

PIMCO Income Strategy Fund II  
Form N-CSR  
October 04, 2011

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM N-CSR**

**CERTIFIED SHAREHOLDER REPORT OF REGISTERED  
MANAGEMENT INVESTMENT COMPANIES**

Investment Company Act file number 811-21601

PIMCO Income Strategy Fund II  
(Exact name of registrant as specified in charter)

1633 Broadway, New York, New York  
(Address of principal executive offices)

10019  
(Zip code)

Lawrence G. Altadonna -1633 Broadway, New York, New York 10019  
(Name and address of agent for service)

Registrant's telephone number, including area code: 212-739-3371

Date of fiscal year July 31, 2011  
end:

Date of reporting period: July 31, 2011

Form N-CSR is to be used by management investment companies to file reports with the Commission not later than 10 days after the transmission to stockholders of any report that is required to be transmitted to stockholders under Rule 30e-1 under the Investment Company Act of 1940 (17 CFR 270.30e-1). The Commission may use the information provided on Form N-CSR in its regulatory, disclosure review, inspection, and policymaking roles.

A registrant is required to disclose the information specified by Form N-CSR, and the Commission will make this information public. A registrant is not required to respond to the collection of information contained in Form N-CSR unless the Form displays a currently valid Office of Management and Budget (OMB) control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2001. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. § 3507.

Item 1. Report to Shareholders



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Dear Shareholder:

This letter focuses on the twelve-month fiscal period ended July 31, 2011. However, it is important to note the significant volatility that has impacted U.S. financial markets since the end of the reporting period. This volatility has been sparked by a variety of economic and geopolitical challenges in both the United States and abroad. Ongoing U.S. government budget battles and the downgrading of its credit rating, fiscal concerns in Europe, and data indicating that the U.S. and global economies are slowing down have all contributed significantly to the recent market downturn.

Hans W. Kertess

*Chairman*

Brian S. Shlissel

*President & CEO*

### **Twelve Month Period in Review through July 31, 2011**

For the twelve-month fiscal period ended July 31, 2011:

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- PIMCO Income Strategy Fund rose 19.46% on net asset value ( NAV ) and 19.67% on market price.
- PIMCO Income Strategy Fund II advanced 19.12% on NAV and 12.53% on market price.

The Barclays Capital U.S. Credit Index, a measure of high quality corporate bond performance, returned 6.70% and the Barclays Capital U.S. High Yield Bond Index, a measure of below investment-grade corporate bond performance, returned 12.95% during the reporting period. Government bonds, as represented by the Barclays Capital Long Term Treasury Index, rose 3.04%. The Barclays Capital U.S. Aggregate Bond Index, a broad credit market measure of government and corporate securities, posted a 4.44% return, and mortgage-backed securities, reflected by the Barclays Capital Mortgage Index, rose 3.88%. As for stocks, the Standard & Poor's 500 Index advanced 19.65% during the fiscal twelve month period.

At the start of the fiscal year, Gross Domestic Product ( GDP ), the value of goods and services produced in the country, the broadest measure of economic activity and the principal indicator of economic performance, was growing at an annualized rate of 2.5%. GDP fell to 2.3% between October and December 2010 and 0.4% between January and March of 2011. It perked up to an annualized rate of 1.3% between April and June 2011.

As the economy struggled, U.S. Treasury prices jumped, sending yields plummeting. After reaching 3.75% in February 2011, the benchmark 10-year Treasury yielded just 2.82% at the end of the fiscal period.

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The slowdown took steam out of corporate bonds, particularly in the higher-yielding ( junk bond ) sector. Corporate profits remained robust, but concerns grew that skittish consumers would reduce spending, jeopardizing future earnings.

The economic weakness prompted the Federal Reserve (the Fed ) to indicate that it would keep interest rates low through 2013. Policymakers have also hinted of additional stimulus measures.

