Woods II" (BWII), the United States remains the center country, but the peripheral country is China. As mentioned earlier, in the wake of WWII, the capital stock of most of Europe and Japan needed to be rebuilt. The monetary regime put in place was designed to help Europe and Japan build a competitive capital stock and to employ as many people as possible. This was to be accomplished by exporting product at a below-market rate by pegging the peripherals' currencies to the dollar and pegging the dollar to gold. Under the agreement, the United States would benefit from the artificially low peg to the dollar by receiving low-priced imports and from low interest rates as dollars flowed overseas. Europe and Japan did not mind the poor return on the dollars they held because they received the benefits of export growth and capital building. This regime faltered after about 20 years, after the peripheral countries had built a globally competitive capital stock and reached near-capacity utilization and full employment. The end of BWI ushered in the end of the gold standard, floating-exchange-rate systems, global inflation and slow real GDP growth, and led to the coining of the term "stagflation."

The current China – U.S. relationship works exactly the same way as BWI. China pegs its currency to the dollar at a low rate and exports products to the center country while building dollar reserves and a competitive capital stock. This relationship has been profitable to both countries and was given a significant boost with the entrance of China into the World Trade Organization in 2001. As China benefits from a quick build-up of infrastructure and capital stock, the U.S. benefits from less-costly imports and low interest rates on debt.

Figure 3. Bretton Woods: Then and Now

Bretton Woods ended due to several factors: (1) Europe and Japan built competitive capital stock, (2) high energy prices and inflation took hold in the United States, (3) the United States moved off the gold standard and floated its currency, and (4) Europe wanted a higher return on investment (ROI) on U.S. dollar holdings in reserve.

Today, the informal BWII relationship is mutually beneficial to China and the United States, but history suggests that BWII will lapse as global trade relationships and economies evolve. We would expect BWII to end when China and the Asia region build competitive capital stock and seek higher ROI on U.S. dollar reserves.



Today, China still appears to be a long way from having a globally competitive capital stock in place and underemployment is significant. Accordingly, BWII should continue for quite some time, perhaps another decade. (The length of BWII will likely not be as long as that of BWI, given China's rapid economic growth.) A repeat of the crisis that followed BWI is avoidable if the United States manages its fiscal spending before the monetary regime ends. Unfortunately, however, the United States is not on track to control spending and unfunded liabilities. Strong anti-trade measures could also accelerate the end of the relationship and cause significant global carnage.

How Do We Know Excess U.S. Dollars Are to Blame for Inflation?

If you accept the argument that global demand is not solely to blame for the rapid energy and commodity price appreciation of the past three years, but instead view the world from a monetary perspective, a different picture emerges. We have witnessed significant asset bubbles in the past 10 years. These started in the technology and telecommunications sectors, and then rolled into the housing markets and China's equity market. Today, the asset bubbles are in the energy and commodity markets.

Each of the past asset bubbles were supported by credit and excess liquidity, and ultimately rolled into "liability bubbles" as the assets deflated and the excess moved into commodities and energy. Oil, being the most significant commodity (and traded in U.S. dollars), had virtually no chance of avoiding the buffeting forces of excess dollars and credit. Unlike China or BWI-era Japan and Europe, the oil-producing countries want a return on the dollar holdings accumulating in their investment funds, banks and reserves. These countries do not look kindly on receiving a lower account value for their product, just because the United States has failed to maintain the value of its currency. In the past, the U.S. dollar/gold relationship meant that if the dollar depreciated against gold, then the oil-producing countries would raise the price of oil, ensuring that they could purchase the same amount of gold per barrel of oil as they could before the devaluation. The rapid oil price increase in the early 1970s was a result of U.S. dollar devaluation and the end of the gold standard. Gold was the currency that mattered; dollars just made transactions more convenient. The same logic applies today; devalue the dollar and oil prices rise to offset the devaluation.

The U.S. dollar has collapsed, putting pressure on countries that have maintained their value of account. The excess U.S. dollar problem also creates inflation in countries that are pegged to the dollar or have a soft peg. We are seeing inflation rates in China and Asia accelerate at levels that cause great concern.

