

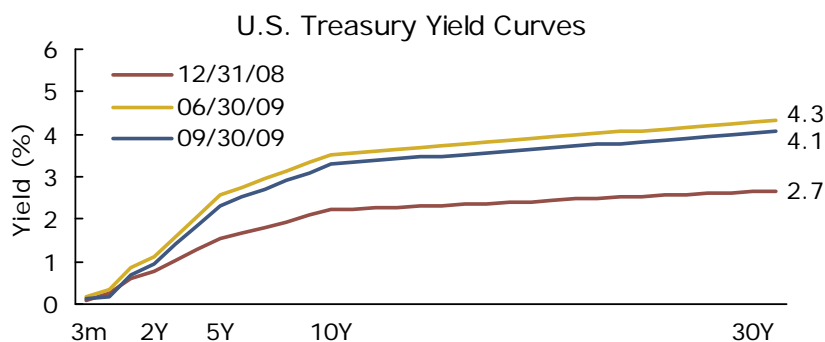
PIMCO – Third Quarter 2009

Market Commentary, Outlook and Strategy

Market Commentary

Economy Continues to Stabilize; Abundant Slack Remains

Financial markets and the broader economy continued to stabilize during the third quarter after the extraordinary events of last year. The Barclays Capital U.S. Aggregate Index, a widely used index of U.S. high-grade bonds, returned 3.74 percent during the quarter. Treasury yields were less volatile than in the first half of 2009 and fell across maturities. The yield on the benchmark 10-year Treasury ended the quarter at 3.31 percent, down 23 basis points from the end of the second quarter. See the graph below for recent movements in the Treasury yield curve:



SOURCE: Bloomberg Financial Markets

Policy initiatives - such as the Federal Reserve's purchase of mortgage and Treasury securities, the government's support for consumer finance markets and near-zero short term rates - helped revive risk appetites and were the major factors behind enhanced stability. Two key programs were extended during the third quarter.

The Fed committed to complete its \$1.25 trillion program to buy mortgage-backed bonds and extended the end date of the program to March 2010 from December 2009. Massive purchases of mortgages from this program, roughly two-thirds complete by quarter-end, helped hold down mortgage rates and supported the fragile housing market. The Fed and the Treasury also announced the extension of the Term Asset-backed Securities Loan Facility, or TALF program, which provides financing to investors buying consumer asset-backed securities. (ABS) Originally set to expire in December of this year, TALF was extended through March 2010 for consumer ABS.

Manufacturing and housing data showed improvement in the third quarter, suggesting that the recession was close to an end. Even so, substantial slack remained in the economy, leading the Fed to announce that it would keep the federal funds rate near zero "for an extended period." The unemployment rate moved closer to 10 percent, making any revival in consumer spending highly unlikely. Businesses continued to draw down inventories, albeit at a slower rate than earlier in the year. Industrial capacity utilization hovered near record lows at below 70 percent,

discouraging new investment. Policymakers faced with these dismal fundamentals were in no position to contemplate withdrawal of stimulus programs any time soon.

Riskier Assets Extend Gains Despite Fragile Economy

Valuations of corporate bonds, mortgages and asset-backed securities continued to richen in the third quarter. These gains were supported less by fundamentals than by positive technical conditions and government policies that helped push investors out of cash and toward higher yielding, riskier assets. The following summarizes fixed income sector returns:

- Agency mortgage-backed securities (MBS) continued their powerful rally during the third quarter, outperforming like-duration Treasuries. The success of the Fed's MBS Purchase Program compressed mortgage yield premiums to the narrowest levels ever seen when measured versus interest rate swaps. Non-Agency mortgages also rallied. A lack of new issuance over the last two years and anticipation of demand from the Public Private Investment Program drove non-Agency prices higher. Consumer ABS enjoyed strong gains versus like-duration Treasuries, owing to robust demand for TALF assets and the re-emergence of unlevered cash investors such as pension funds and insurance companies.
- Corporate bonds, especially high yield credits, were among the best performing fixed income assets during the quarter, buoyed by highly favorable market technicals. Credit premiums continued to tighten and approached levels last seen in 2007 as fund flows into corporate credit were very strong and the supply of available bonds began to contract slightly after years of growth. These circumstances benefitted lower-rated credits the most. Performance was strongest in the financial sector, which gained from improved asset valuations, a continued steep yield curve and increased fee-based income as capital markets revived.
- Municipal bonds outperformed Treasuries by a wide margin during the quarter. Municipal yield ratios relative to Treasuries moved closer to historical averages after widening dramatically last year. As with corporate bonds, technical factors were positive in the municipal market. Inflows into municipal funds remained strong amid heightened expectations for future tax increases. Municipal new issue supply was relatively modest as issuance was diverted into taxable Build America Bonds.
- Treasury Inflation-Protected Securities (TIPS) outperformed their nominal counterparts during the third quarter, supported by positive inflation accruals and lower real yields across most of the maturity spectrum.
- The rally in emerging market (EM) bonds continued in the third quarter. EM bonds denominated in U.S. dollars outperformed Treasuries as credit premiums tightened on most bonds amid an increase in risk appetites and positive flows into the EM sector. EM assets denominated in local currencies also had strong returns, led by monetary stimulus in most EM countries. EM currency appreciation also helped boost returns of EM local assets.
- Yields on government bonds fell modestly in most developed markets during the quarter as concerns about the extent of global economic recovery lingered. Interest rate volatility generally decreased from recent periods. Among developed markets, U.S., U.K. and Eurozone bonds fared the best.