### **The Road Ahead**

The recent market volatility reflects ongoing concerns about the health of the U.S. economy. Key measures such as unemployment and housing remain troubled, and consumer confidence has fallen to levels not seen since 1982.

There are reasons to be hopeful, however, as GDP accelerated between April and June. In addition, there were 3.1 million job openings in May. The Fed is maintaining a low interest rate environment and U.S. companies, holding record amounts of cash, appear healthy. We maintain our view that the U.S. rebound now entering its third year will continue.

For specific information on the Funds and their performance, please review the following pages. If you have any questions regarding the information provided, we encourage you to contact your financial advisor or call the Funds shareholder servicing agent at (800) 254-5197. In addition, a wide range of information and resources is available on our website, [www.allianzinvestors.com/closedendfunds](http://www.allianzinvestors.com/closedendfunds).

Together with Allianz Global Investors Fund Management LLC, the Funds investment manager, and Pacific Investment Management Company LLC ( PIMCO ), the Funds sub-adviser, we thank you for investing with us.

We remain dedicated to serving your investment needs.

Sincerely,

Hans W. Kertess  
Chairman

Brian S. Shlissel  
President & CEO

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**PIMCO Income Strategy Fund/PIMCO Income Strategy Fund II Fund Insights**

July 31, 2011 (unaudited)

For the 12 months ended July 31, 2011, PIMCO Income Strategy Fund returned 19.46% on net asset value ( NAV ) and 19.67% on market price.

For the 12 months ended July 31, 2011, PIMCO Income Strategy Fund II returned 19.12% on NAV and 12.53% on market price.

The unmanaged Barclays Capital U.S. Aggregate Bond Index and Barclays Capital U.S. Credit Index returned 4.44% and 6.70%, respectively, during the reporting period.

While the U.S. fixed income market generated a positive return during the reporting period, there were periods of heightened volatility due to shifting expectations for the economy and periodic flights to quality. Early in the period, there were concerns that the economic recovery was losing momentum and the U.S. may fall back into recession. Beginning in the fourth quarter of 2010, expectations improved and inflationary concerns emerged. Despite a number of geopolitical challenges, the ongoing European sovereign debt crisis and the devastating earthquake in Japan, most spread sectors (non-U.S. Treasuries) outperformed equal-duration Treasuries through the end of April 2011. However, over the last three months of the period, the economy decelerated and investor risk appetite was replaced with risk aversion. Further impacting investor sentiment were concerns regarding the raising of the debt ceiling and the potential for a downgrade of U.S. government securities. Against this backdrop, Treasury yields moved lower and nearly every spread sector lagged equal-duration Treasuries. All told, during the 12 months ended July 31, 2011, both short- and long-term Treasury yields declined and the yield curve steepened.

Sector exposures largely enhanced the Funds' performance

During the reporting period, the Funds significantly outperformed the broad U.S. fixed income market (as measured by the Barclays Capital U.S. Aggregate Bond Index) as well as the U.S. credit market (as measured by the Barclays Capital U.S. Credit Index).

Overall, the Funds' sector exposures within the corporate bond market were beneficial for performance. An emphasis on the life insurance sector, which materially outpaced the broad market, benefited returns. An overweighting to non-captive consumer finance bonds was a strong contributor to performance, as these issues substantially outperformed the overall credit market. An emphasis on banks was rewarded, as recapitalization efforts increased. However, a portion of these gains were given back toward the end of the reporting period as sovereign debt tensions increased and negatively impacted the financial sector. Select exposure to Build America Bonds, a part of the Obama administration's economic stimulus package, which subsidized taxable municipal securities in an effort to attract investors, added to performance, as these municipal issues generally outperformed the broader market. Finally, having an exposure to certain speculative-grade corporate bonds enhanced the Funds' results, as these securities outperformed their higher quality counterparts.

