

A New Era

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As a dedicated golfer and investor, I have found it interesting how both competitive golf and investing in the credit markets have evolved over the years. Golf has changed dramatically in many ways, but perhaps most noticeably in the physical fitness of today's top golfers. As is the case with other top athletes, today's golfers are stronger, more flexible, faster and leaner. Some of the best golfers in the world are now world-class athletes. Tiger Woods, the world's number-one ranked golfer, is a perfect example. Tiger's physical conditioning rivals that of an Olympic athlete.

Ten years ago, golfers had one coach, who helped them with the fundamentals of the golf swing and the technical aspects of driving, chipping, putting and bunker shots. That was the extent of it. Play 18 holes a day, hit balls on the range, putt and chip and you were good to go. Not anymore. Today, any professional golfer who wants to compete with Tiger Woods had better take a more holistic approach: strength trainer, aerobics advisor, flexibility coach, dietitian and maybe even a sports psychologist.

This evolution in golf is surprisingly similar to the evolution currently underway in the credit markets. Powerful new forces are changing the dynamics of credit investing, and those who want to succeed in today's credit markets would be wise to adopt a more holistic approach. At PIMCO, we recognize these changes and have adapted our traditional focus on credit and macroeconomic fundamentals to incorporate a broad array of relatively new technical factors such as our outlook for liquidity, structural shifts in new players and products, capital flows, asset prices, financial conditions and risk appetite. These elements are critical to analyzing today's credit markets, and will be for the foreseeable future. Similar to the fitness trend in golf, this new era of investing is here to stay.

Global Liquidity Boom

The global financial system is indisputably experiencing a boom in liquidity, driven by growth in corporate cash balances, foreign central bank reserves, private equity and hedge funds. This liquidity boom, along with new financial products, is changing the way that investment professionals traditionally view, evaluate and invest in financial markets. On the corporate front, strong global economic growth and easy global monetary policy over the past several years have led to a sharp rebound in corporate profit growth. In the United States, corporate profits as a percent of nominal GDP are now at 40-year highs (Chart 1). Despite this solid profit growth, most CEOs have remained conservative with capital spending. As a result, corporate cash flow and cash balances have soared, providing Corporate America with a surplus of funds.



Source: BEA

Chart 1

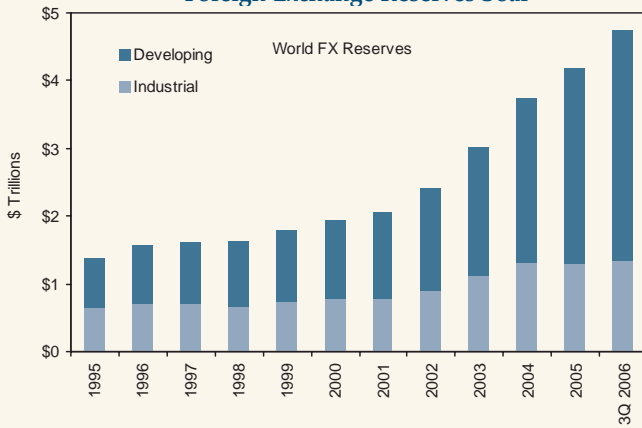
The growth in cash on corporate balance sheets is serving as a catalyst for rising shareholder activism. Aggressive shareholders are increas-

ingly putting pressure on management to redirect large cash balances toward share buybacks and increased dividends. High cash levels are further helping to facilitate more mergers and acquisitions. In addition, private equity investors are tapping into Corporate America’s significant cash position to use as part of an initial equity stake for leveraged buyouts (LBOs). These trends, influenced by high corporate cash balances, are fueling a global boom in equity markets. Thanks to easy access to capital from both the high yield and bank debt markets, cash is being transferred from bondholders to shareholders as Corporate America engages in a re-leveraging campaign.

International developments have also bolstered global liquidity. Solid global economic growth has boosted exports from emerging economies and supported rising commodity prices. The resulting trade surpluses have led to rapid foreign exchange reserve accumulation by central banks in emerging markets (Chart 2), thanks to their determination to maintain competitive exchange rates and build up a cushion against the financial turbulence that has shaken them in the past. Through this dynamic, central banks have supported the U.S. bond market by helping to keep interest rates low, contributing to generous liquidity conditions.