Market Outlook

Recovery To Be Weak in 2010 After Temporary Boost

PIMCO believes that the most likely outcome for the U.S. economy will be a weak recovery in 2010 after a temporary boost in the latter half of this year. On the downside, the U.S. could slip back into recession sometime next year. Emerging economies, especially China, should continue to grow at a faster pace than the developed world, helped by aggressive stimulus policies. The rationale for our forecast is outlined below:

- **Limits to U.S. Growth** – A slower pace of inventory drawdown by businesses and positive effects from stimulus programs should support growth in the third and fourth quarter of this year, but this boost will not be sustainable. The reasons include: excessive levels of consumer debt and an expected increase in savings to work these levels down; a stubbornly high unemployment rate; and weak business investment in the face of record lows in capacity utilization.
- **Muted Monetary Policy** – PIMCO expects the Federal Reserve to retain near-zero policy rates for some time. Even so, the impact of low rates and the Fed's huge liquidity injections may be largely muted by overleveraged consumers' reluctance to borrow.
- **Weak Recoveries in Europe, U.K. and Japan** – The rest of the developed world is expected to face similar challenges with the sustainability of demand into 2010. In Europe, large public debts and economic linkages to the U.S. and U.K. are likely to impose constraints on recovery. Japan's recovery will face limits arising from its reliance on U.S. demand for its exports, especially autos, and weak capital spending as capacity utilization rates remain low.
- **China to Grow Faster** – China is likely to grow far faster than more developed economies. Its fiscal stimulus has been especially large to compensate for a decline in exports. A surge in infrastructure investment has readjusted China's GDP back toward its critical growth target of 8 percent.
- **Bifurcated Emerging Markets** – Emerging economies overall are showing signs of a rebound. PIMCO believes that EM economies that are more reliant on external demand – such as Korea, Mexico and Russia – will face greater headwinds for sustained recovery. Countries driven more by internal demand – including Brazil and India – would appear to be more resilient.
- **Tame Inflation** – Substantial excess capacity in labor and product markets should keep inflation low over a cyclical time frame. Over the longer run, inflation risk may be heightened by the massive liquidity the Fed has injected into the financial system. For now though, transmission of that liquidity into the broader economy will continue to be constrained by strong demand for cash among financial institutions and consumers eager to pay down debt.

Tactically Scale Back Risk as Valuations Richen

PIMCO will tactically reduce risk exposures in portfolios following powerful rallies in non-Treasury sectors driven primarily by favorable technicals and government policy. We believe this approach will protect portfolios in the event the economy slips back into a recession and should allow PIMCO to reinvest at more attractive valuations later.

- **Interest Rate Strategies** – We will target above-index duration. While shorter maturity yields are unlikely to move much from current lows, there could be downward pressure on longer maturity yields should the economy weaken over the next year. PIMCO will retain money market futures positions in the U.S., Europe and U.K. as we anticipate that central banks will tighten more slowly than markets expect.
- **Move Toward An Underweight in Agency Mortgages** – PIMCO's significant overweight to high quality Agency mortgage-backed securities (MBS) has recently been strongly positive for returns. With MBS valuations having richened substantially and the Fed's mortgage purchase program slated to end in March of next year, PIMCO will move to an underweight in an effort to benefit from an expected cheapening of Agency MBS. To help offset any loss of yield from this move, PIMCO will seek to collect premiums from written options on fixed income securities.
- **Reduce Corporate Bond Holdings** – We also will look to trim corporate bond positions into the current rally, especially those that have appreciated most such as senior bonds of high quality banks. While PIMCO will underweight the corporate sector overall, we will retain an emphasis on recession-resistant sectors such as telecom and utilities as well as energy.
- **Emerging Markets and Currency** – PIMCO will take exposure to high quality EM credits such as Mexico, Brazil, Korea and Russia, which have relatively little debt coming due in the near future and a high level of reserves. We will take similar positions in EM currencies, with the exception of Russia, and also take exposure to the Chinese yuan, anticipating that faster growth in these economies should allow their currencies to gain versus the U.S. dollar.
- **Municipals and TIPS** – We will continue to sell tax-exempt municipal bond positions, especially longer-dated issues, which have rallied along with other non-Treasury assets. While TIPS offer a potential hedge against long-run inflation risks, their valuations compared to nominal bonds are unappealing over a cyclical time frame. As a consequence, our TIPS holdings will be relatively light.

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Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than their original cost when redeemed. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally backed by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations. Investing in non-U.S. securities involves heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax. A strategy concentrating in a single or limited number of states is subject to greater risk of adverse economic conditions and regulatory changes. Inflation-linked bonds (ILBs) issued by a government are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise.

The S&P/Case-Shiller Home Price Indices measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan region across the United States. In addition, the S&P/Case-Shiller® U.S. National Home Price Index is a broader composite of single-family home price indices for the nine U.S. Census divisions and is calculated quarterly. It is not possible to invest directly in an unmanaged index.

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