The world does not need a repeat of the post-Bretton Woods era and 1970s stagflation. However, the United States is now in a position where it is difficult to maneuver. The credit crisis is slowing growth but inflation rates are increasing. In our January commentary, we noted that we believe the next big concern is stagflation. A stagflation scenario has become more likely in the past few months as oil, food and other commodity prices have moved up dramatically. The United States is not in a position to add liquidity or lower rates to offset the credit crisis, as the Fed's recent actions attest. It is our hope that some of the speculative excess and premiums come out of commodity prices as global demand slows. The United States needs a strong dollar policy and a focus on fiscal constraint, while at the same time freeing capital to energize entrepreneurs and to stoke the growth potential in the economy.

Economic Growth Concerns, From a Monetary Perspective

The current housing bust and associated credit crisis weighs heavily on the economy. We expect the financial sector will continue to experience further de-leveraging in an effort to stop balance-sheet erosion. It will take time to rebuild balance sheets and for lending activity to resume, though. The credit creation process has slowed dramatically and asset depreciation has not yet bottomed. In a monetary context, Milton Friedman developed the GDP equation that money (M) multiplied by velocity (V) is equal to price (P) multiplied by quantity (Q) produced. In today's terms, we are going to continue to see less velocity of money as the banking credit-creation process or multiplier declines. We are also

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witnessing a decline in monetary growth as the United States deals with a weak dollar and inflation concerns. Therefore, we would expect a period of slow growth bordering on recession over the next few quarters or years. Unfortunately, very slow growth will reveal other weaknesses and will probably push the economy over the brink into a recession. The economy does not function well at very low growth rates; historically, low growth has led to no-growth as businesses suffer, default rates climb and new job creation drops.

How much of this downturn is already reflected in the prices of securities and how much remains? Unfortunately, the answer is very dependent on inflation and interest rates in the months, quarters and years ahead. If inflation can be contained and if interest rates remain low, then a measured credit market healing can take place, which should allow consumers to deal with the cost of credit without additional distress.

The Push and Pull of Global Inflation and Deflation

In this environment, a secular or even a cyclical understanding of inflation is particularly difficult. Some of the major secular trends in place are highly deflationary, including: the expansion of global competition, the technology and information revolution, improved communication, the global housing bust, the bursting of the China bubble, and productivity-led supply-side expansion. However, these deflationary trends are countered by global inflationary influences, such as: U.S. dollar reserves and excesses, financial credit expansion, commodity and energy hoarding and shortages, G7 government unfunded liabilities, and Asian currency pegs.

Ultimately, we believe inflation will be kept in check as the current housing and credit cycles end, and as the expansion of democracy and technology continue to fuel productivity and innovation. Harkening back to Darwin, we also believe that the world will adapt to stratospheric energy prices by changing their usage habits, which should result in slowing demand.

Of course, as we will discuss further, government policy decisions may exert considerable influence over the inflation/deflation push-and-pull. In general, the capitalist spirit drives economies toward deflation as competition and innovation replace the weak and expensive. The technology and telecommunications revolution, the Internet, and Wal-Mart exemplify this principle. In contrast, interventionist governments and centrally controlled economies create inflation and restrict growth by choosing winners and losers while ignoring the markets' pricing mechanism.

Under the Shadow of A Presidential Election

The United States is in an election year and policy direction is a main focus. As we noted above, free markets unleash deflation and disinflation while government-controlled markets lead to inflation and poor allocation of resources. Every major bear market in this century was greatly extended or caused by policies that limited economic freedoms and restricted capital.

Front-runner Senator Barack Obama is promising to reallocate energy wealth, reallocate wealth from the “haves” to the “have lesses,” nationalize health care, raise taxes and redistribute income. These are all clearly socialist agenda items, reflecting the belief that the central government should intervene—against the will and wisdom of markets—to level the playing field. Senator Obama has come out against free trade and appears to have no confidence in the free market. His front-runner status weighs on the market, reflecting concerns that capital and wealth will be targeted, taxed and misallocated. If his policies had positive financial implications for the country, we would likely see calmer markets and stability.

