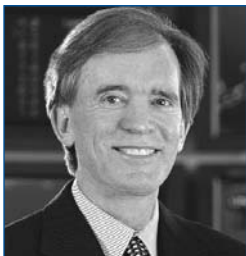


Investment Outlook

by PIMCO's Bill Gross

BEEP BEEP!



Bill Gross
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The current financial and economic crisis is difficult to appreciate, not only for the drop in elevation, but because of the swiftness of the declines. It's been a Wile E. Coyote 12 months—straight down like a dead weight. A year ago, global equity prices were nearly twice today's levels and recession was only a whisper on the lips of the gloomiest of economists. Today, descriptions drawing parallels to the Great Depression make it obvious that a major shift in economic growth and its historic financial model, as well as policy prescriptions for its revival, are underway. Most of the world's connected economies and its citizens are in shock, conscious but not fully aware of the seismic shifts that will unfold in future years.

PIMCO's thesis for several years has held that the levered global economy long ago morphed from a banking-dominated regime to one that hid behind securitized lending and structures resembling a "shadow banking" system. SIVs, hedge funds, CDOs and increasingly levered mortgage and investment banks fueled asset appreciation in all investment markets, which in turn propelled real economic growth and employment to unsustainable levels. But, with U.S. housing prices as its trigger, the delevering process did a Wile E. Coyote and headed over the cliff in mid-year 2007, dragging down almost all asset prices except government bonds. The real economy followed shortly thereafter, not just in the U.S., but globally, proving that linkages work on the "down" as well as the upside. **To PIMCO, the remedy for this deflationary delevering and mini-depression is simple and almost axiomatic: stop the decline in asset prices.** If that can be done, the real economy will level

out as well. When home prices stop going down, newly created households will be more willing to take a chance on ownership as opposed to renting. If stock prices consolidate, recently burned investors will be more willing to invest, as opposed to stuffing their 401(k) mattresses with Treasury bills. Business investment, jobs, and profits should follow quickly behind.

The simplicity of the solution, however, is not easily achieved once deflationary momentum takes hold. Animal spirits, once dampened, are hard to reignite; "fear of fear itself" dominates greed. Under such circumstances, the benevolent hand of government is required and Keynes is reincarnated in an attempt to plug the dike via fiscal spending and imaginative monetary policies that support asset prices. PIMCO has recently been contracted to assist in several publically announced programs which have helped in that effort: the CPFF, which has benefitted commercial paper yields, and the Federal Reserve's purchase program for agency-backed mortgage loans, which has lowered 30-year mortgage rates to 4.5% and fostered the affordability of new and secondary housing prices. These two programs, in our opinion, have been the major policy successes to date—not because of our involvement—but because they have supported and increased asset prices whose decline has been the major deflationary thrust behind the real economy. Stop asset prices from going

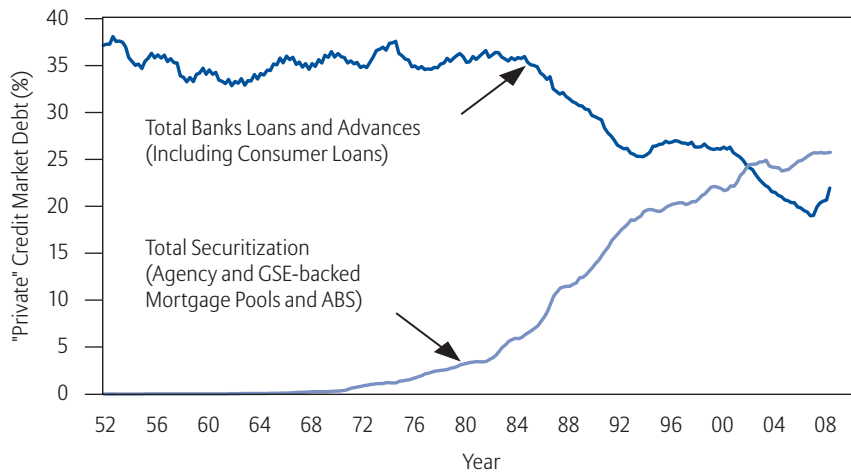
down and with a 12-month lag, unemployment will stop going up, and President Obama’s targeted three million new jobs will have a fighting chance of being achieved.

