

The Housing Project

Update

March 2007

The housing market has played an increasingly important role in U.S. economic growth over the last several years and holds significant implications for the economy and financial markets. Because of these implications, PIMCO created the Housing Project Research effort in 2005, conducted by the Mortgage Team, to track changes in housing and forecast the future path of housing prices. Because publicly available housing data tends to be lagged, the Housing Project aims to collect closer-to-real-time data to predict meaningful changes more accurately in the housing market, and to position client portfolios to benefit from these changes.

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2006 marked an inflection point for the U.S. housing market. Although home prices continued to rise, the rate of increase slowed and some regions began to see price declines. The most drastic impact of the housing slowdown was felt in the subprime sector (mortgage loans to lower credit-quality borrowers) where mounting delinquencies and losses squeezed already-thin profit margins for mortgage lenders, forcing some to shut their doors. PIMCO believes that mortgage finance was critical to the rise in home prices since 2000, and also will be critical to the period ahead, which undoubtedly brings a correction of some sort. We want to answer the question: How much of a correction?

Housing Data

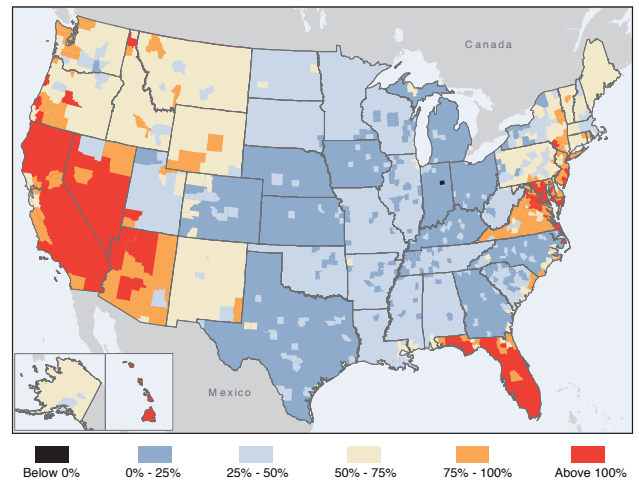
In 2005, PIMCO forecasted home price appreciation (HPA) of 5% for 2006, with stronger gains in the first half of the year and smaller gains through the second half. The OFHEO (Office of Federal Housing Enterprise Oversight) home price index appreciated by 5.9% in 2006, with the largest gains occurring early in the year. This represented the smallest annual increase since 1999.

Despite the continued growth of the average housing price, there was substantial variation between different regions. Several states saw price declines in the 4th quarter: California, Hawaii, North Dakota, Nevada, and Nebraska. Michigan became the first state to see a year-over-year decline in several years, primarily due to employment weakness in the auto industry.

Most housing indicators turned lower in 2006. New and existing home sales both fell during the year. Sales of existing homes were down 7% for the year and 13% from their 2005 peak. The drop in new home sales was slightly more pronounced, plummeting by as

much as 23% before recovering to finish the year 11% lower. The number of vacant homes for sale increased by over 34% and homebuilders are coming under increasing pressure to control the surging inventories. The housing supply has continued to increase early in 2007 and the number of vacant homes for sale now stands at over 2.1 million (2.7% of all homes).

Five-Year Appreciation (2001 Q3 - 2006 Q3)



OFHEO Home Price Index Year-Over-Year Change



New vs. Existing Home Sales

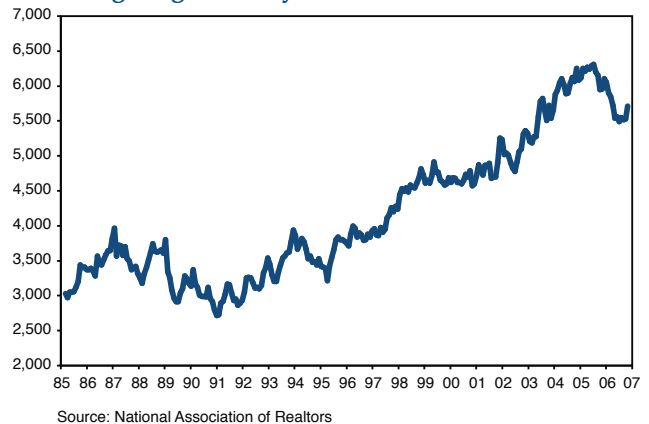
The new home sales and price data for 2006 was volatile and we believe the reason is important. In the early '90s California housing recession, only one of the top 10 builders was a public company. Today, nine of the top 10 homebuilders are public companies. This is important because equity investors punish public companies for high inventory. We have long expected to see the builders cut prices to unload new homes, which they did in 2006. We also believe prices were softer than the reported data reflect because, instead of cutting the sales price, a builder often will include several thousand dollars of upgrades, which aren't reflected in the sales-price data.

