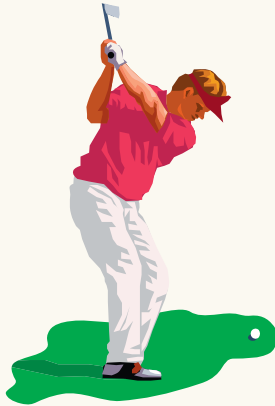


Driver or 2-Iron?

November 2007

Mark
Kiesel



Golf is a game of risk and reward, and golfers face numerous decisions in every round where potential opportunities for upside are balanced against the risk of making mistakes. This point is illustrated perfectly by one of my favorite golf holes on the South Course at Coto de Caza in Orange County. Hole #17 is a short, 300-yard, par 4, with a narrow fairway, thick rough and out of bounds to the left, woods on the right, a water hazard in front of the green, and numerous sand traps surrounding the green. “Hitting driver” here is tempting, but an errant shot can be very costly.

Go for it, or lay-up? In order to make this decision, one must evaluate the upside versus the risks. Going for the green is risky given all the hazards, yet could yield a potential eagle, or two under par. In contrast, a well struck 2-iron off the tee combined with an accurate 100-yard sand wedge usually results in a putt for birdie, or one-under par. Driver or 2-iron? It’s not always clear, and it depends largely on your risk appetite at the moment you’re standing at the tee.

Investors in the credit markets face a similar dilemma in the current environment: should they aim for the green by liberally increasing credit risk, or reach for the 2-iron and tread more conservatively into credit? To answer this question, we need to look at the fundamentals, technicals and valuations that give us insight on both upside and downside in today’s credit markets.

Housing and Profits: Potential “Hazards”

At PIMCO, we have written extensively about fundamentals and leading indicators in assessing economic cycles. In the current environment, we believe housing is today’s leading indicator of economic growth. Due to record new and existing home inventories, tighter lending standards, depressed buyer sentiment and rising adjustable-rate mortgage resets, housing foreclosures are likely to accelerate as delinquencies rise. As a result, house prices are likely to fall, resulting in hits to both consumer and business confidence. Consumer spending growth should slow and, despite a healthy global economy, corporate profit growth will likely soften resulting in slower job creation (Chart 1). Slower job creation leads to further declines in consumer spending, and so on.

Renewal of Risk Appetite: Seeing Only the Putting Green

Although the housing-led economic downturn has clearly begun - complete with slower U.S. growth, the sub-prime crisis and a major credit crunch - its full effect has not shown up yet in the equity markets, in large part due to the lag implied by the cycle identified above. Equities still seem to be propped up by the same factors that have underpinned them in recent years. A weak dollar and robust global growth allowed multinational companies to expand exports. Cost cutting and outsourcing labor to China, India and Eastern European countries helped Corporate America expand profit margins. Easy lending standards and the ability to securitize credit risk through the structured credit markets allowed consumers to take on debt, finance new home purchases, and fund spending. As evidence, mortgage debt grew faster than nominal GDP over the past decade (Chart 2).

In fact, by observing equity markets around the world, risk appetite in the current environment appears entirely robust, with stocks near or at new highs thanks to abundant liquidity, strong profit growth

Weaker Profit Growth Leads to Softer Job Creation

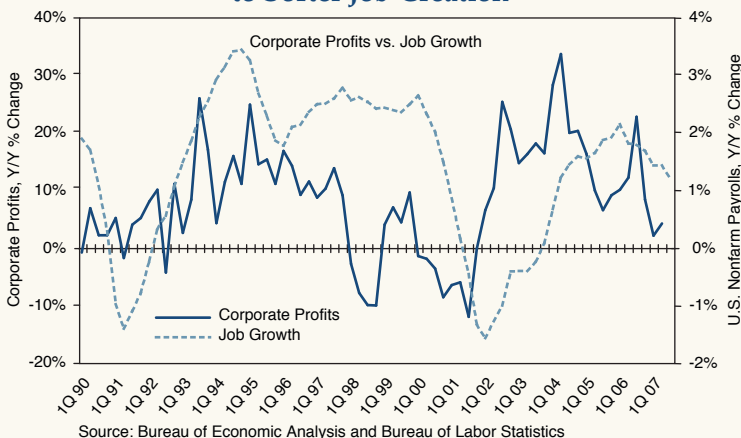
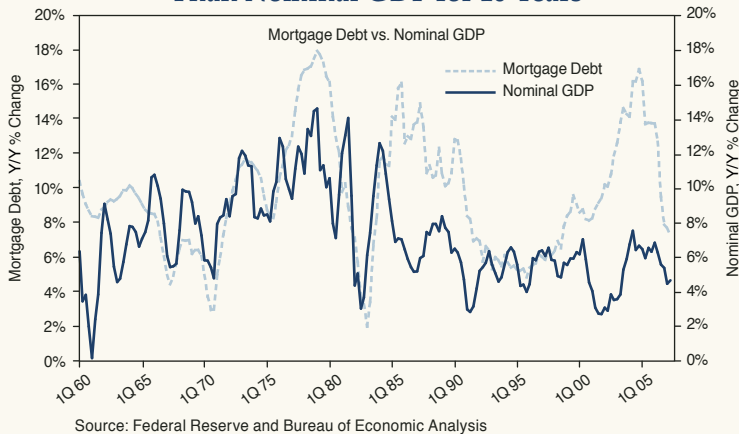


