



MICHAEL J. MURPHY
State Treasurer

The QUARTERLY

Local Government Investment Pool

First Quarter 2007

Subprime Woes and Inflation Risk

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The Federal Open Market Committee (FOMC) decided to keep its target for fed funds at 5.25 percent during its March 2007 meeting. Meeting minutes highlighted the Fed's recent iteration about inflation risk due to pressure coming from the high level of resource utilization. The Fed is much more sanguine about the prospects of economic growth, despite the current housing slowdown and the "subprime" turmoil being felt by credit markets. The FOMC statement also dropped reference to "additional firming" in rates which is an indication that their policy is still dependent on reconciling their views on both the possibility of inflation risk and economic slowdown. Flexibility in keeping their options open makes monetary policy-making much more efficient. It is akin to the Fed walking on a "policy tightrope" to achieve its twin goals of fostering growth and moderating inflation.

The *subprime story* dominated market talks about the subsequent housing slowdown and its concomitant effects on consumers. Federal Reserve Bank President Fischer has said "damage from the US subprime mortgage market is mostly contained and regulatory agencies are working hard to avoid overreaction to credit standards that would cause too much slowdown in housing or the overall economy." Most Fed members came out to demystify the negative effects of the subprime story but that did not prevent investors from formulating theories as expressed by the resurgence of market volatility from its state of stupor.

During the first quarter of 2007 a look at fed fund futures showed a market expectation of three rate cuts in 2007. However, those expectations largely dissipated upon the release of the Nonfarm payroll numbers in April. The monthly jobs report registered an 180,000 increase, which was greater than what the market was expecting and

the jobless rate fell to 4.4 percent. There were economic commentaries explaining the recent job growth phenomenon. One explanation blamed companies' low business capital spending, which created pressure to hire more workers. Another reason cited was the dearth of skilled workers to fill the current demand. Both reasons have valid points but economists worry that this job growth phenomenon could significantly effect productivity, which has been the long-running beacon of the US economy. The high productivity rate in the US economy has been the most important factor that revived the US economy from its past recessions. If the pick-up in labor demands has been due to a lower productivity rate, the economy could be suffering from substitution. The minutes also said that labor costs might rise more rapidly as a consequence of tight labor demand, which was seen as a risk to higher inflation. The cocktail mix of lower productivity and higher inflation risk should be the most worrying factor the fed has to face in examining economic data for the succeeding quarters.

Indeed, Bernanke's case seems credible enough for the Fed to worry more about inflation than economic growth. The FOMC minutes explicitly said that "higher interest rates could still prove necessary to control inflation". The specific statement that roiled the market was its reference to inflation failing to moderate as expected. With strong payroll numbers and higher inflation numbers, the market almost immediately discounted any hopes of a rate cut until late 2007.

Growth

Although the economy has shown signs of a slowdown, a respectable growth rate was

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Market summary

from page 1

still registered for the first quarter of 2007. Despite the housing slowdown and the *subprime* stories, consumer demand was still very strong. Retail sales registered decent numbers albeit drags coming from higher interest rates and higher energy prices affected growth. The factors given as the main drag, other than housing, was sliding consumer confidence. Consumer spending was cited as the only engine left to support growth as capital spending has been very weak since last year. Confidence has slowed down as consumers have been battered by higher prices and a weaker housing market. The *subprime story* has not had a significant economic effect but has caused consumers to be wary of current economic conditions. Supply of repossessed homes and lower property prices have exacerbated consumers' sentiment. Refinancing, which was also a tool used by consumers to liquefy fixed assets, has been dramatically reduced due to rising interest rates.

The U.S economy grew 2.50 percent in the fourth quarter of 2006. The housing slowdown has given signals that lower GDP growth is what is in store for 2007. Economists have lowered their GDP estimates to around 2.0-2.4 percent for 2007. The *subprime story* has also contributed to declining appetite for houses but a spillover to the overall mortgage market has been very minimal.

Inflation

US inflation risks have risen as the latest CPI (year-on-year) jumped to 2.8 percent and 2.5 percent (ex food and energy year-on-year). Most investors have known that the Fed's comfort range, in terms of inflation, is between 1-2 percent *core PCE*. Recent developments have elevated inflation risks as a confluence of factors such as accelerating labor costs, higher food prices, a jump in energy prices and dollar depreciation are perceived to be risk pressures for the economy. Fed members have voiced their concern about a higher inflation rate and the risk of not being able to bring inflation down to more manageable levels.

Although core inflation is somewhat elevated,

the pace of inflation rate increases has not exceeded earlier rates. Investors are quite sanguine about inflation going down to around 2.2- 2.4 percent range towards the end of the year.

