FROM THE INVESTMENT STRATEGY GROUP

J. Reed Murphy
Chief Investment Officer
Calamos Wealth Management

Contributions by:

Rob Young, CFA
Strategy & Analytics Specialist
Calamos Wealth Management

Investing involves a multitude of decisions that require constant risk and reward considerations.

INVESTMENT INSIGHTS

Market Dislocations Creating Investment Opportunities

EXECUTIVE SUMMARY

- *Government shut downs have created economic pain and a dip in equity and bond markets.*
- *Massive and unprecedented monetary and fiscal stimulus and re-openings have created a strong rebound in equity markets.*
- *However, many fixed income markets are still dislocated.*
- *We dive deep into the concerns and rhetoric regarding downgrades and defaults from a historical perspective.*
- *The result, there are tremendous opportunities in various fixed income and convertible markets.*

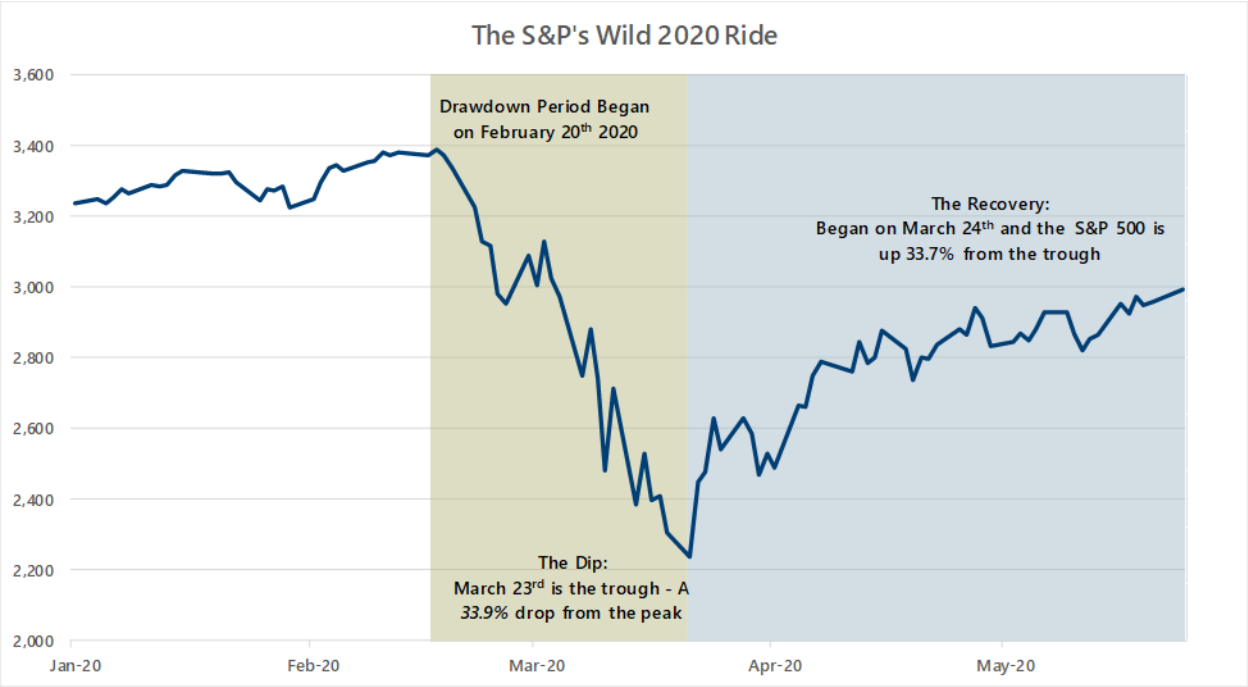
UPS AND DOWNS –REACTING TO COVID-19

Covid-19 originally broke out in the Chinese Province Hubei and specifically its capital city Wuhan in late 2019. Ever since, its effect on health, sentiment, economies and markets has been astonishing. The economic and market effects are tied to government closings of economies, which are now reopening.

As mentioned in our recent quarterly commentary (found here), the 1st quarter of 2020 was the worst starting quarter for U.S. equities (i.e., S&P 500) since 1928. Fixed income markets didn't fare much better with the narrow exception of U.S. Treasuries. As central banks and governments responded to the healthcare crisis, April witnessed the beginning of a rebound. In the case of U.S. equities, it was the 12th best month we've seen since 1928.

Exhibit 1 shows the equity market dip and recovery, which was largely driven by monetary and fiscal support packages. The S&P 500 declined nearly 34% from its high on February 19th through its low point on March 23rd. As of its recent high on May 26th, the S&P 500 had climbed up nearly 34%.

Exhibit 1: S&P 500 –A Dip and Recovery



Source: Bloomberg, Data as of 5/26/2020; S&P 500 is considered generally representative of the U.S. equity market. Past Performance doesn't guarantee Future Results.