Existing home sales are a more stable indicator of sales volume for the bulk of the housing stock. Unlike new homes, where the owner is a builder who is a highly motivated seller, an existing homeowner will most often stay in the home rather than discount the price heavily. As a result, many existing homes that don't sell quickly simply are taken off the market.

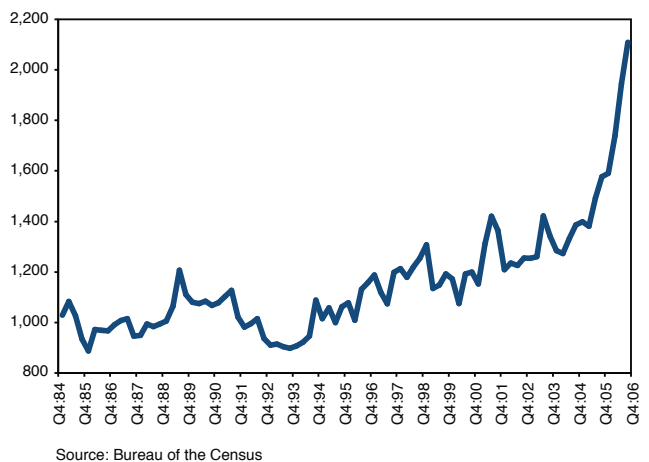
What's More Important: Volumes or Prices?

We believe the volume of homes sold holds more significance because it has considerable second-order effects on the economy. A slowdown in housing leads to a reduction in employment not only for builders and construction-related sectors, but also for mortgage lenders, appraisers, brokers, and realtors. More importantly, it triggers a substantial decline in consumption. Fewer homes being sold means that there are fewer people buying new furniture, electronics, and other goods and services that normally accompany a new home purchase.

Existing Single-Family Home Sales (in thousands)



Vacant Housing Units: For Sale (in thousands)



Mortgage Lending: Subprime Finally Weakens

If mortgage lending was fuel for the housing bonfire since 2000, it was the firehose in late 2006 and early 2007.

2006 was a pivotal year for subprime mortgage lenders, many of whom had resorted to riskier lending practices in order to maintain loan volumes amid a more competitive environment. The result was a continuing increase in the percentage of loans with low docu-

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mentation, weak borrower credit histories, and high loan-to-value ratios. There is no doubt that higher HPA in previous years has limited losses from riskier loans, but performance for the 2006 vintage deteriorated rapidly amidst the combination of a housing slowdown and increasingly liberal underwriting standards. The increase in delinquencies and losses further eroded profit margins for mortgage lenders, and several companies were forced to close their doors in late 2006, including Ownit Mortgage Solutions, Mortgage Lenders Network, and Sebring Capital.

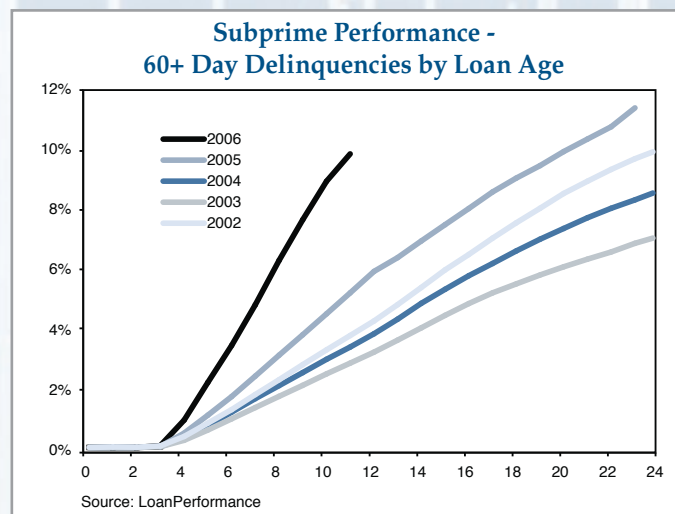
The difficulties in the subprime market intensified early this year as loan delinquencies rose past their 2001 peak. HSBC said it would set aside an additional \$1.76 billion in capital to cover bad loans – 20% more than consensus analyst estimates. New Century likely lost money in the 4th quarter and will need to restate its earnings for 2006. Fremont delayed the release of its 4th quarter and 2006 results. Ameriquest is effectively on life support from Citigroup, which also has an option to purchase the company. NovaStar Financial announced disappointing 4th quarter and 2006 results and does not expect to earn any taxable income for the next 5 years. Stock prices for many lenders plummeted and have prompted numerous class-action lawsuits alleging failures to disclose surges in loan repurchases (lenders are required to buy back loans that fail to make initial payments).