Underweight exposure to technology detracted from results as this sector rallied and outperformed the overall credit market. An underweighting to the metals and mining sector was also not rewarded, as this sector benefited from increasing metal prices. Elsewhere, the Funds' exposure to the European banking sector detracted from performance as select issuers were adversely impacted by sovereign credit concerns.

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**PIMCO Income Strategy Fund Fund Performance & Statistics**

July 31, 2011 (unaudited)

<b>Total Return(1):</b>	<b>Market Price</b>	<b>NAV</b>
1 Year	19.67%	19.46%
5 Year	3.35%	3.01%
Commencement of Operations (8/29/03) to 7/31/11	4.65%	4.27%

<b>Market Price/NAV Performance:</b>		<b>Market Price/NAV:</b>	
Commencement of Operations (8/29/03) to 7/31/11		Market Price	\$12.39
		NAV	\$11.39
		Premium to NAV	8.78%
Market Price		Market Price Yield(2)	7.26%
NAV			

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**PIMCO Income Strategy Fund II Fund Performance & Statistics**

July 31, 2011 (unaudited)

<b>Total Return(1):</b>	<b>Market Price</b>	<b>NAV</b>
1 Year	12.53%	19.12%
5 Year	0.32%	0.06%
Commencement of Operations (10/29/04) to 7/31/11	1.23%	1.61%

<b>Market Price/NAV Performance:</b>		<b>Market Price/NAV:</b>	
Commencement of Operations (10/29/04) to 7/31/11		Market Price	\$10.27
Market Price		NAV	\$10.04
NAV		Premium to NAV	2.29%
		Market Price Yield(2)	7.59%

**Portfolio Composition**

(as a % of total investments)

(1) **Past performance is no guarantee of future results.** Total return is calculated by determining the percentage change in NAV or market price (as applicable) in the specified period. The calculation assumes that all income dividends, capital gain and return of capital distributions, if any, have been reinvested. Total return does not reflect broker commissions or sales charges in connection with the purchase or sale of Fund shares. Total return for a period of more than one year represents the average annual total return.

Performance at market price will differ from results at NAV. Although market price returns typically reflect investment results over time, during shorter periods returns at market price can also be influenced by factors such as changing views about the Funds, market conditions, supply and demand for each Fund's shares, or changes in the Funds' dividends.

An investment in the Funds involves risk, including the loss of principal. Total return, market price, market price yield and NAV will fluctuate with changes in market conditions. This data is provided for information purposes only and is not intended for trading purposes. Closed-end

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funds, unlike open-end funds, are not continuously offered. There is a one time public offering and once issued, shares of closed-end funds are traded in the open market through a stock exchange. NAV is equal to total assets attributable to common shareholders less total liabilities divided by the number of common shares outstanding. Holdings are subject to change daily.

(2) Market Price Yield is determined by dividing the annualized current monthly per common share dividend (comprised of net investment income) payable to common shareholders by the market price per common share at July 31, 2011.

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**PIMCO Income Strategy Fund Schedule of Investments**

July 31, 2011

Principal Amount (000s)		Credit Rating (Moody s/S&P)*	Value
<b>CORPORATE BONDS &amp; NOTES 58.8%</b>			
<b>Airlines 5.1%</b>			
\$900	American Airlines, Inc., 10.50%, 10/15/12	B2/B	\$949,500
3,774	American Airlines Pass Through Trust, 9.73%, 9/29/14	Caa2/CCC+	3,697,932
1,861	10.18%, 1/2/13	Caa1/CCC+	1,861,294
14,637	United Air Lines Pass Through Trust, 10.40%, 5/1/18 (j)	Baa2/BBB+	16,484,010 22,992,736
<b>Banking 8.3%</b>			
2,600	AgFirst Farm Credit Bank, 7.30%, 8/29/11 (a) (b) (d) (g) (k) (acquisition cost-\$2,225,000; purchased 2/26/10-4/15/10)	NR/A	2,611,448
1,200	Barclays Bank PLC (g), 7.375%, 12/15/11 (a) (d)		