But stopping the decline of asset prices can be and has been attempted in numerous, seemingly uncoordinated ways. Recapitalization of the banks has been the **major** thrust, in the hopes that banks would extend credit which would reinvigorate asset pricing. Those who argue strongly for a recapitalization of the banking system, however, may be missing the distinction

between the banking system as we once knew it, and the “shadow banking” system that superseded it. Jim Bianco, who heads up the research tank bearing his own name, brought the difference to mind in a recently produced piece entitled, “When Will The Banks Start Lending?” His conclusion was that banks already were – lending—but it was the “shadow system” (my words) that was holding up the parade. According to his analysis, shown in Chart 1, securitization has for several years exceeded bank loans as a percentage of private credit market debt. In contrast to recent headlines, however, banks **have** been picking up their lending, but it has been the “shadow banks” that have faltered. That makes sense. While banks may have tightened their lending standards, fresh capital from the TARP has made it possible to make new loans. The shadow banks, however— hedge funds, investment banks, and structured financial conduits—have been forced to delever as government funds have been directed to more visible institutional lenders. Granted, Goldman Sachs and Morgan Stanley have been TARP recipients, but only under the conditions of downsizing and degearing on their way to becoming regular banks, which have cut their holdings of assets significantly in percentage and actual dollar terms. It should not surprise, therefore, that with the exception of specifically directed government programs directed at commercial paper rates and 30-year mortgage yields, past policies have been unsuccessful. Banks have been recapitalized—yes—and banks have cautiously started to lend. But shadow banks are still delevering due to disappearing and unavailable fresh capital and, as they do, they continue to drag asset prices with them. PIMCO’s Ramin Toloui has produced Chart 2 which correlates the contraction in household debt to the decline of the securitization market. He estimates that there is a one trillion dollar hole that needs to be filled by policymakers in this area alone.

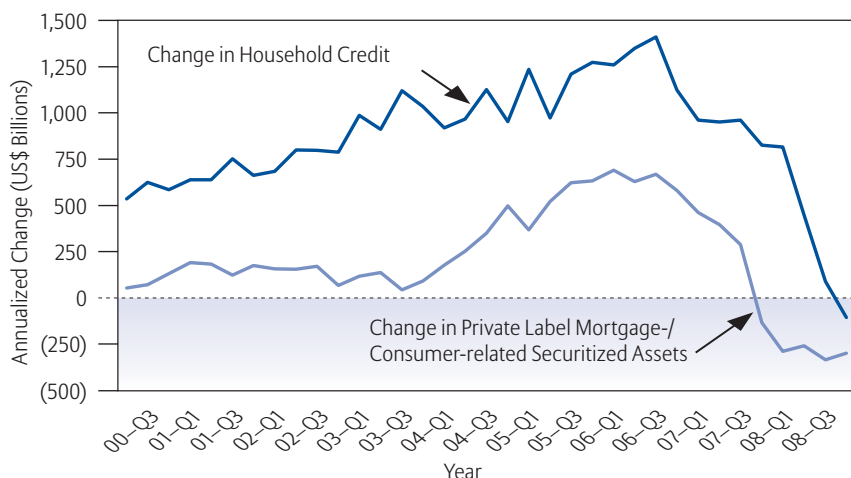
Stressing the importance of the shadow banks is not the same thing as suggesting that they should be next in line for government largesse and bailouts. Lord knows, the Obama Administration is not going to bail out hedge funds, CDOs, private equity firms (Cerberus?), or Donald Trump. There are levered risk takers that will be, and should be, allowed to fail. But in permitting failure,

CHART 1
The Shadow Knows



Source: Federal Reserve Board ©1990, 2009 Bianco Research, L.L.C. All Rights Reserved. This chart is not indicative of the past or future performance of any Allianz Global Investors product.