Chart 1

Mortgage Debt Has Grown Faster Than Nominal GDP for 10 Years

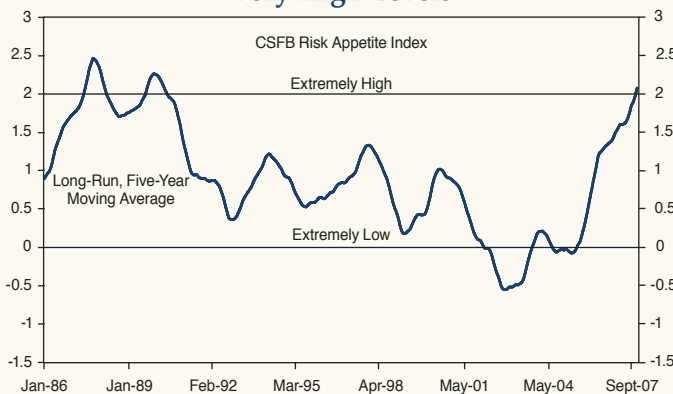


Source: Federal Reserve and Bureau of Economic Analysis

Chart 2

and healthy economic growth. In the U.S., the stock market is being supported by the weak dollar, recent interest rate cuts by the Federal Reserve, and optimistic earnings projections. Equity volatility has declined and commodity markets are hitting new highs, which appear to be giving an “all clear” signal. Risk takers are back across all markets (Chart 3).

Risk Appetite Is at Very High Levels



Source: CSFB

Chart 3

Reaching for the Wrong Club?

In our belief, the hope for continued strength in stocks and double-digit earnings expectations for next year argue that investors are “hitting driver,” perhaps without seeing all the hazards. Going forward, the outlook for corporate profits looks less promising. Easy credit conditions of the past are changing dramatically, with banks writing off loans, increasing loan loss reserves and cutting back significantly on extending credit to both companies and individuals. This is critical as credit extension goes hand-in-hand with economic growth and, ultimately, corporate profits and stock valuations.

And there are signs that problems in the credit markets may get worse before they get better. Another wave of rating-agency downgrades is likely in both mortgage-backed securities and structured investment vehicles (SIVs). Pressure on conduits and SIVS could then lead to further freezing up in the money markets. Banks may be forced to take commercial paper back on their balance sheets that they did not plan on. This will result in a further tightening of credit extension and further exacerbate housing problems and corporate profits.

In credit markets, the period of sub-par economic growth underway will have significant implications. Why? A slower pace of economic growth tends to lead to a rise in the corporate default rate (Chart 4). Once defaults start to rise, risk appetite should decline further and markets will likely become less liquid.

Slower Economic Growth Leads to Higher Defaults

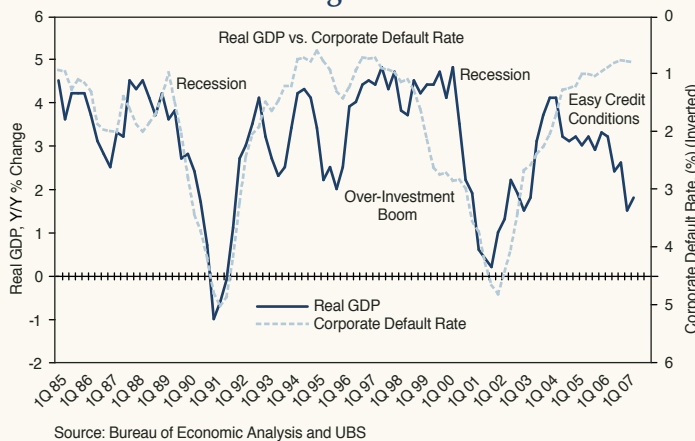


Chart 4

Banks & Lenders: Rising Caution

The large debt overhang in recent years was sustainable so long as banks were willing to lend, structured credit markets provided liquidity and housing prices rose. Of course, those factors changed radically in August. While the Federal Reserve will likely lower the Fed Funds rate considerably in this environment, I don't believe the risk appetite to extend credit to individuals