THE CATALYST: MONETARY & FISCAL SUPPORT

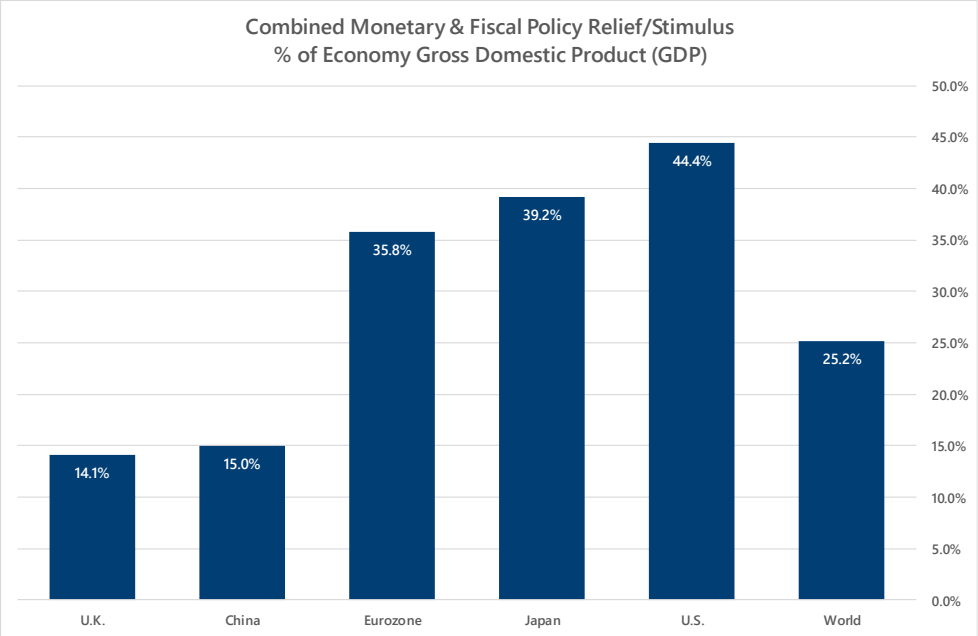
In the depths of the Global Financial Crisis (i.e., Great Recession of 2008/2009), markets were consumed with a potential banking collapse. Back then, Treasury Security Henry Paulson, famously stated in his July 2008 testimony before the Senate Banking Committee:

> *"If you've got a squirt gun in your pocket, you may have to take it out. If you've got a Bazooka, and people know you've got it… you're not likely to take it out."*
>
> *– Henry Paulson (2008)*

Well, the Federal Reserve did bring out a bazooka during that period – creating an environment that stabilized markets and created an economic recovery.

Today, central banks and governments have rolled out not just one bazooka, but an artillery of bazookas . . . and cannons. Exhibit 2 shows the massive and historically unprecedented amount of announced monetary and fiscal relief packages and stimulus relative to the size of each respective economy.

Exhibit 2: Size of Monetary & Fiscal Packages Relative to Respective Economies

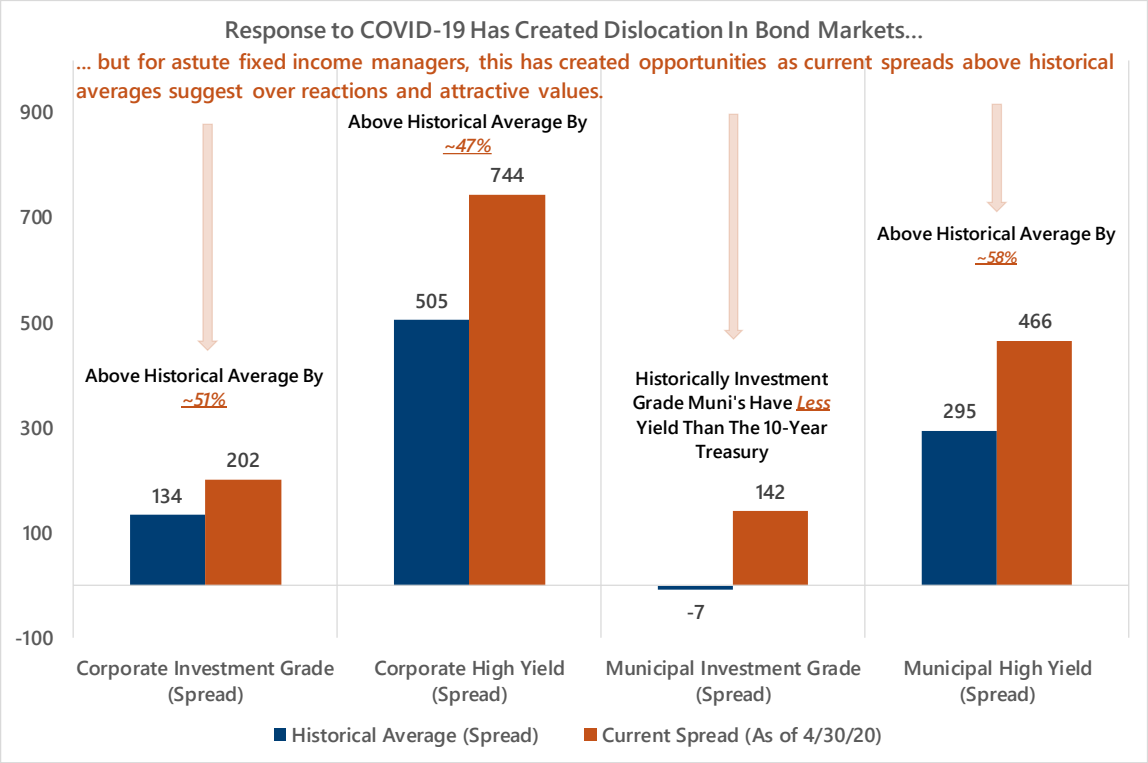


Source: Cornerstone Macro. As of May 27, 2020.