The first major regulatory actions against subprime lending took place in early March. Fremont agreed to a cease-and-desist order from the FDIC and announced that it would exit subprime lending. New Century announced that it is the subject of a criminal probe, focusing on its accounting and trading in its securities. The company is also in breach of its debt covenants with several of its warehouse lenders, who

finance its operations, and analysts have suggested that it likely faces liquidation or bankruptcy.

Over 30 subprime originators have failed or exited the business since late 2006.

The poor subprime performance has been reflected in the financial markets where the new ABX market – derivatives that track the cost of insurance for a basket of home-equity asset-backed securities (ABS) – allowed investors to express their views on risk in the subprime sector. The cost of insurance for BBB and BBB- rated home equity ABS deals from 2006 increased dramatically late in the year following the surge in delinquencies and the closures of subprime originators. The market was staggeringly one-sided with a large number of protection-buyers (shorts) and few willing protection-sellers (longs). Early in 2007, the trend accelerated as the frequent news headlines prompted a wave of sentiment-driven selling.



Tale of Two Mortgage Markets: Prime vs. Subprime

The rapid growth of subprime lending since 2000 and the innovation it has brought to the mortgage market generate a lot of interesting and alarming head-

lines, but the prime market actually comprises the majority of US mortgage loans, and has been unaffected substantially by the housing slowdown.

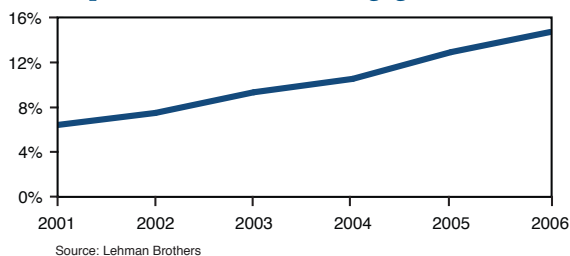
What distinguishes a prime loan from a subprime loan? Ask 10 mortgage professionals and you're likely to get 10 slightly different answers, as there isn't a single standard definition. In the broadest terms a subprime loan is one made to a riskier borrower. This usually means a FICO or credit score below 650 and a loan type that most often is aimed at equity extraction or debt consolidation with the lowest-possible monthly payment for the borrower.

Mae, or Freddie Mac. (Most subprime loans are not credit-eligible to be sold to the agencies.) **Agency MBS have been unaffected by the housing slowdown.**

Spreads on high quality MBS and AAA-rated ABS remain near historic tight levels, but lower-rated bonds have widened substantially. Investors increasingly are differentiating or tiering between originator/servicer quality, loan quality and many other aspects of mortgage credit – something PIMCO has been doing actively for some time. Mortgage credit analysis is granular, credit-intensive, and bond-specific. Generalities rarely apply.

The lenders that are most likely to emerge from the downturn are those with a significant, complementary prime mortgage business such as Countrywide, Wells Fargo, Chase, and Bank of America.

Subprime Share of the Mortgage Market



Mortgage Market Size by Loan Type

Loan Type	Amount (\$B)	% of Total
Agency (prime)	3,500	43%
Jumbo (prime)	2,300	29%
Options ARMs	500	6%
Alt-A	550	7%
Subprime	1,200	15%
Total	8,050	100%

Source: Lehman Brothers

The prime market, on the other hand, is the traditional market that has served several generations of homeowners – typified by a 30-year or 15-year fixed rate, a 20% down payment, and a FICO or credit score above 700. The majority of these high-quality loans are sold into MBS (mortgage-backed securities) and guaranteed by one of the mortgage agencies – Ginnie Mae, Fannie

Top Subprime Lenders – 2006 Q4

1. HSBC Finance
2. New Century
3. Countrywide
4. WMC Mortgage Corp.
5. First Franklin Financial
6. Wells Fargo
7. Option One Mortgage Corp.
8. Fremont Investment & Loan
9. Washington Mutual
10. CitiFinancial

