

PIMCO Income Strategy Fund II
Form N-CSR
October 03, 2014

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)

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

Registrant's telephone number, including area code: 1-888-877-4626

Date of fiscal year July 31, 2014
end:

Date of reporting period: July 31, 2014

ITEM 1. Report to Shareholders

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Letter from Chairman of the Board & President

Dear Shareholder:

After three years of generally moderate growth, the US economy contracted during the first quarter of 2014. However, this proved to be a temporary setback as the economy expanded during the second quarter of the year. Longer-term bond yields declined and stocks produced very strong returns during the 12 months ended July 31, 2014.

12-Month Period in Review through July 31, 2014

For the 12-month period ended July 31, 2014:

- PIMCO Income Strategy Fund returned 13.82% on net asset value (NAV) and 9.95% on market price.
- PIMCO Income Strategy Fund II returned 15.88% on NAV and 12.39% on market price.

During the reporting period, Barclays US Credit Index, a measure of high quality corporate bond performance, rose 6.64%; the Barclays US High Yield Bond Index, a measure of below investment-grade corporate bond performance, returned 8.19%; and government bonds, represented by the Barclays Intermediate-Term Treasury Index, gained 1.12%. The Barclays US Aggregate Bond Index, a broad credit market measure of government and corporate securities, increased 3.97% and mortgage-backed securities, reflected by the Barclays Fixed Rate Mortgage Backed-Securities Index, rose 4.17%. As for stocks, the Standard & Poor's 500 Index advanced 16.94% during the fiscal 12-month period ended July 31, 2014.

After several years of positive growth, severe winter weather in parts of the United States constrained the US economy in early 2014. Looking back, 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, expanded at a revised 3.5% annual pace during the fourth quarter of 2013, contracted at an annual pace of 2.1% during the first quarter of 2014 and then expanded at an estimated 4.2% annual pace during the second quarter of 2014.

The Federal Reserve (the Fed) maintained an accommodative monetary stance during the reporting period. Announcements and actions related to the reduction of the Fed's monthly asset-purchase program contributed to bond-yield volatility during the December to May period. The markets have also been scrutinizing Fed statements related to when interest rates would begin to rise. In July, the Fed repeated that it would not raise rates in the near future, saying that it is likely

will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored.

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Outlook

We remain constructive on the US economic recovery, as confirmed by the meaningful bounce in GDP during the second quarter. Fed officials have tied the outlook for monetary policy to incoming economic data. Based on our forecasts for growth, we believe that Fed asset purchases will end in the fourth quarter of 2014, with lift-off in the fed funds rate possible in mid-2015.

Please note, at the close of business on September 5, 2014, Pacific Investment Management Company LLC (PIMCO), previously the sub-adviser, replaced Allianz Global Investors Fund Management LLC as the investment manager.

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 (844) 33PIMCO (844-337-4626). In addition, a wide range of information and resources is available on PIMCO's website, pimco.com/closedendfunds.

Sincerely,

Hans W. Kertess
Chairman

Julian Sluyters
*President & CEO**

* President & CEO through September 5, 2014.

Fund Insights

PIMCO Income Strategy Fund/ PIMCO Income Strategy Fund II

July 31, 2014 (unaudited)

For the 12-months ended July 31, 2014, PIMCO Income Strategy Fund returned 13.82% on net asset value (NAV) and 9.95% on market price. For the 12-months ended July 31, 2014, PIMCO Income Strategy Fund II returned 15.88% on NAV and 12.39% on market price.

The unmanaged Barclays US Aggregate Bond Index and Barclays US Credit Index returned 3.97% and 6.64%, respectively, during the reporting period. The US fixed income market experienced periods of volatility during the 12-month reporting period ended July 31, 2014. This was triggered by a number of factors, including mixed economic data, Fed asset purchase tapering and numerous geopolitical issues. All told, short-term Treasury yields rose during the reporting period, whereas longer-term Treasury yields edged modestly lower. Longer-term Treasury yields fell as investor risk aversion increased due to concerns about moderating global growth and uncertainties overseas. The benchmark 10-year Treasury bond began the reporting period yielding 2.60% and ended the period at 2.58%.

While the US credit market was also volatile at times, it significantly outperformed the overall bond market. The credit market was supported by declining long-term interest rates. Investor sentiment for the asset class was also positive given generally strengthening fundamentals, overall solid corporate profits and low defaults. Against this backdrop, investment demand was robust for much of the reporting period as investors sought to generate incremental yield in the low interest rate environment.

Sector exposures and yield curve positioning impact the Funds performance

During the reporting period, PIMCO Income Strategy Fund and PIMCO Income Strategy II Fund (the Funds) outperformed the broad US fixed income market (as measured by the Barclays US Aggregate Bond Index) as well as the US credit market (as measured by the Barclays US Credit Index).

The Funds allocation to non-agency mortgage-backed securities contributed to results, as the sector performed well, supported by the improving US housing market. The Funds overweighting to the Financial sector was beneficial. In particular, the Funds allocation to bank capital was rewarded due to continued deleveraging of their balance sheets. Elsewhere, the Funds allocation to municipal bonds, especially taxable municipal bonds, helped performance as they were supported by declining yields.