WHILE EQUITY MARKETS HAVE RALLIED, WHY HAVEN'T SOME BOND SECTORS?

Through April, muni and corporate high yield markets had not rebounded like the equity markets, nor the corporate investment grade bond market. This could be due to investor pessimism, political rhetoric, less support and less actual open market-buying by the government. In addition, there were major outflows in April, which limited the ability of many managers to rebound. This can be witnessed through an evaluation of spreads of various bond yields relative to U.S. Treasuries. When spreads (e.g., corporate bond yield minus US Treasury yield) are large (i.e. wide), those bonds are cheap and vice versa. Currently, those spreads continue to be wide. Herein, lies the opportunity (Exhibit 3).

Exhibit 3: Despite The Rally In Equities, Bond Market Dislocation Remains



Source: Bloomberg, As of 4/30/2020. Past Performance doesn't guarantee Future Results. IG = Investment Grade. HY = High Yield. High Yield Corp is represented by the Bloomberg Barclays US Corporate High Yield Average OAS Index, which measures the USD-denominated, high yield, fixed rate corporate bond market. Securities are classified as High Yield if the middle rating on Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below.; Investment Grade Corp is represented by the Bloomberg Barclays US Agg Corporate Avg OAS Index, Investment Grade Muni is represented by the S&P Municipal Bond Investment Grade, The S&P Municipal Bond Investment Grade Index consists of bonds in the S&P Municipal Bond Index that are rated investment grade by Standard & Poor's, Moody's and/or Fitch.; High Yield Muni is represented by the S&P Municipal Bond High Yield Index, The S&P Municipal Bond High-Yield Index consists of bonds in the S&P Municipal Bond Index that are not rated or are rated below investment grade.. Corporate Investment Grade and High Yield are Option Adjusted Spreads; Investment Grade and High Yield Municipality Spreads are calculated by taking the market-weighted yield for the index and subtracting the 10-yr yield. Averages are calculated as of earliest possible date: Corporate Investment Grade; 12/31/1990 – 4/30/2020; Corporate High Yield: 1/31/1994 – 4/30/2020; Municipal Investment Grade and Municipal High Yield: 1/29/1999 – 4/30/2020.

DON'T FALL VICTIM TO POLITICAL RHETORIC, EMOTIONS & HYPERBOLE

The Covid-19 pandemic has turned a once sleepy municipal market into one filled by a narrative that a large number of municipals would declare bankruptcy and default on their obligations - a similar notorious call was made by famed analyst Meredith Whitney in 2010. It was wrong then, and we suggest it is largely false again.

According to Eaton Vance, one of the oldest investment management firms in the United States, "Political rhetoric will always be more volatile than policy outcomes. Investors should keep that in mind as they digest the headlines. The ability to analyze actual data can give investors a tremendous advantage so they can avoid overreacting in an anxious time. For municipal bond investors, the advantages of professional management and credit oversight have never been more apparent."

Stated another way, investors should remember that rhetorically, it's a market of bonds, NOT a bond market. Active management is extremely important.

MONETARY & FISCAL SUPPORT – NEXT STEPS

In addition, market reactions may further be changing with CARES Act 2.0. According to numerous sources, the $3 Trillion opening bid from Democrats has earmarked $900 Billion for fiscal support to state and local municipalities. Fed Chairman Powell has also stated that the Fed will not run out of ammunition (broadly speaking) and they will do what it takes. This could suggest more open market purchases also.

WHERE DISLOCATION STILL EXISTS – OPPORTUNITIES ARE PRESENT

The combination of stimulus announcements and government re-openings; over 400 and 120, respectively, over the last 6 to 8 weeks, and the massive amount of announced and potentially forthcoming stimulus moves may create tremendous opportunities for areas of the bond market that are still showing signs of dislocation – investment grade and particularly high yield corporate and muni bonds. Convertibles also present a favorable outlook.

