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Founder's Corner:

Even in a Growing Economy, Risk Management Matters

John P. Calamos, Sr., Chair, Calamos Investment Committee
Founder, Chairman, and Global Chief Investment Officer

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Stocks, convertible securities and high yield bonds rallied strongly in the first quarter. U.S. economic data remained positive overall, supported by business-friendly fiscal policy and a healthy consumer. Corporations announced strong earnings and revenue results. Market apprehension about the Federal Reserve receded as the central bank pivoted to a more "dovish" stance. Financial conditions improved dramatically after a December squeeze, and credit spreads tightened significantly over the quarter as investors shifted from "risk-off" to "risk-on." Outside the U.S. (especially in Europe), economic conditions were less encouraging, but the global growth outlook improved, helped by a contained U.S. dollar, optimism about an eventual resolution to global trade disputes, and data supporting the view that China's economy could achieve a soft landing.

We believe the U.S. economy will extend its steady expansion through this year and beyond. Importantly, economic cycles should not be measured by their duration, but by fundamentals—and the fundamentals remain compelling. Tax reform and de-regulation can provide sustained catalysts for the corporate sector. Inflation is benign, unemployment is low, and a healthy consumer can continue to fuel growth. An accommodative Federal Reserve is likely to buoy US economic growth and markets further, with positive knock-on effects globally.

Although we see tailwinds for growth and opportunities across asset classes, we believe conditions require a highly selective approach. We expect volatility and sideways markets will characterize this phase of the economic cycle, as investors grapple with global uncertainties ranging from Brexit and stagnant economic conditions in Europe, to rising jitters about the next U.S. presidential election. The brief inversion of the yield curve should not be viewed as a precursor of imminent recession, but it does indicate building pressure, which we are monitoring closely, along with other potential risks such as corporate debt levels and shifts in global central bank policies.

When markets rally as strongly as they did in the first quarter, investors may be inclined to overlook the need for risk management. However, as the fourth quarter illustrated, markets can succumb to short-term selloffs in the midst of longer-term advances. Successful asset allocation strategies should focus on both current opportunities as well as being prepared for turns in market, economic and political cycles. With the right strategies at the core of an asset allocation, it is easier to stay invested through full market cycles, including through selloffs such as the one we saw in December.

Going forward, we expect a stock picker's market to prevail, rather than one in which a rising tide will lift all boats. Attention to valuations and company fundamentals will be essential. In our positioning, we see compelling prospects for a number of U.S. growth companies, including those tied to consumer activity.

As we have discussed in past commentaries, strategies that can play both defense and offense are well suited for the current environment and the longer-term conditions we expect. We remain especially constructive on convertible securities as a way to gain equity market exposure while mitigating downside risk. Our approach seeks to actively manage the hybrid characteristics of convertibles to capture more equity upside than downside over full market cycles. We have used market volatility to rebalance the portfolio,

favoring cyclical and secular opportunities, primarily in technology, health care and select areas of the consumer sector.

For many years, stubbornly low rates have challenged investors seeking income. However, fixed income remains an essential element of a long-term asset allocation. Within the fixed income market, we are identifying idiosyncratic opportunities in high yield bonds, favoring companies with reliable debt servicing and stable-to-improving leverage metrics. In contrast, at current market levels, the lowest credit quality tier of the investment grade market calls for vigilance due to high levels of debt on balance sheets.

We see considerable benefits in including risk-managed liquid alternative strategies within both the equity and fixed income sides of an asset allocation. For example, for the equity side of the allocation, our global long/short and hedged equity approaches employ different strategies to change their level of exposure to the equity market, dampening the impact of volatility while still participating in upside. Meanwhile, to address the limitations of traditional fixed income bonds in a low interest rate environment, we believe the case is strong for market neutral strategies that are not dependent on interest rates for income generation.

Calamos Wealth Management 2020 Calamos Court | Naperville, IL 60563 | 888.857.7604 | www.calamos.com/wm | cwm@calamos.com

CWM 8392 0419 FC