The broader change in global savings patterns has been dramatic. Current account deficits in the emerging world have given way to current account surpluses. Borrowers have turned into lenders. China, now with a current account

Foreign Exchange Reserves Soar



Source: IMF

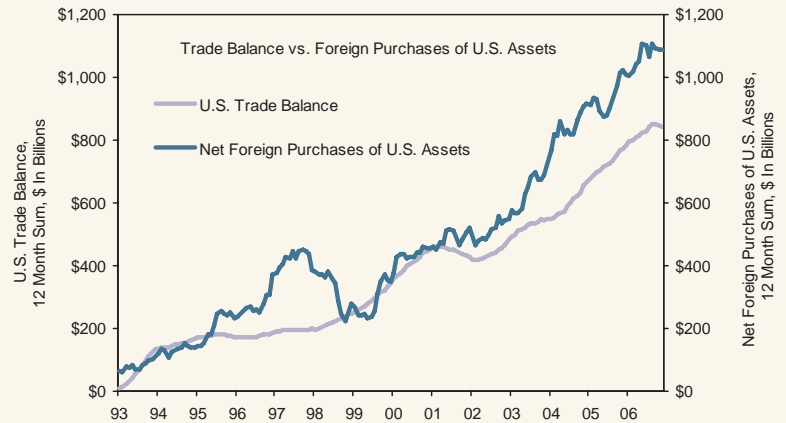
Chart 2

surplus of over 8% of GDP, exemplifies this trend of capital rolling “uphill” from the developing world to the developed world. In addition to Asian savings, the rise in crude oil over the past several years has resulted in massive savings by oil exporters, a large portion of which have flowed into sovereign investment funds in Middle Eastern countries. This phenomenon has enabled the U.S. economy to finance its large and growing current account deficit, which reflects high consumer spending and low savings. America’s consumption is financed by capital inflows from abroad (Chart 3). Foreigners remain comfortable with the U.S. monetary, political and legal system, and view America as an attractive place to invest.

Indeed, foreigners have become the dominant bid in some segments of the U.S. market. In the U.S. corporate bond market, foreigners are increasingly shifting their bond allocations into credit markets, in order to earn higher yields. Due to large foreign capital flows, the credit market is

currently in a state of technical imbalance in which the demand for bonds is greater than the new supply of bonds. Over the past three years, foreign buyers have absorbed more than 100% of the net new corporate bond issuance in the marketplace (Chart 4). Therefore, not surprisingly, credit spreads remain near all-time tight levels.

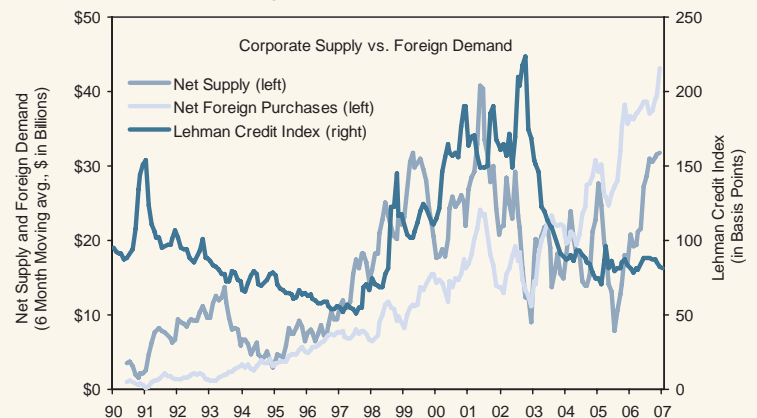
Foreign Purchases of U.S. Assets Continue to Grow



Source: U.S. Census Bureau and U.S. Treasury

Chart 3

Robust Foreign Demand for Corporate Bonds



Source: U.S. Treasury, Thompson Financial and Lehman

Chart 4

Finally, private equity capital and hedge funds have further benefited from a structural shift in the markets, and have helped to provide fresh liquidity into the financial markets. Private equity groups announced \$700 billion worth of deals in 2006, more than double the record set in 2005.¹ Deal sizes are also increasing. The Blackstone Group's recent \$39 billion all-cash purchase of Equity Office Properties (EOP) attests to the liquidity private equity players now have at their disposal. Hedge fund growth has also exploded and there appears to be no near-term end in sight given that these firms are now able to come to the public markets to raise equity to grow their capital base. As an example, Fortress Investment Group LLC recently raised \$634.3 million in equity through an initial public offering (IPO).² Private equity and hedge fund investors, driven by the need to justify lofty management fees, are seeking higher returns by embracing higher risk tolerances. As we discussed in our December 2006 U.S. Credit Perspectives, *Credit Innovation and Opportunity*, the quest for yield has fueled rapid innovation and rising risk in the credit markets.