Energy prices jumped 5.9 percent in March and food prices increased by 0.3 percent after a 0.8 percent rise in February. The back-to-back increases in energy and food prices have been factors that worried both the equity and bond markets. The good news was that excluding food and energy, the core consumer prices rose by only 0.1 percent which was the smallest gain in three months after a 0.2 percent gain in February.

Investors have discounted any hope of rate cuts in the face of current inflation worries. At best, the market is expecting that the fed will keep interest rates unchanged for a longer period of time until after they could ascertain manageable inflation numbers. The fed specifically cited the risks associated with rising labor costs as the main cause of a worsening inflation outlook.

The Bond Market

The bond market has been in a very solid range since the start of the year as both bulls and bears have been trying to convince themselves that their respective views make more sense. Economic indicators have not helped either camp since numbers always had something for everybody. Bonds are expected to trade a range depending on what current economic indicators suggest. Monthly indicators have suggested that economic growth is slowing down but not grinding to a halt. Meanwhile inflation seems to be creeping up, mainly due to rising commodity and energy prices. A range trade has developed where investors watch 10-year yields between 4.60 and 4.73 percent. Curve positioning has also gotten a lot more fervor as investors expressed their views by either using a steepener or a flattener. Callable instruments have been popular as the GSEs have added supply to the market.

LGIP Returns

Gross LGIP yields have hovered around 5.25% for the last nine months and will

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Market summary

continue to do so as long as the Fed holds the targeted funds rate at 5.25%. For the most part the strategy has been to invest in repos in the short end of the market and have a small ladder of US Treasury and Agencies in the one-year area. The weighted average maturity of the portfolio is around 40 days. While this is longer than during the time period when the Fed was tightening at every meeting, it is still fairly short. The average daily balance of the portfolio in March 2007 of \$5.6 billion was \$1.2 billion higher than a year earlier.

Also offered by the Office of the State Treasurer . . .

LOCAL Program

Financing solutions for local government equipment and real estate needs.

www.tre.wa.gov/local.htm

Contacts:

Noah Crocker
Lease purchase specialist
360-902-9020

Pam Johnson
LOCAL specialist
360-902-9021

Save the Dates:

The 2007 Conferences are coming soon!

September 19-21, 2007
WFOA Conference
Kennewick

State Treasurer Michael J. Murphy pictured in front of the vault in his Olympia office presents the newly minted Washington State Quarter.



In the photo, Michael Murphy inspects the treasurer's first order of the new Washington State quarters which arrived at the Treasurer's Office on April 11th. Since then, the Treasurer's Office has done brisk business moving them into circulation through their teller windows.

The Washington quarter is part of the United States Treasury 50 State Quarter Program. State designs are displayed on the reverse (tails) of the quarters, while the obverse (heads) of the quarters continues to display the familiar image of George Washington. The reverse of Washington's quarter features a king salmon breaching the water in front of majestic Mount Rainier. The coin bears the inscriptions "The Evergreen State," "Washington" and "1889."

According to Washington State Treasurer Michael Murphy, the Treasurer's Office is making every effort get these coins into circulation: "Henceforth we will only be giving out Washington quarters."

So, if you haven't yet found one of these beautiful coins in your pocket change, you can always get one, or even a roll of them, from the Office of the Washington State Treasurer at the Legislative Building in Olympia.

LGIP Advisory Committee: April 20, 2007 meeting minutes

The LGIP Advisory Committee meeting was held Friday, April 20, 2007, at noon in the State Treasurer's Office, Legislative Building, Olympia, Washington. The following members were present: Barbara Stephenson, Stan Finkelstein, Lisa Frazier, Morgan Jacobson, Doug Streeter, Judi Morris, Michele Pearson, Dan Underwood, and Carrie Lewellen. Treasurer's Office Staff included State Treasurer Michael J. Murphy, Assistant Treasurer Michael Colleran, Doug Extine, and Robbi Stedman. The following members were absent: Chuck Greenough, Dani Burton, and Mary Nelson.

After welcoming the members of the LGIP Advisory Committee Treasurer Murphy began the meeting by announcing upcoming changes in the make-up of the committee. Appointments due to expire April 30, 2007 are Lisa Frazier, Chuck Greenough, Dan Underwood, and Doug Streeter. Doug Streeter and Dan Underwood, appointments of the Public Utility District Association and WFOA, respectively, have been reappointed to three year terms. Treasurer Murphy presented Lisa Frazier a Certificate of Appreciation for her years of service and also acknowledged Chuck Greenough, who was unable to attend the meeting. New appointees to the committee are Toni Habegger from Eastern Washington University (Treasurer Murphy appointment) and Island County Treasurer Linda Riffe (WSACT appointment).