and companies will resurface anytime soon amid falling home prices and slowing corporate profits. Financial sector write-downs will likely continue into next year given declining asset quality, and banks will likely be increasing loan loss provisions. Not exactly the best environment for fostering lending and risk taking. The Federal Reserve loan officers' survey confirms these trends (Chart 5).

Banks Are Tightening Lending Standards, Particularly on Mortgage Loans

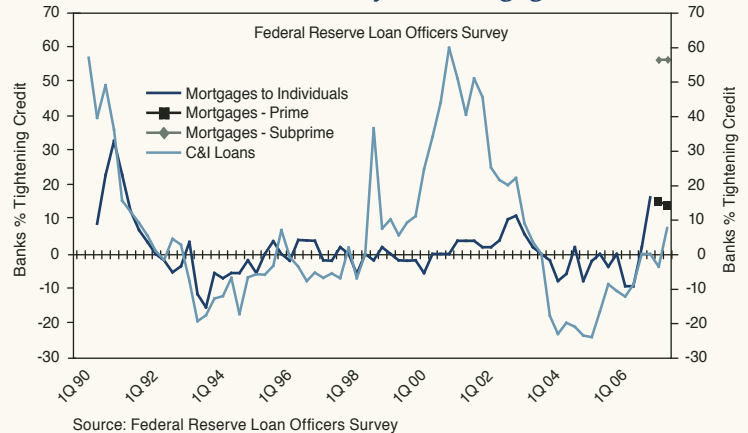


Chart 5

New Supply: A Negative Technical and Potential Opportunity

At this point, banks still have a significant amount of credit risk exposure in the form of SIVs, bridge loan commitments to corporations, and sub-prime mortgage, credit card and other housing and consumer-related loans to individuals. To deal with this overload of risk, banks have

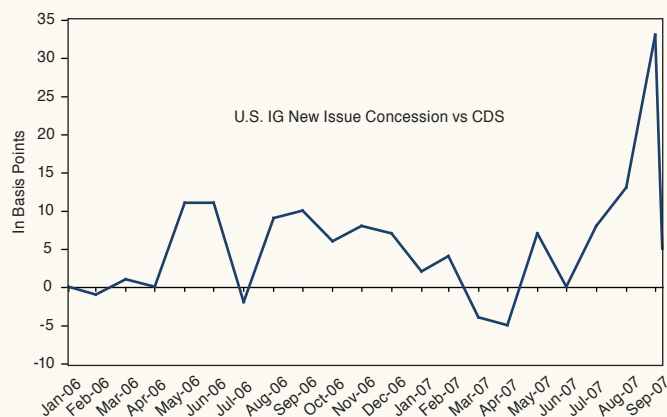
two options: tightening lending standards or off-loading credit exposure. Tighter standards are already in play, but banks will increasingly offer investors a piece of the action by “termining out” bank loan commitments in the secondary market, and issuing corporate bonds to fund growing and unforeseen credit commitments.

Increasing corporate bond and bank loan issuance in the market is a negative risk factor facing the credit markets, because it raises supply relative to demand, pushing prices lower. Nevertheless, where there is risk there may be potential opportunity. In late July through the end of September, PIMCO added tens of billions of investment-grade corporate bonds at attractive valuations through the new issue market, as uncertainty caused companies to offer significant new issue concessions (Chart 6) to clear deals. Today, with credit spreads tighter and new issues offering smaller concessions, we are being more selective.

Assessing Relative Value: Cash vs. CDS/CDX

While new issue concessions have decreased from September’s peak levels, cash bonds remain “cheap” relative to credit default

New Issues “Cheap” to CDS

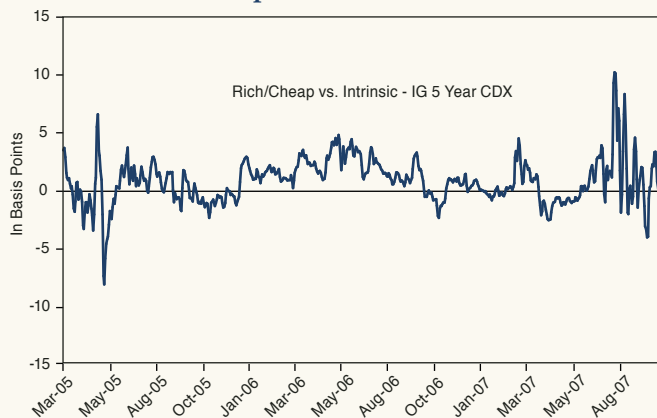


Source: Barclay's (1/06-9/07). PIMCO Estimate (10/07).