Senator Obama's popularity is understandable, but some of his policies give us pause. Despite all evidence pointing to the failure of socialism, societies often lean in this direction during crises or periods of rapid change. We believe Winston Churchill said it best when he noted, *“The inherent vice of capitalism is the unequal sharing of the blessings; the inherent virtue of socialism is the equal sharing of the miseries.”*

Republican Senator John McCain stands for some degree of free markets and free trade, but he presents a confusing and, at times chaotic picture when he attempts to lay the ground work for the economy. Still, we believe he would most likely be a fiscal conservative with the courage to veto spending that President Bush ignored. Because Senator McCain's policies of free trade and fiscal spending constraints appear to be best suited to resolve the U.S. current malaise, he may end up as our next President. After all, history includes many examples in which the right individual emerges to handle the unique problems of the time.

It will certainly be a race to keep an eye on. While our readers can see which outcome we believe is better for the U.S. and the economy, we will have to follow Darwin's principles and be prepared to adapt as opportunities may dictate.

Strategic Positioning

We believe that many of the concerns we've discussed are already reflected in the current market pricing. As a result, we believe it will be difficult to benefit from overly defensive moves. Of course, the actions we take to protect assets and take advantage of opportunities will be influenced by future policy changes and how the world attempts to solve some of the existing problems. The good news on this front is that history is full of good examples of what to do and what not to do. We also have more than 30 years of our own experience to draw upon, and we believe this longevity will continue to serve us in good stead.

Broadly, we have positioned our portfolios with a bias toward mid- and large-cap growth-oriented companies, where a near-historic valuation gap has emerged over the past seven years. We favor companies with healthy balance sheets, high return on invested capital, and substantial revenues from non-U.S. sources.

The push and pull of global inflation and deflation has significant policy implications and impact on the world's stability and growth. Given the heightened near-term uncertainty, we are staying with the long-term secular themes and trends that have helped build wealth and transform the world. We believe these trends will continue to offer opportunities for investors, even through slower periods of global growth. For example, the expansion of information and communication is a tough genie to put back in the bottle. We continue to favor industry groups that enhance productivity and benefit from global competition, including information technology, telecommunications, select financial companies and growth-oriented industrials (such as those involved in global infrastructure building).

We have not moved to overweight positions in energy or commodities sectors. As we noted, we believe that inflation will be tamed eventually, as behaviors adapt and as technology and democracy expand. We expect that the very high equity valuations in the energy and commodity sectors will come under pressure, and that high commodity prices will ultimately give way to slowing demand and a price correction. We continue to believe that performance in these sectors is more a function of market timing and trading than investing. (Interestingly, in the past, most pension plans considered investing in non-productive assets as speculative; today they are embracing these assets at these speculative levels.)

From a regional perspective, although we continue to find a number of individual opportunities in Europe, we are cautious on the region as a whole. The landscape looks less hospitable to us due to a convergence of factors, including a strong euro, rising inflation, the bursting of certain European housing markets, and inflexible labor markets, as well as reverberations from the global credit crisis. We expect that emerging economies will be tested, and we see opportunities arriving as the markets weigh the resolve and creditworthiness of many of these nations.

Low-grade credit is being marked down aggressively along with what was once thought to be high-grade credit. As investors become better compensated for risk, we expect to increase our low-grade exposure in months ahead.

“As we have for more than three decades, we look forward to adapting to the changing environment. We have invested through many difficult times before, and our experience underpins our conviction that fundamentals will ultimately persevere.”

Conclusion

Although our near-term outlook on the economy is less optimistic than at points past, we remain positive on the long-term potential for the global economy. We expect that the expansion of democracy and progress will continue, opening new doors to wealth for individuals all over the world. We continue to be strong believers in humankind's ability to solve problems, by employing know-how and technology to remove obstacles to progress.

Looking forward, we have sought to position our strategies for the next leg up in the markets with a watchful eye towards the interventionist government policies that have generally caused bigger or longer-term problems. As we have for more than three decades, we look forward to adapting to the changing environment. We have invested through many difficult times before, and our experience underpins our conviction that fundamentals will ultimately persevere.

¹ "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises," Carmen M. Reinhart and Kenneth S. Rogoff, March 30, 2008, National Bureau of Economic Research

² "An Essay on the Revived Bretton Woods System," Michael P. Dooley, David-Folkerts-Landau, and Peter Garber, September 2003, National Bureau of Economic Research

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