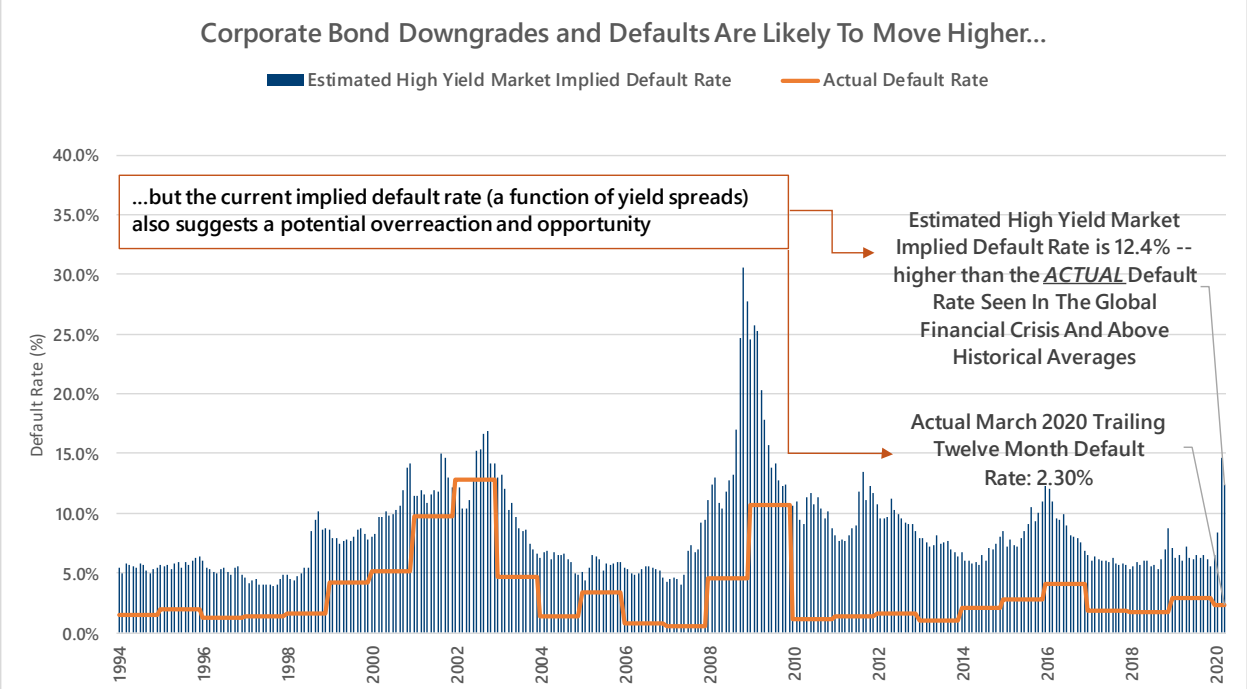
Corporate Bonds

Corporate debt outstanding has been one of the fastest growing segments since 1996 and it has two primary classes; 1) investment grade and, 2) high yield. An investment grade company is defined as one that presents a relatively low risk of default. In contrast, high yield tends to have more defaults, but an investor captures a higher income (i.e., yield) by assuming the greater risk.

As Covid-19 spread across the globe, corporate bond markets are pricing in default rates that exceeds the actual rates seen in prior stress environments. The phenomenon is not new. In the case of investment grade, we estimate that the market was implying a default rate of approximately 5.1% (as of April 30, 2020), which assumes a 60% recovery rate (i.e., amount that is actually recovered in the event of a default). According to Brown Brothers Harriman, the peak year of defaults for the BBB class of investment grade (the lowest quality class of corporate investment grade) was just over 2% during the Great Depression with another peak in 2002 of just 1.8%.

For corporate high yield bonds, defaults are more common, but a similar dislocation is present. We estimate that the market implied default rate for high yield is 12.4% - beyond what was experienced during the Global Financial Crisis (Exhibit 4).

Exhibit 4: Markets Tend to Over-Estimate Default Rates, Creating Opportunities for Corporate Bonds



Source: Bloomberg, Federated and JPM. As of 4/30/2020. Data Range from January 1994 – April 2020. Past Performance doesn't guarantee Future Results. High Yield default rates are calculated by Calamos Wealth Management and include the assumption that a defaulted security has a 40% recovery rate. High Yield Spreads are represented by the Option Adjusted Spreads (OAS) of the Bloomberg Barclays High Yield Corporate Index. Market implied default rate = High Yield Credit spread (above Treasury) / (1-assumed recovery rate)

The impact of such dislocations has historically been short-term drawdowns, followed by significant returns over the next several years. Exhibit 5 highlights those historical returns. We are now coming out of the 3rd worst drawdown on record for corporate high yield.

Exhibit 5: Corporate High Yield Bonds Have Performed Well After Large Drawdowns

						Subsequent Performance (Total Cumulative %)				
Rank	Event	Peak	Trough	Length (Months)	Drawdown (Total Return)	1-Year	2-Year	3-Year	4-Year	5-Year
1	GLOBAL FINANCIAL CRISIS	May-07	Dec-08	19	-35.3	75.7	102.3	112.3	145.9	164.2
2	1990 RECESSION	Jul-90	Oct-90	3	-17.2	48.7	71.3	102.0	104.5	136.5
3	COVID-19 PANDEMIC	Feb-20	Mar-20	2	-19.8	??	??	??	??	??
4	WORLDCOM	Mar-01	Aug-02	17	-12.9	29.4	47.5	61.3	70.2	80.9
5	ENERGY CRISIS	May-15	Feb-16	8	-12.9	27.1	32.4	38.1	46.6	??
6	TECH BUBBLE	May-99	Dec-00	19	-9.4	7.7	6.2	37.0	52.2	56.4
7	S&L CRISIS	Aug-89	Feb-90	6	-8.0	7.5	46.3	67.2	90.5	94.0
8	US DEBT CEILING	Jul-11	Oct-11	2	-9.6	23.4	34.4	42.2	39.4	53.6
9	LTCM PANIC	Aug-98	Oct-98	2	-8.5	5.7	4.0	3.9	-1.8	31.3
10	BLACK MONDAY	Mar-87	Oct-87	7	-6.9	17.3	19.6	4.2	55.0	78.6
					Average Period Return	27.0	40.5	52.0	66.9	86.9

Source: Bloomberg, Loomis Sayles sited periods. S&P 500 is considered generally representative of the U.S. equity market. Past Performance doesn't guarantee Future Results. Dates Used: #1 Global Financial Crisis: May 29th 2007 – December 12th 2008; #2 1990 Recession: July 31st 1990 – October 31st 1990; #3 COVID 19 Pandemic: February 1st 2020 – March 23rd 2020; #4 Worldcom: March 8th 2001 – August 15th 2002; #5 Energy Crisis: May 29th 2015 – February 11th 2016; #6 Tech Bubble: May 4th 1999 – December 4th 2000; #7 S&L Crisis: August 31st 1989 – February 28th 1990; #8 US Debt Ceiling July 26th 2011 – October 4th 2011; #9 LTCM Panic: August 7th 1998 – October 15th 1998; #10 Black Monday: March 31st 1987 – October 30th 1987.