Source: National Mortgage News

Top Prime Lenders – 2006 Q4

1. Countrywide
2. Wells Fargo
3. CitiMortgage
4. Bank of America
5. Chase Home Finance
6. Washington Mutual
7. IndyMac Bancorp
8. Wachovia
9. GMAC-RFC
10. GMAC-Residential

Source: National Mortgage News

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Outlook for 2007:

PIMCO expects the housing slowdown to continue in 2007 with a steeper decline in home sales than for home prices. New home prices should fall the most since they appreciated the most relative to existing housing during the run-up in prices. Attempts by homebuilders to reduce heavy inventories also will put downward pressure on new-home prices. The National Association of Realtors index, which tracks median home prices, should fall by 4-5% in 2007. The OFHEO index tracks repeat sales and PIMCO expects it to decline by over 1% this year (new home sales have little impact on this index).

The slowdown in housing should drag GDP down by approximately 1% over the next several quarters. Due to the multiplier effect that a slowdown has on consumption, it is likely that the impact on the economy will be even more substantial.

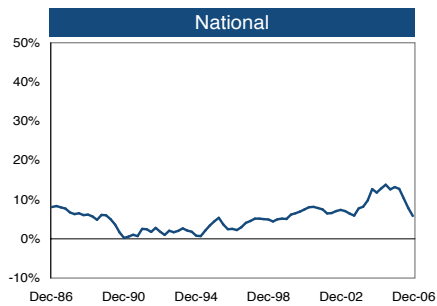
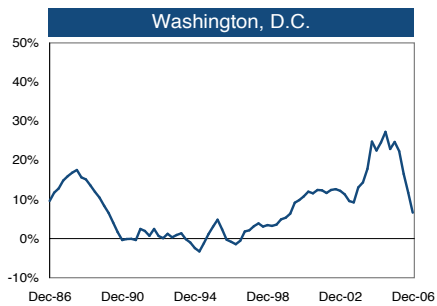
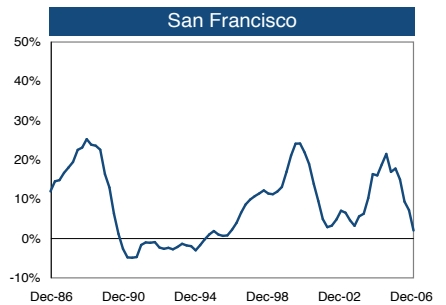
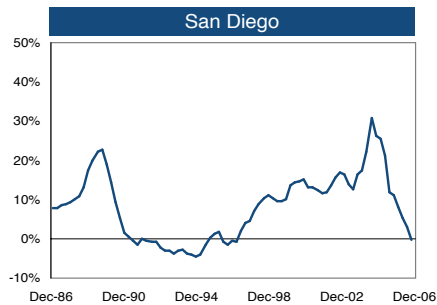
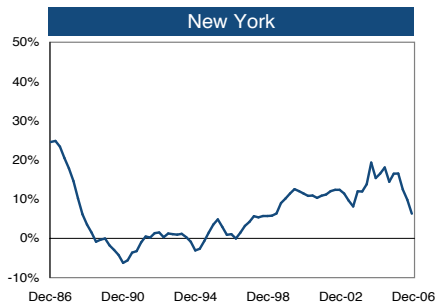
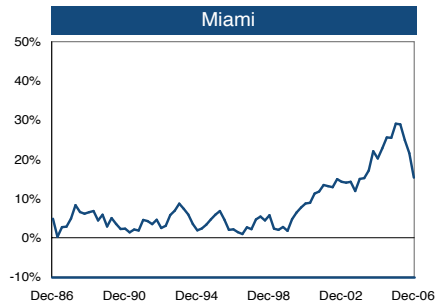
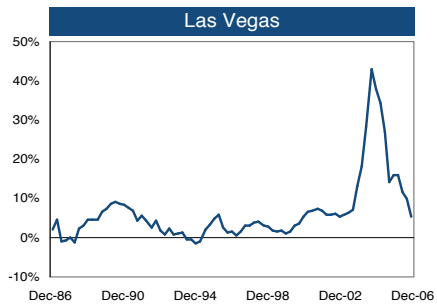
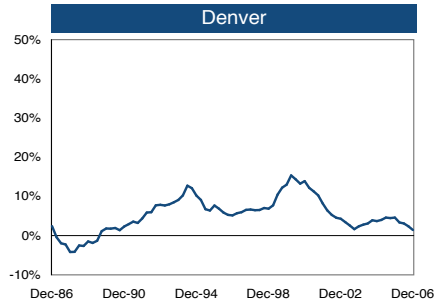
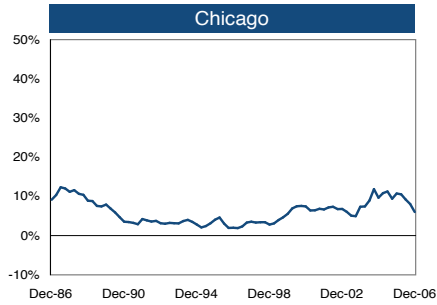
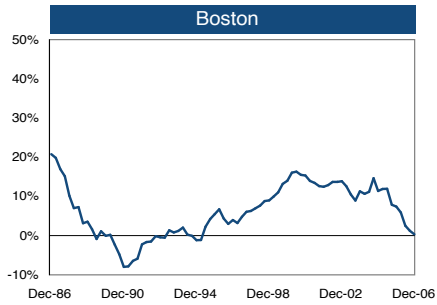
We expect the problems in the subprime market will result in continued consolidation of lenders, as the weaker players are not able to sustain loan production volumes or meet the tighter standards that are currently underway. Due to this consolidation, we expect to see subprime issuance decrease dramatically in 2007-2008. Much contraction has already taken place as year-to-date issuance has dropped nearly 10% compared to 2006 at this point in time. We envision a credit squeeze among low FICO, high loan-to-value and first-time homebuyers who are used to liberal credit standards.