New pools of capital are also seeking out alternative investments. This trend has fueled significant growth in the financial advisory services industry for mergers and acquisitions, as well as investment management. Not surprisingly, Goldman Sachs has benefited tremendously from these secular changes in the financial markets (Chart 5). Goldman Sachs is not only one of the largest global advisory firms in the world, but it is also

the largest manager of hedge fund assets.³ It is a primary beneficiary of the growth in collateralized debt obligations (CDOs) and credit derivatives, which have acted to expand liquidity in the credit markets through disintermediation and innovation. Goldman Sachs has aggressively moved into private equity capital fund raising, and reportedly just raised \$19 billion through a new fund.⁴ The firm's stock is a reflection of today's global liquidity boom.

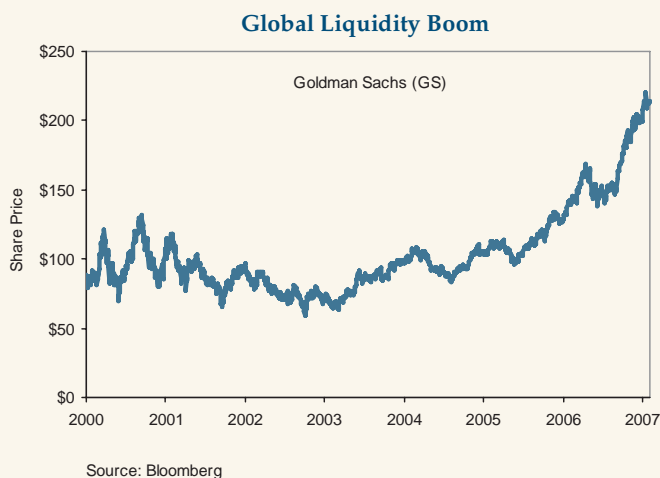


Chart 5

The trends that have contributed to tight corporate bond spreads are having a similar effect on the U.S. stock market. The supply of new stock issuance (Chart 6) has turned sharply negative due to rising share buybacks and LBOs. This technical imbalance, combined with solid economic and corporate profit growth, has helped lift equity prices to record highs. Robust global liquidity combined with reduced supply has changed the landscape of equity investing.

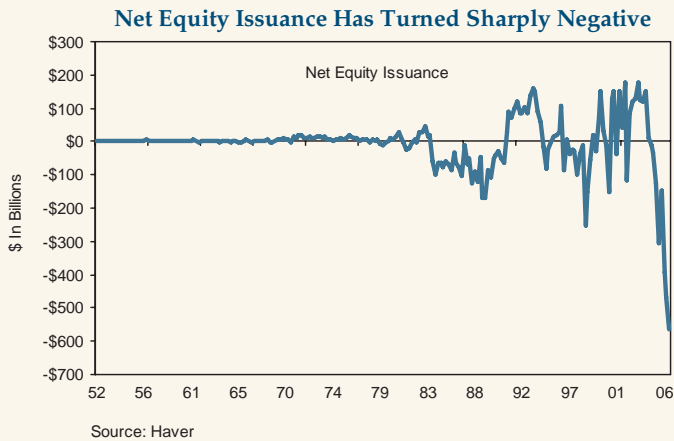


Chart 6

Asset Prices, Risk Premiums and Financial Conditions

The global liquidity boom has its consequences. Rising asset prices are leading to easy credit conditions, which in turn are supporting economic growth, lowering volatility and compressing risk premiums. In this environment, investors with relatively short memories have embraced this recent period of economic nirvana as if it were here to last, by taking on more leverage and adding even riskier investments.

In the credit markets, the low and declining default rate has encouraged a strong propensity to take risk over the past few years. As a result, the growth in global liquidity has increasingly been funneled into higher risk asset classes such as lower-quality investment grade corporate bonds, high yield bonds, emerging market bonds, collateralized debt obligations (CDOs), real estate and equities. This trend further reduces the cost of capital to take on leverage, supports more LBOs and provides additional fuel for the equity market. In fact, LBO volumes have grown at an

annualized rate of 64% from 2002-2006.⁵ We have not seen this type of growth in corporate re-leveraging since the late 1980s. Given these conditions, it is no wonder the Federal Reserve is sounding hawkish. Accommodative financial conditions are providing a stimulus to the economy.