Municipal Bonds

Ok, what about municipals? I thought, they were safe. As previously noted, the Covid-19 pandemic has turned a once sleepy municipal market into one filled with a narrative that municipals would declare bankruptcy and default on their obligations. (Municipal bonds are debt obligations of state and local governments.)

In the first quarter of 2020 the overall municipal market performance was flat at the investment grade level (ICE BofA Investment Grade index declined 0.68%). What troubled investors was its relative under performance to Treasuries, which returned a positive 8.2% (Bloomberg Barclays U.S. Treasury Index). This represented the worst relative under performance since the fourth quarter of 2008 during the Global Financial Crisis. It is worth pointing out that following that quarter, investment grade municipal bonds outperformed treasuries over the next five consecutive quarters for a cumulative gain in excess of Treasuries of 1,800 bps (18%).

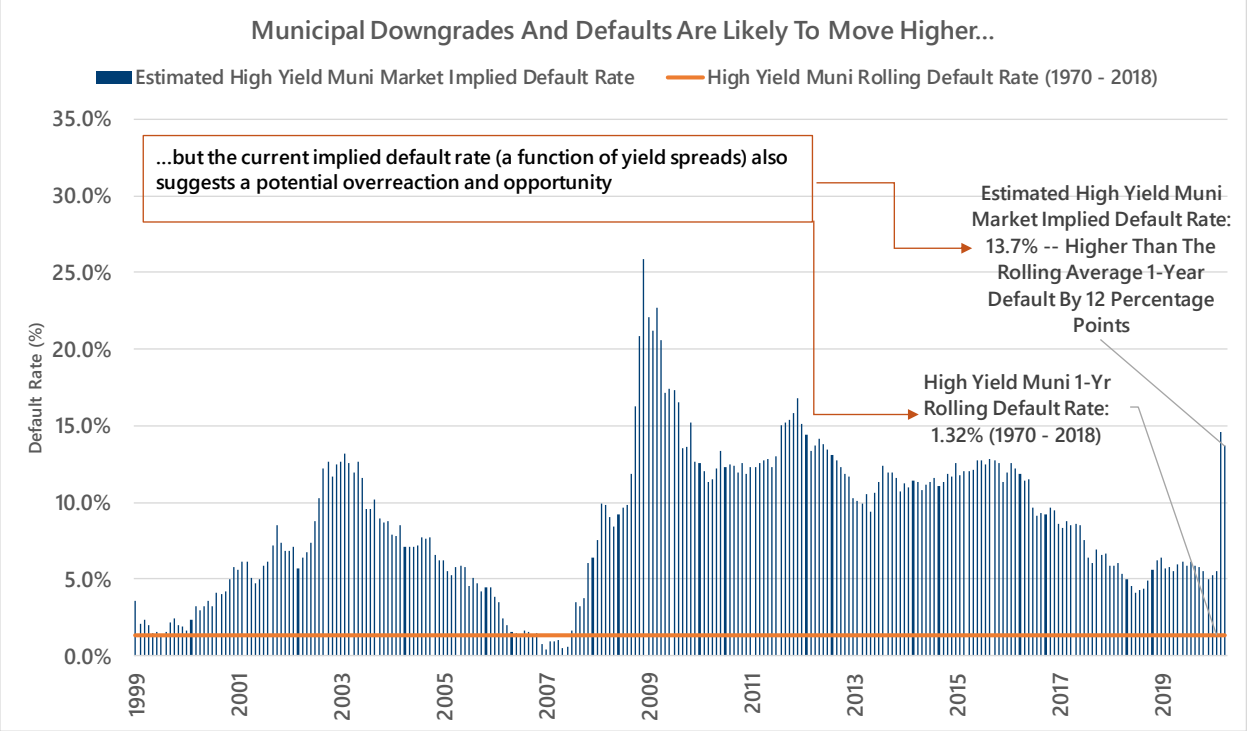
Defaults in municipal debt are very rare. At the "state level", it is constitutionally prohibitive for a state to go into bankruptcy. In fact, the last state to default on its debt was Arkansas during the Great Depression in 1933. Local municipal defaults are also limited. The rolling one-year actual default rate for investment grade munis from 1970 through 2018 was just 0.1%. The dislocation in markets have created an implied default rate of 4.2%, which presents investment opportunities.

To further provide solace, recovery rates on defaulted debt tends to be very high. According to Moody's, in the rare occurrence when munis do default, investors recover approximately 66% of their capital investment compared to a 40% recovery rate for high yield corporate bonds. More importantly, defaults by types of muni bonds varies greatly. According to a Fitch study, recovery rates by the following types of muni bonds can be assumed.