Treasurer Murphy then announced that Mike Colleran the Assistant State Treasurer would be retiring effective May 1, 2007. The committee acknowledged Colleran and thanked him for all his years of service. Murphy announced that Allan Martin would be taking Colleran's place.

The net rates for the Pool for January, February and March were 5.21, 5.28, and 5.24 percent, respectively. The anticipated gross rate for April is 5.25%. The fed funds rate has remained steady at 5.25 percent since June of 2006. Based on fed fund futures the market expects the Fed to remain at 5.25 until later in 2007.

Doug spoke about the strategy for managing the LGIP portfolio. Currently, the portfolio has an average life of 42 days. As has been the case for the past several months, given the shape of the yield curve, the strategy has been to keep the average life of the portfolio fairly short. Discussion followed.

A hand out was distributed to committee members describing LGIP month-end balance activity for FY 2004, 2005, 2006, and 2007. Discussion took place on how the LGIP balance, currently at \$5.9 billion, is over a billion dollars over where it was a year ago. Doug mentioned

that if the Pool's balance cycle continues as expected we will break our balance record. The state has also experienced a similar trend in the state balances.

For the LGIP Administration portion Robbi gave an update on the status of the LGIP's updated emergency contact information. The cell phones are in and the LGIP e-mail inbox is now available. She explained the cell phones and email would work exactly like the 800 number and that participants shouldn't expect that their transactions confirmed until they hear back from one of us. Robbi also discussed how OST has elected to migrate to Bank of America's new "Northwest Platform". For the LGIP this means a change of bank account number. OST will contact participants as soon as we know when the migration will take place. Discussion followed.

Doug reviewed the proposed budget for FY 2007 budget utilizing a handout provided to committee members. With higher balances fees are now estimated to be about \$1,900,000 and with expenses of \$560,000, the estimated rebate for FY 2007 is now over \$1.3 million. If the current estimates hold true the net fee will be less than a basis point for the first time in the 21 year history of the LGIP.

Doug then briefed the committee on the Statewide Custody Program with Union Bank of California. OST has been pleased Union Bank's performance thus far with 12 utilizing the program which has a combined value of \$1.9 billion. Doug also announced the release of the RFP for custody and securities lending for the state treasury and LGIP. Four vendors have indicated their intent to respond to the RFP. Discussion followed.

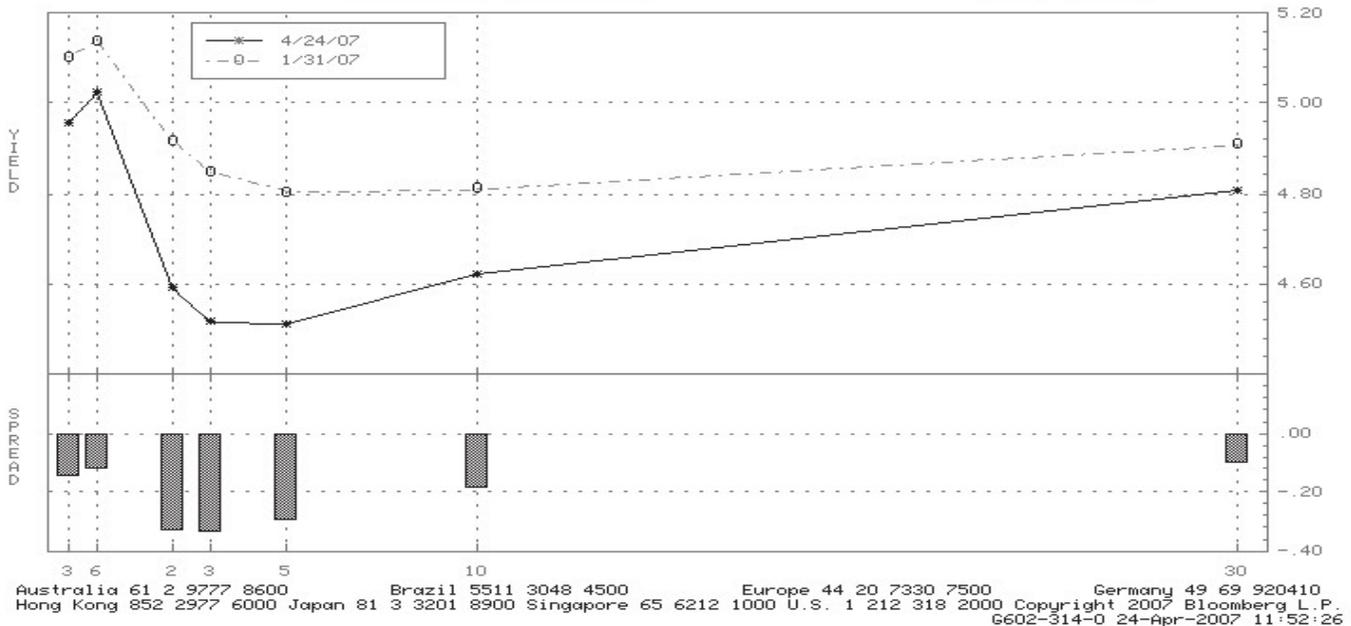
Doug gave a brief update on WMTA reporting the April conference had been a success. He also mentioned that at WFOA in September OST would be having four investment tracks with speakers Mark Evans and Deanne Woodring.