Chart 6

swaps (CDS). The cash, or secondary, market has re-priced at wider spreads over the past several months, resulting in supply and demand imbalances for new issues. Another factor cheapening secondary cash bonds was selling by Wall Street dealers that were paring back balance sheets and overall risk. As cash bond prices fell, investors had also gone short credit in the CDS market. But following the Federal Reserve’s surprise 50 basis point cut in the Fed Funds rate on September 18, a good deal of fear in the market dissipated. As equity markets rallied, fast money investors in the credit markets moved aggressively into the more liquid CDS and credit default swap indices (CDX) by selling protection, causing CDS and CDX to become “rich” versus cash corporate bonds.

CDX Is No Longer "Cheap" vs. Intrinsic Value



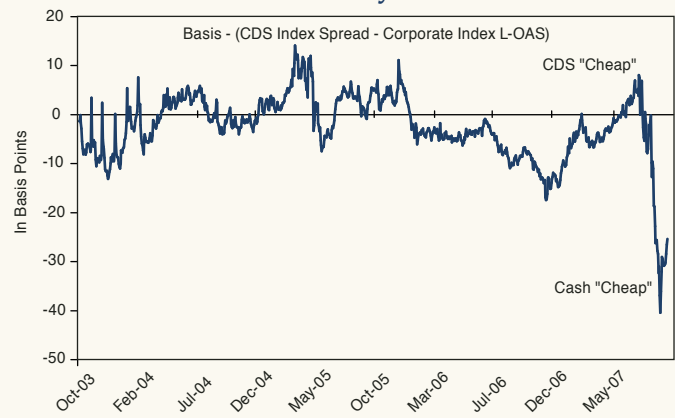
Source: PIMCO

Chart 7

PIMCO has been taking advantage of this recent pricing disparity by buying relatively cheap cash bonds in the new issue market, and reducing credit risk in less attractive CDX contracts. Our pro-active, tactical decisions to move into cheap assets and out of rich assets have been critical in helping the performance of many of our portfolios. Back in early July, we added CDX near the widest spread levels, when CDX was trading both “cheap” to the underlying CDS contracts (Chart 7) and “cheap” to cash corporate bonds. Now, with CDX at roughly fair valuation versus underlying CDS, it is less compelling, and cash bonds look more attractive vs. CDS (Chart 8).

PIMCO’s relative value approach in credit mirrors the approach we take in other

Cash Bonds Have Cheapened Considerably vs. CDS



Source: Lehman

Chart 8

fixed-income products such as treasuries, swaps and mortgages. We are constantly moving into and out of cash and derivative products, towards “cheap” assets and away from “rich” assets. Our ability to take advantage of dislocations in the market by leveraging our global resources remains a key competitive edge. Our credit derivative specialists monitor CDS/CDX valuations daily, while our credit analysts and portfolio managers seek out attractive relative value trades between cash and CDS/CDX. Through our dedicated and focused efforts, we seek to gain credit exposure in the most cost effective manner for our clients.

Driver or 2-Iron?

In the credit markets, the decision to hit driver or 2-iron is not an easy one given

today's uncertainty. Some investors appear to be holding a driver in their hands, sitting on significant liquidity, effectively in a risk-seeking mode with eyes on healthy global growth. Yet, other lenders are signaling a more cautious 2-iron off the tee, tightening credit standards due to concerns over housing, asset values and corporate profit growth.

At PIMCO, we will continue to evaluate new issue and secondary opportunities in the credit markets with a close eye on fundamentals, technicals and valuations. In particular, we are expecting to see opportunities arise as over-extended players seek to reduce risk exposure.

Our global credit team of 31 analysts and our top-down investment process allow us to evaluate each opportunity independently. In addition, our credit derivatives specialists help to determine if we are taking credit risk in the cheapest securities. Hitting driver or 2-iron depends uniquely on each situation. Fortunately, our experience investing in credit markets gives us the confidence to make those decisions, and we look forward to evaluating each opportunity in the credit

markets and, as always, investing in the most attractive assets for our clients.

Mark Kiesel

October 24, 2007

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