While monetary conditions have tightened somewhat with a higher Fed Funds rate, credit and financial conditions remain easy. These conditions are a significant reason why Moody's consistently has pushed back its estimates for rising default rates (Chart 7). I believe investors are underestimating the risks present in today's low default rate environment, because today's credit markets are significantly impacted by technical factors. I am skeptical that credit spreads are at near all-time tights because of improved fundamentals, especially given the rise in shareholder-friendly initiatives, growth in private equity and increasing occurrence of LBOs.

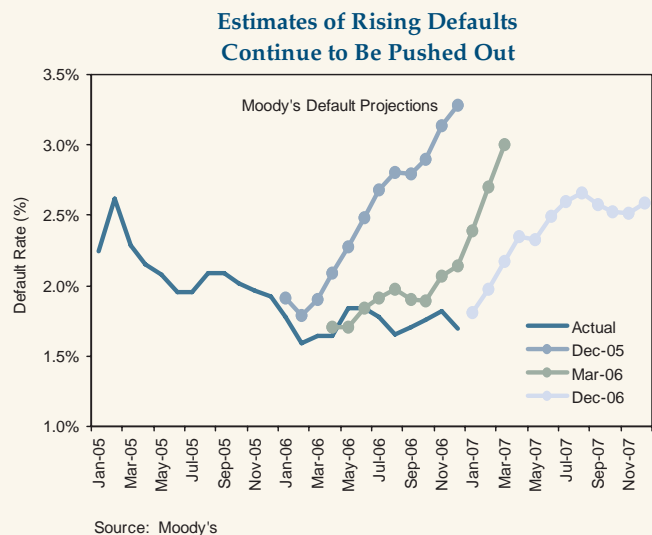


Chart 7

More than likely, today's era of tight credit spreads reflects the strong, powerful technical dynamics discussed above, which must be thoroughly analyzed before investing in the sector.

Implications for Credit Investing

The liquidity-driven boom in today's financial markets has had a significant impact on corporations. Cash continues to pile up on corporate balance sheets, and companies have never before found such easy access to capital, due to a benign credit environment and tremendous growth in the bank debt and private equity markets. Hedge fund growth has also led to strong demand for structured credit risk. These financial sponsors are flooding corporations and markets with new pools of capital. This trend helps to explain why corporate default rates have failed to rise despite projections of higher default rates. Simply put, it is hard to default when investors continue to lend money.

Despite low default rates, the credit market faces significant challenges arising from the growth in private equity and hedge fund capital. Equity-friendly measures, such as LBOs (chart 8), share buybacks, divestitures and mergers and acquisitions are on the rise. In addition, corporate profit growth is slowing, and management is beginning to re-leverage balance sheets in response to increasing pressure from hedge fund and private equity investors. As the pendulum continues to shift from bondholders to equity holders, we should expect shareholder-friendly initiatives to remain elevated.

Easy Credit Has Led to a Surge In Re-Leveraging Deals

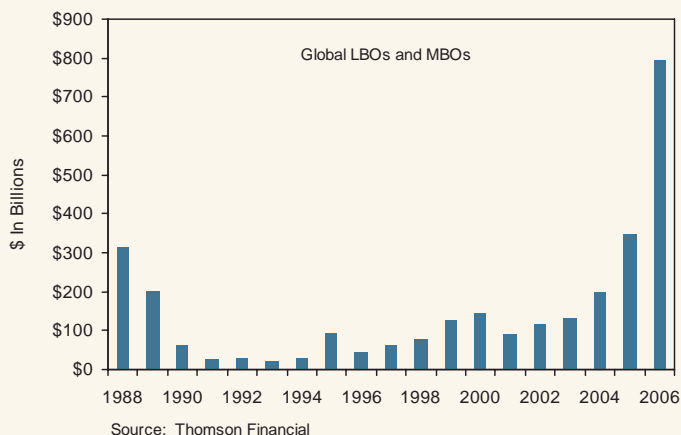


Chart 8

Given these heightened credit risks, PIMCO continues to maintain a defensive bias in managing credit portfolios, by emphasizing corporate bonds with covenant protection issued by companies with hard assets and pricing power. The investment-grade corporate market has seen a sharp rise in new issues with change-of-control language, designed to protect bondholders in the event of an LBO or other change in ownership that could damage credit quality (Chart 9). We view this as a good start, but remain aware that the majority of investment-grade corporate bonds today lacks any form of covenant protection. Given the risks, we remain under-weight investment grade corporate bonds, and are focusing our investments in bonds with covenant protection and in credits that are less prone to re-leveraging events.

