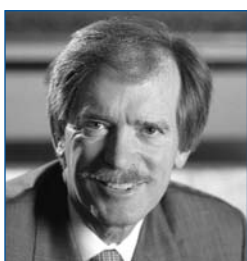


Investment Outlook

by PIMCO's Bill Gross

Grim Reality



Bill Gross
Founder and CIO,
PIMCO

Life, it seems, has become one giant reality show—or is it vice versa? Which is truth and which is the illusion, or have both simply morphed into a uni-consciousness that feeds off information from different computers—one the living kind with two arms and two legs, the other more stationary with a plasma and keyboard. My Apple screensaver for instance features a stunning series of pictures of our galaxy and beyond, from detailed midnight close-ups of the moon's craters to spinning supernovas of unimaginable beauty. While everyone "knows" that those objects are really "out there," it's possible to admit that they're also in "there." My legs, like Thoreau's at Walden Pond, can take me outside at midnight to perceive nature from one perspective, or my hands like Carl Sagan's can move a computer mouse to perceive it from another. Deciding which is the reality though is not straightforward because both are visual images that enter my consciousness as a series of "bits." It's only my past experience that commonsensically points to the "out there" as real and the "in there" as an illustration. If I'd been raised and confined in a room with nothing but a computer, the tilt of perception would most likely be in the other direction.

Am I really suggesting that life might lie within "2001's" HAL as well as on Walden Pond? Modernity is certainly moving in that direction. There is an online virtual world of its own called *Second Life*, one of many metaverses that can now be accessed via the Internet. On it, or in it, inhabitants can create another life for themselves that goes beyond just the playing of a video game. Inhabitants are displayed as avatars capable of communicating and relating to other avatars in cyberspace. They can walk, cohabit, start businesses, buy homes—in short do just about anything someone can do "out there." An IBM spokesman, whose company is leading this invasion into a second world, is quoted in the *Financial Times* as saying "These are real people. Sometimes people see an

avatar and think they are watching an animated movie. They are not. Behind every avatar there is a person." Have you messed up your first life? Why not try a second one. Get a different job, buy another house, become the Henny Youngman of cyberspace—"take my wife—please"—and exchange her for a new one. Success and that illusive happiness can be just around the virtual corner. All very confusing isn't it. Old worlders would say it's just a game, because you can't touch its images. New worlders would say it's a reality because everything's just bits of information streaming into a consciousness. They might not have had computers at Thoreau's Walden Pond, but they do in 2007, and the mystery of life and what defines living somehow has become ever more complex.

Such complexity is also evident in the financing of the U.S. housing market. Long ago and far away there used to be an old "20% down" reality that morphed somehow into a subprime/Alt A cyberspace free-for-all (literally "free for all"). Talk about a second life! U.S. homeownership has expanded from 65% to 69% of households since the turn of the century, in part because it became so easy, and so cheap to finance a home. No avatars in that bunch—they were living, breathing U.S. citizens who yes, might knowingly or unknowingly have taken advantage of "low doc" or "no doc" applications, who might have taken out a "liar loan" in the face of "full disclosure" documentation required of their mortgage lenders, or who simply might just have jumped on board the 1% Fed Funds financing train of 2003. No matter. They bought a house, began living the American dream by making money with someone else's money, and expected to live happily ever after.

Well, not so fast, at least for some of them, it seems. Home prices, as measured by the National Association of Realtors, have gone down by 2% nationally over the past 15 months and there's fear in the air that it could get worse. It most assuredly will.

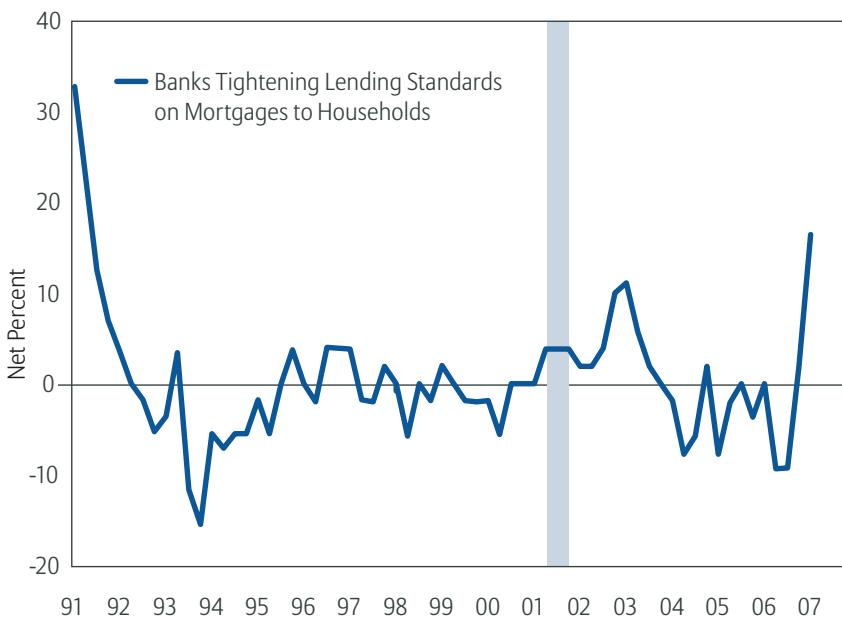
The problem with housing, however, is not the frequently heralded increase in subprime delinquencies or defaults. Of course write-offs, CDO price drops, and even corporate bankruptcies of subprime originators and servicers will not help an already faltering U.S. economy. But foreclosure losses as a percentage of existing loans will be small and the majority of homeowners have substantial amounts of equity in their homes. Because this is the reality of our U.S. housing market, analysts and pundits now claim we're out of the woods: the subprime crisis is or has been isolated and identified for what it is—a small part of the U.S. economy.