Shad Pruitt, OST Deputy Treasurer of Operations, gave an update on the upcoming release of the RFP for the FY 2007 external audit of the LGIP. The contract with Peterson Sullivan, who has conducted the audit for the past five years, has ended. Pruitt proposed that OST conduct the RFP and present the results, along with a recommendation, to a sub-committee comprised of three LGIP Advisory Committee members. A motion was made and passed unanimously to accept Pruitt's plan. Morgan Jacobson, Judi Morris, and Doug Streeter volunteered to serve on the sub-committee.

The next meeting will be scheduled for July 27, 2007. The meeting was adjourned at 1:45 p.m.

HISTORICAL YIELD CURVE

DATE RANGE **1/31/07** **4/24/07** MTY RANGE **3M** **30Y**



From the LGIP Administrator's Desk:

By Robbi Stedman

I mentioned in the last newsletter that the LGIP was going to get some new emergency contact information because we want to be accessible to our customers in case of an emergency. So our cell phones are in and LGIP email is up and running. We anticipate that we will be sending out new business cards to all of our participants with the new contact information. In the mean time here it is:

Email: lgip@tre.wa.gov

Cell Phone: (360) 791-0485

Please use these alternative means of communication only in case of emergency. As is the case when leaving voice mail notification of transactions when you call the toll-free line, **do not** consider your transaction confirmed until you receive confirmation from us that we have received your transaction information. If you have any questions about the new contact information please feel free to give me a call.

On the banking services front, OST has elected to migrate to the new Bank of America platform, which is being called the "Northwest Platform." This will necessitate a new bank account for the LGIP. The routing number will stay the same. We anticipate this change to happen the end of June or beginning of July. We will notify participants as soon as we know what the new account number will be and when it will become effective. In order to help minimize the possibility of problems during this transition, there will be a period of time when both the old account number and the new one will be accepting wires. We thank you in advance for your patience during this process.

LGIP Holiday Schedule for 2007

The Local Government Investment Pool will be closed on the following days:

Monday	May 28	Memorial Day
Wednesday	July 4	Independence Day
Monday	September 3	Labor Day
Monday	October 8	Columbus Day
Monday	November 12	Veterans Day (observed)
Thurs/Fri	November 22-23	Thanksgiving Holiday
Tuesday	December 25	Christmas

State Treasurer Michael J. Murphy announced the appointment of Allan J. Martin to Assistant State Treasurer.

Martin will be responsible for the day-to-day operations of the Office of the State Treasurer, including oversight of the investment of state and local government investment pool funds, receipting and disbursement transactions, and debt management.

Allan joined the Office of the Washington State Treasurer in July 1998 and was appointed Deputy Treasurer and Secretary of the State Finance Committee in 1999.



Allan J. Martin, Assistant State Treasurer

Prior to joining the Office, Martin served as Chelan County Treasurer. A native of Eastern Washington, having grown up in the Wenatchee Valley, he graduated magna cum laude from Washington State University with a Bachelor of Arts degree in Social Sciences. He is a graduate of San Francisco College of Mortuary Science, attending on a scholarship from the Washington State Funeral Directors' Association. Before entering public service Martin was employed in banking.

Martin's professional activities include serving as immediate past president of the Washington Municipal Treasurers' Association, and past president of the Washington State Association of County Treasurers. He is also a member of the Washington Finance Officers' Association, and an associate member of the National Association of State Treasurers, participating in its State Debt Management Network.

He and his wife Sue make their home in Olympia. They have three children, including a daughter serving in the United States Marine Corps.