1. General tax obligation debt – 100% recovery rate
2. Nursing homes, continuing care and multi-family homes – 90%
3. Hospitals, stadiums and prisons - 40%

Similarly, as exhibit 6 illustrates, the dislocation in higher yielding municipal bonds is also creating opportunities. According to a study by Nuveen, one of the oldest national investment management firms, the average rolling one-year default rate for this segment has averaged 1.32% from 1970 through 2018. As Exhibit 6 illustrates the current implied default rate of 13.7% is suggesting a potential over reaction and, consequently, a good investment opportunity. If normalcy returns, investors may be favorably rewarded.

Exhibit 6: High Yield Munis - Markets Tend to Over-Estimate Default Rates, Creating Opportunities



Source: Bloomberg, Moody's. As of 4/30/2020. Past Performance doesn't guarantee Future Results. Data Range: Jan 1999 to April 2020. High Yield Muni is represented by the S&P Municipal Bond High Yield Index, The S&P Municipal Bond High-Yield Index consists of bonds in the S&P Municipal Bond Index that are not rated or are rated below investment grade. Municipal High Yield default rates are calculated by Calamos Wealth Management and include the assumption that a defaulted security has a 66% recovery rate. High Yield Municipality Spreads are calculated by taking the market-weighted yield for the index and subtracting the 10-yr yield. High Yield Municipal defaults are represented by the rolling one-year default rate from 1970 to 2018. Market implied default rate = High Yield Municipal Credit spread (above Treasury) / (1-assumed recovery rate).

Convertibles

Because convertibles combine attributes of stocks and traditional bond securities, they can provide many potential benefits. The following list provides several merits for convertibles, not only generally, but specifically to the environment we are in. Many of these concepts are further discussed in the following Founder's Corner article by John P. Calamos Sr.: *Convertible Securities: A Compelling Choice for Uncertain Times*.

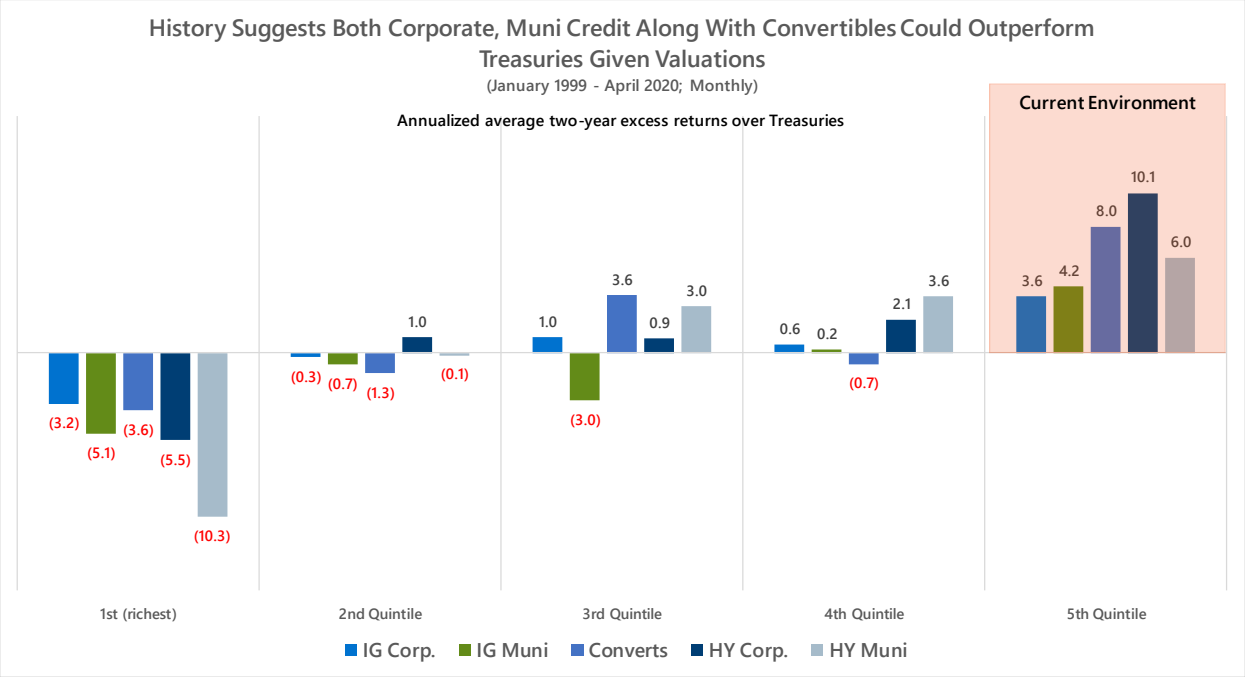
1. Historically lower volatility equity participation. Convertibles can benefit as their underlying equities appreciate because the convertible's embedded option (to convert to common stock) becomes more valuable. However, the fixed income attributes of the convertible—such as coupon income and the bond floor—may provide a potential cushion when stock markets are volatile. We believe this will be an extremely important benefit in the coming months given the potential for markets to move upward, but with considerable volatility along the way.
2. Access to higher growth names. The convertible universe is dominated by growth-oriented companies, including small and mid-caps. Because their fixed income characteristics may mitigate equity volatility, convertibles can provide a way to access this growth, with potentially less exposure to equity risk.
3. The structural features of convertibles may provide an edge in any number of economic scenarios.
4. Attractive valuations. Relative to longer-term levels, convertible valuations are currently compelling on the whole, with many issues trading at an unusually wide discount to fair value.