It will not be loan losses that threaten future economic growth, however, but the tightening of credit conditions that are in part a result of those losses. To a certain extent this reluctance to extend credit is a typical response to end-of-cycle exuberance run amok. And if one had to measure this cycle's exuberance on a scale of 1–10, double-digits would be the overwhelming vote. **Anyone** could get a loan because shabby credits were ultimately being camouflaged within CDOs that, in turn, were being sold to unsophisticated foreign lenders

in need of yield as opposed to 1/4% bank deposits (read Japan/Yen carry trade). But there is something else in play now that resembles in part the Carter Administration's Depository Institutions and Monetary Control Act of 1980. Lender fears of potential new regulations can do nothing but begin to restrict additional lending at the margin, as will headlines heralding alleged predatory lending practices in recent years. After doubling over 18 months between 2005 and the first half of 2006, non-traditional loan growth has recently turned negative, and lenders' attitudes are turning decidedly conservative as shown in Chart 1.

Bulls and bears argue over websites as to the percentage of **all** lending that subprime and alternative mortgage loans provide but while important, the argument obscures the critical conclusion that tighter lending standards and increased regulation will change the housing outlook for some years to come. **As past marginal buyers are forced to sell their home to prevent foreclosures, so too will future marginal buyers be restricted from buying them.** No one really knows the amount that homes must fall in order to balance supply and demand nor the time it will take to do so, but if one had to hazard a conclusion, it would have to be based in substantial part on affordability statistics that in turn depend on financing yields and home price levels in a series of different scenarios as outlined in Chart 2. The chart shows the amount that home prices or mortgage rates (or a combination of the two) need to decline in order to revert back to affordability levels in 2003, a year which might have been the last to be described as a "normal" year for home price appreciation. Since then, 10+ annual gains have been the rule whereas average historical estimates provided by Robert Shiller may have suggested something on the order of 4%–5%. By that measure alone, homes are likely 15%–20% overvalued (3 years x 5%+ annual overpricing). Chart 2, in addition suggests much the same thing. If mortgage rates don't come down, home prices need to decline by 20% in order to reach prior affordability levels. If rates do come down, home prices will drop less.

CHART 1
Buddy Can You Spare a Loan?



Source: Federal Reserve
This chart is not indicative of the past or future performance of any Allianz Global Investors product.
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CHART 2
Take 'em Down

Home prices need to decline if →	Mortgage rates change this much
-20%	0 Basis Points
-15%	-30
-10%	-60
-5%	-90
0	-120

Source: PIMCO
This chart is not indicative of the past or future performance of any Allianz Global Investors product.

Chart 2, while somewhat subjective and time dependent, introduces the critical connection between home prices and interest rates. PIMCO cares about housing and its fortunes, but primarily because of its influence on yields. And while the Fed may be willing to allow U.S. homeowners to suffer a little pain as indeed they have in recent quarters, a double-digit decline would risk consequences that few central banks would be willing to underwrite. So a forecast of home prices almost implicitly carries with it a forecast for interest rates. To prevent a double-digit decline in prices, PIMCO's statistical chart suggests that mortgage rates must decline a minimum of 60 basis points and the sooner the better. The longer yields stay at current levels, the more downward pricing pressure will build as foreclosures/desperate sellers dominate price trends as opposed to prospective buyers. While the Fed, as pointed out in last month's *Investment Outlook* must be cognizant of an array of asset prices in addition to housing, homes are the key to future equitization trends, and fundamental therefore to the outlook for consumption.

You may want to take this looming grim reality with a grain of salt or suggest as old worlders do that it's not real at all if it can't be touched or if it doesn't touch you. Not so. Don't take my word for it though. Investigate the Fed's own study, written in September of 2005 ("Monetary Policy and House Prices: A Cross-Country Study") covering housing cycles in aggregate and individually for 18 countries over the past 35 years. **This study's important conclusion for PIMCO and our clients is that if home prices in the U.S. have peaked, and are expected to stay below that peak on a real price basis for the next three years, then the Fed will cut rates and cut them significantly over the next few years in order to revigorate an anemic U.S. economy. Strong global growth (not part of this study's assumptions) may temper historical parallels and provide a higher floor than would otherwise be the case.** Nonetheless, prices for houses that I can see and touch every day outside my office are morphing with bond yields inside my computer screen to produce a reality show that speaks to an ongoing bond bull market of still undefined proportions.

William H. Gross



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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