WMTA Investment Policy Certification Program

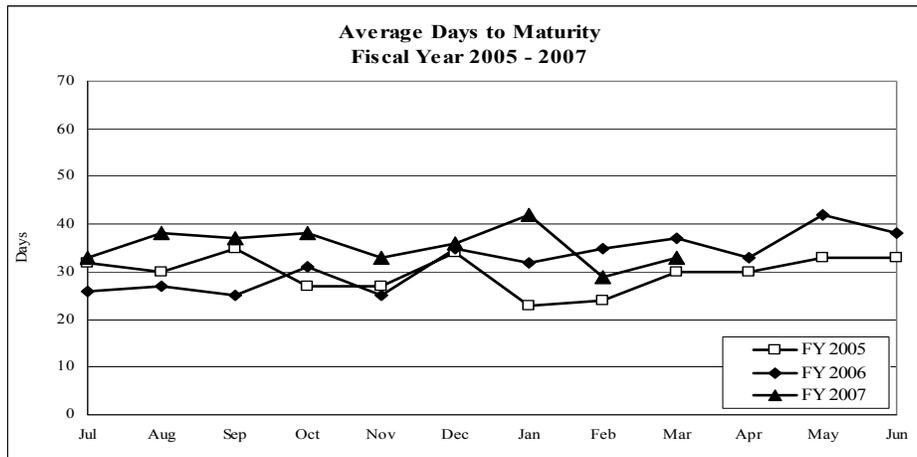
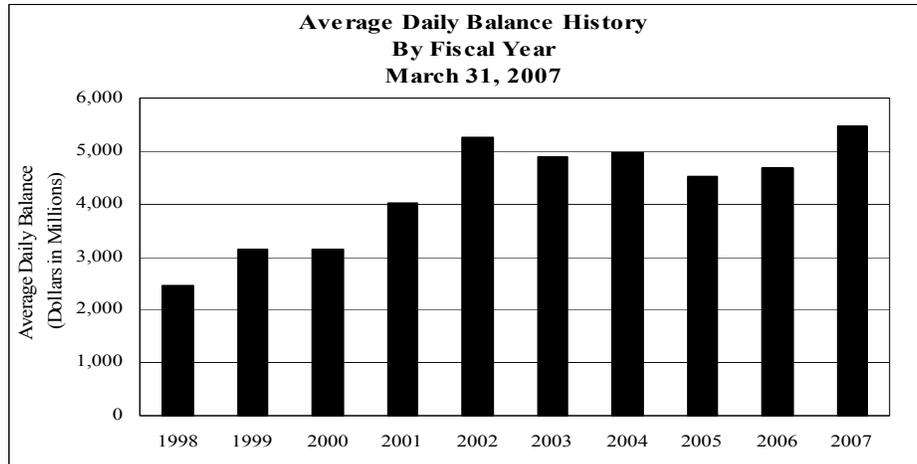
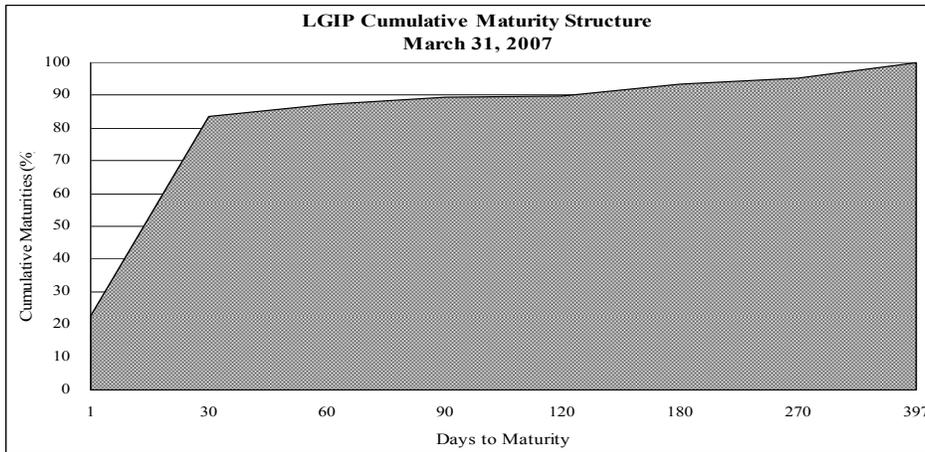
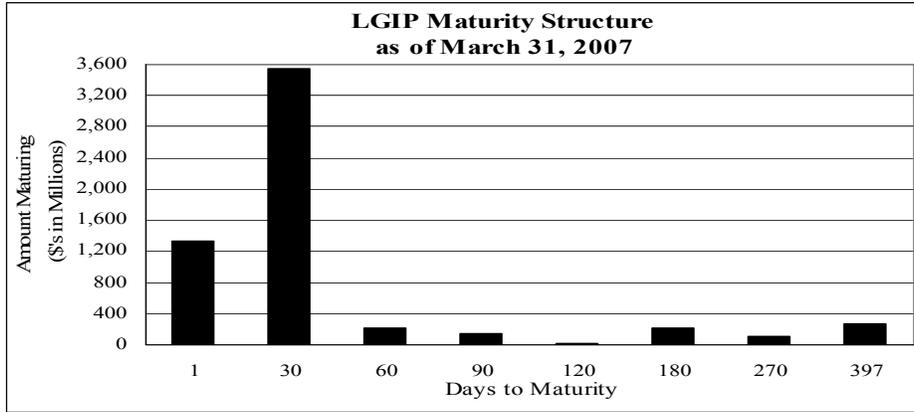
In 1988 the Washington Municipal Treasurer's Association (WMTA) began assisting local governments with their investment policies through the WMTA Investment Policy Certification Program. Since that time over 100 policies have received certification.