CHART 2
Trillion Dollar Sinkhole



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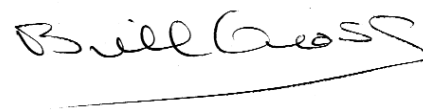
policymakers must still be cognizant of the need to support asset prices—hopefully by inducing confidence and trust in private investors, as pointed out by Robert Shiller in a recent *Wall Street Journal* op-ed, but if need be by the financing or purchase of assets themselves. It's not so much that the stock market needs to go back to 10,000. That would be nice for millions of 401(k)s that have been cut in half over the past 12 months, but it is not likely. Rather, asset prices securitizing commercial real estate and credit card receivables, as well as plain old-fashioned municipal bonds, must stop going down if the real economy has any chance to revive by 2010.

Example: CMBS or commercial real estate mortgage-backed securities are now priced to yield over 12% vs. 5% in recent years. As real estate financing comes due and rolls over in the next few years, it is imperative these yields return to mid-single digits if shopping centers, retail malls, and office buildings are to remain viable. How best to bring those yields down is debatable: another CPEF-like structure with self-insurance and contributed fees as its equity backstop? A generous portion of remaining TARP billions providing a reserve cushion for Federal Reserve funding? A good bank, bad (aggregator) bank structure? **All three are being debated by policymakers and we should have clarity within a week's time.** But one thing is certain: an economic recovery is dependent upon commercial real estate prices stabilizing and most retail stores staying open for business in the months and years ahead.

Similarly, municipal yields are now trading at nearly twice their Treasury counterparts, implying that municipal bonds are trading at 80 cents on the dollar instead of 113 cents like the average Treasury. To enable states and cities to return to normal functioning, those bonds must return to par. Modern day capitalism depends on the successful refinancing and issuance of securities at a price and yield level not significantly divorced from past experience. **That is the same thing as saying that current yields must come close to matching the economy's embedded cost of debt if default is to be avoided.** Not only municipalities, but

the efficient operation of hospitals, nursing homes and even universities depend on the leveling and returning of municipal bond prices to higher levels. Similar arguments can be made for corporate bonds as well.

PIMCO's advice to policymakers is as follows: you can't bail out everyone, yet economic recovery is not possible unless certain critical asset sectors are not only relieved, but rejuvenated in price. The prior Administration's focus on the banks has been critical but unidimensional. The shadow banking system with its leverage and financial innovation, powered a near 25-year global economic expansion, but it is the delevering of those hidden quasi-banks that is now threatening its petrification. Policymakers should not focus entirely on one-off bailouts of large real estate developers, municipalities, or even credit card issuers like they have with Citi, BofA, and AIG. Rather, they should recognize that supporting critical asset prices such as municipal bonds, CMBS, and even investment grade corporate bonds is a necessary step towards eventual economic revival. **Capitalism at its philosophical and practical center depends on credit, and while new loans can be and are being advanced via the banking system, it's a much more difficult task to force shadow banks to lend. That lending depends on securitization which in turn depends on stable and eventually higher asset prices than currently exist.** The original focus of the TARP was on asset prices, but the prior Administration quickly lost its way or perhaps its nerve. Like his Road Runner nemesis, Wile E. Coyote must now extend some infrequently used figurative wings to avoid the deflationary precipice below. Support asset prices. Beep Beep!



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Managing Director

About the Author

Bill Gross is Co-Founder and Managing Director of PIMCO, one of the country's foremost fixed income managers with a client list that includes many of the largest U.S. corporations. Regarded by many as America's most influential authority on the bond market, Mr. Gross makes frequent appearances on TV and in the business press.

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