Investment-Grade Corporate Bond Covenants On The Rise

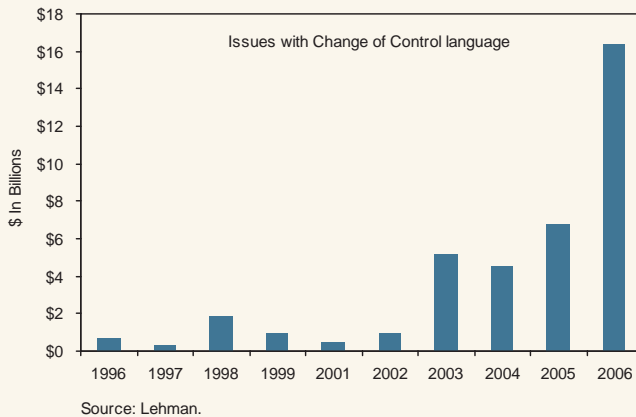


Chart 9

A New Era

For golfers and investors, a new era is upon us, in which players in both disciplines are forced by market conditions to develop a more holistic approach. A commitment to physical fitness is now a prerequisite for today's top professional golfers. Golf, like investing, requires the top players in the world to continually strive to improve their capabilities in order to remain competitive.

Investors are also embracing change in the credit markets. A thorough analysis of the new factors driving the credit markets must now complement traditional, fundamental analysis. Technical considerations, such as liquidity, the emergence of new players, and structural shifts in products and capital flows, now play a large role in determining asset prices. Low default rates and easy financial conditions support the stock market and have helped to tighten credit spreads to new all-time tights.

Despite extremely tight credit spreads on investment-grade corporate bonds, investors continue to seek higher returns by investing further down the capital structure. This classic, late-cycle behavior supports the notion that we are in a liquidity-fueled market in which downside risk far exceeds potential upside returns, particularly for most investment-grade corporate bonds without covenant protection and for lower-rated, high yield bonds.

Just as golfers are taking a more holistic approach by preparing more thoroughly, so too must corporate bond investors in order to face this new paradigm. At PIMCO, we not only employ bottom-up analysis, but we also use a multi-faceted approach, which incorporates the effects of the powerful, technical, and global dynamics in our marketplace. PIMCO's global credit platform positions us to assess these changing conditions and to act accordingly for our clients.

Mark Kiesel

February 21, 2007

¹ Thomson Financial, as of December 2006.

² Bloomberg, February 9, 2007.

³ Hedge Fund Research, as of December 31, 2006.

⁴ Wall Street Journal, February 9, 2007.

⁵ Credit Suisse, S&P LCD.

Past performance is no guarantee of future results. Each sector of the bond market entails risk. Municipals may realize gains and may incur a tax liability from time to time. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed. Mortgage-backed securities are subject prepayment risk. With corporate bonds there is no assurance that issuers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in non-U.S. securities may entail risk as a result of non-U.S. economic and political developments, which may be enhanced when investing in emerging markets.

Investments in Collateralized Debt Obligations ("CDOs") can involve a high degree of risk and are intended for sale only to qualified investors capable of understanding the risks entailed in purchasing such securities. Such securities can principally cause a decrease in income, which result in a decrease in residual profits. If the collateral performs inadequately, investors may lose some or all of the investment and there may be periods where no cash flow distributions are received. Investors investing in CDOs are exposed to risks such as credit risk, default risk, liquidity risk, management risk, interest rate risk, and credit risk by the underlying portfolio.

Portfolios may use derivative instruments for hedging purposes or as part of the investment strategy. Use of these instruments may involve certain costs and risks, including the risk that a portfolio could not close out a position when it would be most advantageous to do so. A portfolio investment in commodity-linked derivative instruments may subject it to greater volatility than investments in traditional securities. Portfolios investing in derivatives could lose more than the principal amount invested.

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