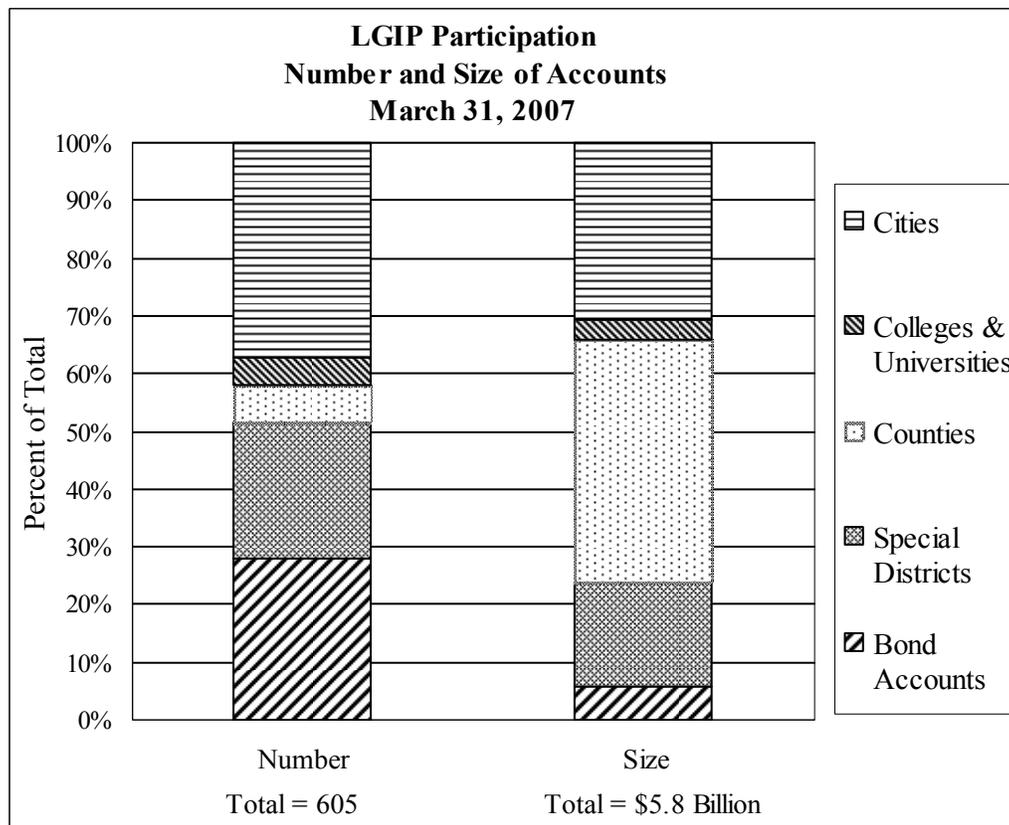
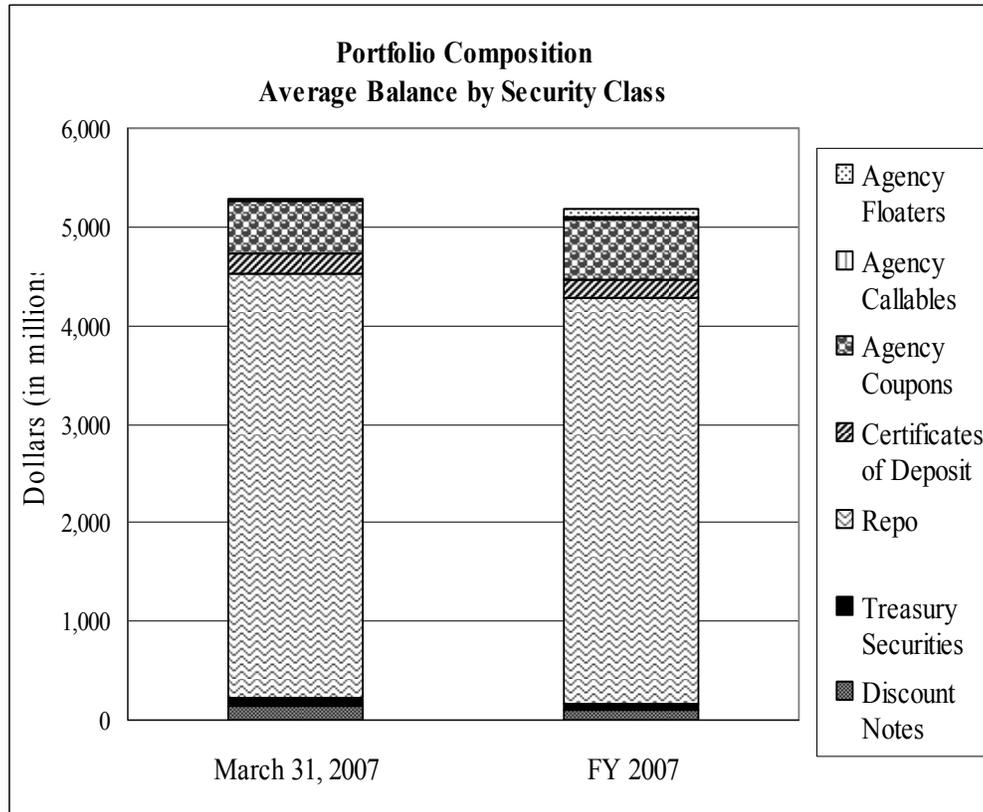
Investment policies should be reviewed on a regular basis and revised as necessary to keep current. If the revisions to your policy are significant, you should consider having the policy re-certified. Many of the policies that have received certification over the last several years were re-certifications.