It is likely that the poor performance we have seen in subprime loans will carry over to some degree into the most aggressively underwritten loans in the "Alt A" and possibly Jumbo prime markets. We do not believe prime loans will be materially affected. The pronounced problems in the

subprime market will not disappear as quickly as they emerged; instead we believe it will be a long process that will take perhaps years to correct.

PIMCO has often compared the housing market to a supertanker – a massive ship which takes 23 miles to come to a stop after being thrown into full reverse. We believe we are in the middle of a downturn, not at the end, and that the problems created by expensive housing, overstretched consumer finance, and years of Fed tightening have yet to take their full toll on the US housing market.

Home Price Appreciation in Major Cities Year-Over-Year Changes



Source: OFHEO

Reported by:

The PIMCO Mortgage Team

Scott Simon	Alfred Murata	Jing Yang
Dan Ivascyn	Saumil Parikh	Lalantika Padmanabhan
Josh Anderson	Sharad Bansal	Hansford Warner
Jennifer Bridwell	Stefanie Evans	Sunil Kothari
Giang Bui	Alfonso Portillo	

P I M C O

Newport Beach

Pacific Investment Management Company LLC
840 Newport Center Drive
Newport Beach, CA 92660
USA
800-927-4648
949-720-6000

Amsterdam

PIMCO Europe Ltd¹
Amsterdam Branch
Schiphol Boulevard 315, Tower A6
1118 BJ Luchthaven Schiphol
The Netherlands
31-20-655-4710

Hong Kong

PIMCO Asia Ltd²
24th Floor
Units 2403 and 2405
Nine Queen's Road Central
Hong Kong
852-3650-7700

London

PIMCO Europe Ltd¹
Nations House
103 Wigmore Street
London W1U 1QS
England
44-20-7872-1300

Munich

PIMCO Europe Ltd Munich Branch¹
Nymphenburger Straße 112-116
80636 Munich
Germany
49-89-1221-90

New York

Pacific Investment Management Company LLC
1345 Avenue of the Americas
New York, NY 10105-4800
USA
212-739-3000

Singapore

PIMCO Asia Pte Ltd³
30 Cecil Street #23-01
Prudential Tower
Singapore 049712
65-6491-8000
Registration No. 199804652K

Sydney

PIMCO Australia Pty Ltd⁴
ABN: 54 084 280 508
AFS License: 246862
Level 19, 363 George Street
Sydney, New South Wales 2000
Australia
612-9279-1771

Tokyo

PIMCO Japan Ltd⁵
Toranomon Towers Office 18F
4-1-28, Toranomon, Minato-ku,
Tokyo, Japan 105-0001
813-5777-8150

Toronto

PIMCO Canada Corp.⁶
120 Adelaide Street West
Suite 2005
Toronto, ON
Canada M5H 1T1
416-368-3350

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