5. A risk-aware way to build global equity exposure with a variety of businesses with growth profiles.
6. Historically attractive default profile. Convertible securities have historically had lower defaults than high yield corporate debt.
7. A growing universe of opportunity. Convertible issuance has been healthy over recent years, as companies have sought access to capital in a growing economy.
8. Income less vulnerable to interest rates.

ASSYMETRICAL RETURN OPPORTUNITIES

Valuations in both corporate and municipal bonds are attractive relative to treasuries and domestic equities, which have both performed well since recent market lows. And historically, when we've hit these spread levels, outperformance by Treasuries has not lasted. As exhibit 7 shows, when spreads are at these extreme levels (i.e., 5th quintile) corporate and muni bonds, particularly high yield sectors, have performed very well.

Exhibit 7: At Current Valuations, Corporate, Muni Bonds and Convertibles Have Historically Outperformed Treasuries

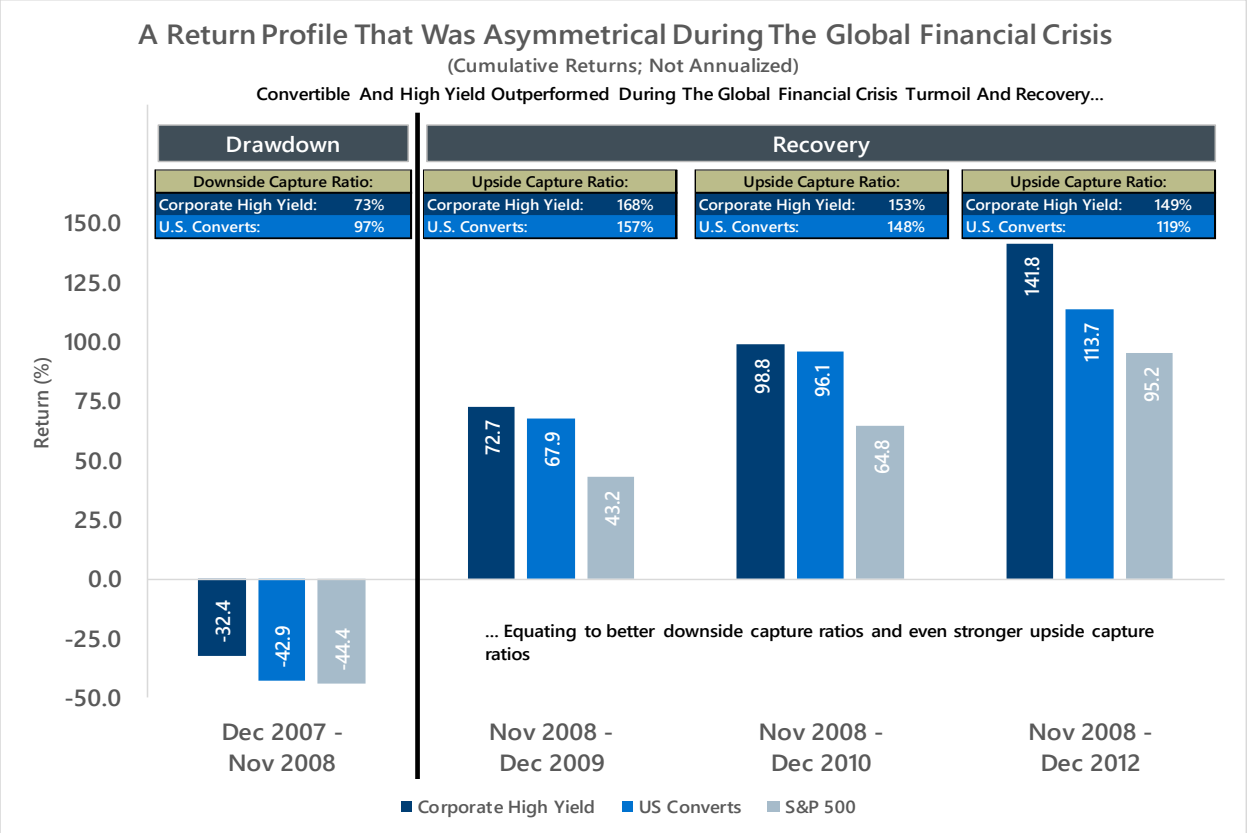


Source: Bloomberg, As of 4/30/2020. Past Performance doesn't guarantee Future Results. IG = Investment Grade. HY = High Yield. High Yield Corp is represented by the Bloomberg Barclays US Corporate High Yield Average OAS Index, which measures the USD-denominated, high yield, fixed rate corporate bond market. Securities are classified as High Yield if the middle rating on Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below.; Investment Grade Corp is represented by the Bloomberg Barclays US Agg Corporate Avg OAS Index, Investment Grade Muni is represented by the S&P Municipal Bond Investment Grade, The S&P Municipal Bond Investment Grade Index consists of bonds in the S&P Municipal Bond Index that are rated investment grade by Standard & Poor's, Moody's and/or Fitch.; High Yield Muni is represented by the S&P Municipal Bond High Yield Index, The S&P Municipal Bond High-Yield Index consists of bonds in the S&P Municipal Bond Index that are not rated or are rated below investment grade.. Corporate Investment Grade and High Yield are Option Adjusted Spreads; Investment Grade and High Yield Municipality Spreads are calculated by taking the market-weighted yield for the index and subtracting the 10-yr yield. Yield to worst: High Yield Corporate is represented by the Bloomberg Barclays High Yield Index, Investment Grade Corporate is represented by the Bloomberg Barclays Investment Grade Index, High Yield Muni is represented by the ICE BofA High Yield Muni Index, and Investment Grade Muni is represented by the ICE BofA Investment Grade Index. Spreads for each market are put into quintiles and performance is forward two year performance is averaged for those respective buckets