This past year WMTA awarded three investment policy certifications at the conference in April:

City of Sunnyside
City of Kirkland
Lake Whatcom Water and Sewer District

If you have not submitted your policy for certification, we would like to encourage you to do so. Also, you may want to check your investment policy and see if it needs to be re-certified. Now is a great time to send it in...you still have about 9 months before the deadline for 2008. If you have any questions please feel free to contact Robbi Stedman, Investment Policy Certification Chair at (360) 902-9013 or the WMTA website at www.wmta-online.com. Don't let this chance pass you by!





**Washington State Local Government Investment Pool
Position and Compliance Report
as of 3/31/2007**

LGIP Portfolio Holdings	Amortized Cost	Percentage of Portfolio
Agency Bullets	\$ 460,635	7.90%
Agency Discount Notes	25,000	0.43
Agency Floating Rate Notes	163,508	2.81
Agency Variable Rate Notes	74,996	1.29
Certificate of Deposit	208,350	3.57
Interest Bearing Bank	343,083	5.89
Repurchase Agreements	4,553,448	78.12
U.S. Treasury Bills	0	0.00
U.S. Treasury Coupons	0	0.00
	<u>\$ 5,278,386</u>	<u>100.00%</u>

Securities Lending Holdings	
Repurchase Agreements	53,065
	<u>\$ 53,065</u>

Total Investments & Certificates of Deposit	<u>\$ 5,882,085</u>
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Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

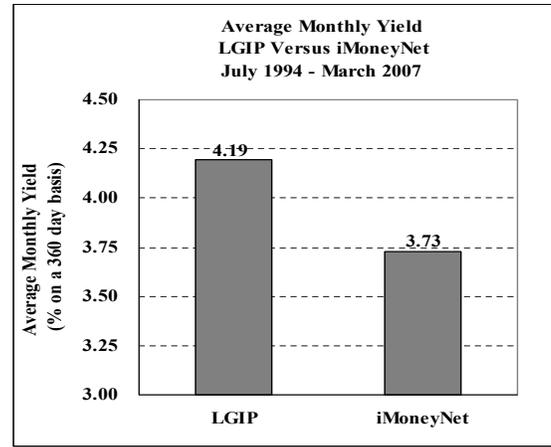
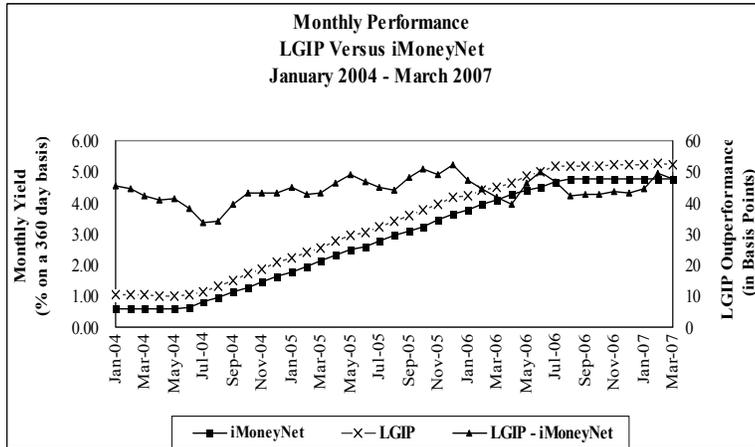
	Holdings	Percentage of Portfolio	Policy Limitations Percentage
Floating Rate and Variable	\$ 74,996	1.29%	30%
Variable Rate Notes > 397	0	0.00%	10%
Other Structured Notes	25,000	0.43%	10%
Term Repo > 30 Days	0	2.84%	30%
Certificate of Deposit	208,350	3.57%	10%
Bankers' Acceptances	0	0.00%	20%
Commercial Paper	0	0.00%	25%
Reverse Repo	0	0.00%	30%
Security Lending + Reverse Repo	51,313	0.88%	30%