An underweighting to high yield bonds detracted from the Funds results, as the sector outperformed the broad credit market during the reporting period. Having an underweighting to the long end of the yield curve was negative for the Funds performance, as the yield curve flattened during the 12-months ended July 31, 2014. The Funds tactical allocation to Brazilian local rates in the third quarter of 2013 detracted from performance, as rates increased sharply during this period.

Performance & Statistics

PIMCO Income Strategy Fund

July 31, 2014 (unaudited)

Total Return(1):		Market Price	NAV	
1 Year		9.95%	13.82	%
5 Year		18.92%	19.99	%
10 Year		5.76%	6.90	%
Commencement of Operations (8/29/03) to 7/31/14		5.88%	6.70	%

Market Price/NAV Performance:

Commencement of Operations (8/29/03) to 7/31/14

Market Price/NAV:

Market Price	\$11.87
NAV	\$12.15
Discount to NAV	-2.30%
Market Price Yield(2)	9.10%
Leverage Ratio(3)	29.24%

NAV
Market Price

Performance & Statistics

PIMCO Income Strategy Fund II

July 31, 2014 (unaudited)

Total Return(1):		Market Price	NAV	
1 Year		12.39%	15.88%	
5 Year		19.17%	19.79%	
Commencement of Operations (10/29/04) to 7/31/14		4.36%	5.29%	

Market Price/NAV Performance:

Commencement of Operations (10/29/04) to 7/31/14

Market Price/NAV:

Market Price	\$10.50
NAV	\$10.88
Discount to NAV	-3.49%
Market Price Yield(2)	9.14%
Leverage Ratio(3)	20.05%

NAV
Market Price

Performance & Statistics

PIMCO Income Strategy Fund

PIMCO Income Strategy Fund II

July 31, 2014 (unaudited)

* Bond ratings apply to the underlying holdings of the Funds and not the Funds themselves and are divided into categories ranging from highest to lowest credit quality, determined for purposes of this presentation by using ratings provided by Moody's Investors Service, Inc. (Moody's). The Funds use ratings provided by Moody's for this purpose, among other reasons, because of the access to background information and other materials provided by Moody's, as well as the Funds' consideration of industry practice. When a bond is not rated by Moody's, it is designated in the chart above as "NR" for not rated. Credit quality ratings assigned by a rating agency are subjective opinions, not statements of fact, and are subject to change periodically, even as frequently as daily. Ratings assigned by Moody's or another rating agency are not absolute standards of credit quality and do not evaluate market risk. Rating agencies may fail to make timely changes in credit ratings, and an issuer's current financial condition may be better or worse than a rating indicates. In formulating investment decisions for the Funds, Pacific Investment Management Company LLC, the investment manager to the Funds, develops its own analysis of the credit quality and risks associated with individual debt instruments, rather than relying exclusively on rating agencies or third-party research.

(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 dividends and 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 and includes the effect of any expense reductions. 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 each Fund, market conditions, supply and demand for each Fund's shares, or changes in each Fund's dividends.

An investment in each Fund 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 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 dividend per common share (comprised of net investment income) by the market price per common share at July 31, 2014.

(3) Represents Preferred Shares and Reverse Repurchase Agreements (collectively "Leverage") that may be outstanding, as a percentage of total managed assets. Total managed assets refer to total assets (including assets attributable to Leverage) minus liabilities (other than liabilities representing Leverage).

Schedule of Investments

PIMCO Income Strategy Fund

July 31, 2014

Principal Amount (000s)		Value
Corporate Bonds & Notes	31.5%	
	Airlines 0.5%	
\$3,458	American Airlines Pass-Through Trust (b)(e)(f), 9.73%, 9/29/14	\$108,596
1,527	10.18%, 1/2/13	15,273
1,159	Continental Airlines Pass-Through Trust, 9.798%, 10/1/22	1,333,150
630	United Air Lines Pass-Through Trust, 10.40%, 5/1/18	709,892
		2,166,911
	Auto Manufacturers 4.1%	
12,700	Ford Motor Co., 7.70%, 5/15/97 (i)	16,089,008
	Banking 9.6%	
4,700	Barclays Bank PLC, 7.625%, 11/21/22	5,261,062
£6,300	14.00%, 6/15/19 (g)	14,518,531
\$800	Citigroup, Inc., 6.125%, 8/25/36	921,954
300	Cooperatieve Centrale Raiffeisen-Boerenleenbank BA, 8.40%, 6/29/17 (g)	337,875
£1,600	Credit Agricole S.A., 7.50%, 6/23/26 (g)	2,728,292
	LBG Capital No. 1 PLC, 7.375%, 3/12/20	292,550
200	8.50%, 12/17/21 (a)(c)(g)	2,201,904
\$2,000	LBG Capital No. 2 PLC, 9.125%, 7/15/20	959,229
£534	Lloyds Banking Group PLC, 7.625%, 6/27/23 (g)	5,153,112
2,900		
\$1,550		