Convertibles and corporate high yield bonds have also actually outperformed domestic stocks during these wider spread environments. This may be particularly prophetic since a case can be made that domestic equities (as of late May) have already rallied strongly.

As many have drawn comparisons of today's current environment to that of the Great Financial Crisis (GFC), it is constructive to evaluate how corporate high yield and convertibles performed during this period. Corporate high yield and convertibles provided better returns during the steep GFC drawdown (i.e., decline) with even stronger relative returns during the recovery. This asymmetrical behavior is witnessed in a better downside capture ratio and stronger upside capture ratio (Exhibit 8).

Exhibit 8: Asymmetrical Return Pattern Creates Opportunity – A Historical Global Financial Crisis Example



Source: Bloomberg. As of 4/30/2020. Past Performance doesn't guarantee Future Results. For Illustrative purposes only --- Corporate High Yield is represented by the Bloomberg Barclays US Corporate High Yield, which measures the USD-denominated, high yield, fixed rate corporate bond market. Securities are classified as High Yield if the middle rating on Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below; Converts is represented by the ICE BofA Convertible Index, which is U.S. dollar denominated investment grade and non-investment grade convertible securities sold into the U.S. market and publicly traded in the United States. The Index constituents are market value weighted based on the convertible securities prices and outstanding shares, and the underlying index is rebalanced daily; S&P 500 is considered generally representative of the U.S. equity market. Drawdown: is a peak-to-trough decline during a specific period for an investment, trading account or fund. A drawdown is usually quoted as a percentage between peak and the subsequent trough.

CONCLUSION

Investing involves a multitude of decisions that require constant risk and reward considerations. Investing also involves careful portfolio construction considerations regarding the sizing and correlation of various investments utilized within a broader portfolio. If history is to repeat itself, the dislocation in certain asset classes is presenting tremendous opportunities for investors, particularly if utilizing skilled active managers, to

fulfill on the concepts. Naturally, the exposure to each respective asset class or individual idea may vary by each client circumstance.

We remain committed to actively monitoring Covid-19 developments and will provide updates as news events warrant. If you have questions or want to learn more about these and other opportunities, please contact your Calamos Wealth Management advisor or any member or your wealth advisory team.

ABOUT THE AUTHOR

Reed Murphy serves as Chief Investment Officer of Calamos Wealth Management where he oversees all aspects of the firm's investment platform with over 25 years of industry experience. Reed has held a variety of executive level roles in the industry and is a speaker on topics pertaining to personal and institutional investing.

Definitions and Disclosures

S&P 500, is represented by the S&P 500 Index, which measures the market performance of 500 large companies on the stock exchanges of the US.

US Aggregate, represented by the Bloomberg Barclays U.S. Aggregate Bond Index, covers the U.S. denominated, investment grade, fixed-rate, taxable bond market of SEC registered securities.

US High Yield is represented by the Bloomberg Barclays US Corporate High Yield Bond Index, which measures the USD-denominated, high yield, fixed rate corporate bond market. Securities are classified as High Yield if the middle rating on Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below.

US Investment Grade is measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers

Municipal Investment Grade is represented by the S&P Municipal Bond Investment Grade, The S&P Municipal Bond Investment Grade Index consists of bonds in the S&P Municipal Bond Index that are rated investment grade by Standard & Poor's, Moody's and/or Fitch.

Municipal High Yield consists of bonds in the S&P Municipal Bond Index that are not rated or are rated below investment grade.
Convertible is represented by the ICE BofA Convertible Index, which is U.S. dollar denominated investment grade and non-investment grade convertible securities sold into the U.S. market and publicly traded in the United States. The Index constituents are market value weighted based on the convertible securities prices and outstanding shares, and the underlying index is rebalanced daily.

Upside / Downside Capture Ratio: The upside/downside capture ratio measures the ratio of the upside and downside of an investment vs a benchmark. This ratio explains to you how an investment typically performs in relation to their benchmark index.

Please remember that past performance may not be indicative of future results. Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations. The information contained therein is based on internal research derived from various sources and does not purport to be statements of all material facts relating to the information mentioned, and while not guaranteed as to the accuracy or completeness, has been obtained from sources we believe to be reliable. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Calamos Wealth Management LLC), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful.

Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Calamos Wealth Management LLC. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Calamos Wealth Management LLC is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. If you are a Calamos Wealth Management LLC client. Please remember to contact Calamos Wealth Management LLC, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. A copy of the Calamos Wealth Management LLC's current written disclosure statement discussing our advisory services and fees is available upon request.