Maturity Limitations

	Currently	Policy Limitations
Weighted Average Maturity	32 day(s)	90 day(s)
Maximum Maturity		
Bullet Maturities	368 day(s)	397 day(s)
Floating Rate and Variable Rate Notes	109 day(s)	762 day(s)
Repos	30 day(s)	180 day(s)
Reverse Repos	0 day(s)	90 day(s)

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LGIP Performance Comparison iMoneyNet, Inc. ¹ versus Local Government Investment Pool



The chart on the left shows a monthly comparison from January 2004 through March 2007 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to March 2007. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.4 basis points. This translates into the LGIP earning \$216.79 million over what the average comparable private money fund would have generated. ■

¹ Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, *Money Market Insight*, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

Position and Compliance Report from page 9

<u>Repo Limits Per Dealer</u>	<u>March 31, 2007</u>	<u>Total Repo Percentage (20% limit)</u>	<u>Projected Redemptions 4/02/2007</u>	<u>Projected Position 4/02/2007</u>
Banc America Securities	\$ 553,448	9.49%	\$ 253,448	\$ 300,000
Barclays Capital Inc.	500,000	8.58%	0	500,000
Bear Stearns & Co.	800,000	13.72%	0	800,000
BNP Paribas	750,000	12.87%	750,000	0
Cantor Fitzgerald	600,000	10.29%	300,000	300,000
Citigroup Global Markets Inc.	200,000	3.43%	0	200,000
Merrill Lynch	300,000	5.15%	300,000	0
Morgan Stanley Dean Witt	53,065	0.91%	53,065	0
UBS Warburg	850,000	14.58%	550,000	300,000
Total	\$ 4,606,513		\$ 2,206,513	\$ 2,400,000

Local Government Investment Pool
STATEMENT OF NET ASSETS
March 31, 2007
(in Thousands)

Assets

Investments, at Amortized Cost:	
Repurchase Agreements	\$ 4,308,406
U.S. Agency Securities	919,144
U.S. Treasury Securities	<u>24,846</u>
Total Excluding Securities Lending and Securities Purchased But Not Settled	\$ 5,252,396
Securities Lending Investments, at amortized cost:	
Repurchase Agreements	\$ 55,320
Total Securities Lending	<u>55,320</u>
Total Investments (Settlement Date Basis)	\$ 5,307,716
Due from Brokers - Securities Purchased But Not Settled, at Amortized Cost:	
U.S. Treasury Securities	24,846
Total Due from Brokers	<u>24,846</u>
Total Investments (Trade Date Basis)	5,332,562
Interest Bearing Bank Deposits	
Certificates of Deposit	\$ 338,562
Cash	150,850
Interest Receivable	314
Total Other Assets	<u>19,200</u>
Total Assets	\$ 5,841,488

Liabilities

Accrued Expenses	\$ 581
Obligations under Securities Lending Agreement	55,320
Investment Trades Pending Payable	<u>24,852</u>
Total Liabilities	\$ 80,753

Net Assets

Net Assets	\$ 5,760,735
Total Amortized Cost - Settlement Date Basis	<u>\$ 5,797,128</u>

QUARTER AT A GLANCE
January 1, 2007 to March 31, 2007
(in Thousands)

Total investment purchases:	\$ 55,546,574
Total investment sales:	\$ 571,513
Total investment maturities:	\$ 54,700,445
Total net income:	\$ 77,077
Net of realized gains and losses:	\$ 106
Net Portfolio yield (360-day basis):	
January	5.2113%
February	5.2768%
March	5.2372%
Average weighted days to maturity:	33 days

WASHINGTON STATE LOCAL GOVERNMENT INVESTMENT POOL
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OLYMPIA WA 98504-0200

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