



MICHAEL J. MURPHY
State Treasurer

The QUARTERLY

Local Government Investment Pool

Second Quarter 2007

The minutiae of inflation and re-pricing of credit 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 June 2007 meeting. FOMC members gave an explicit warning that inflation risk was their most immediate concern. Strong global economic growth and higher inflation risk prompted other central banks to raise interest rates in order to stave off a foreboding omen of higher inflation numbers. Commodity markets have performed well as listed companies in the global market went on a rampage buying resources all over the world. Oil has also seen consistent price pressures due to multiple extraneous factors. The US, however, has seen surprisingly better inflation numbers which market prognosticators see only as temporal at best. Will weaker economic growth trump inflation pressures? Will labor weakness deflate pressures from resource utilization and subsequently arrest wage cost pressures? Just like fed members, the bond market has vacillated between inflation and growth worries.

Risk premia have gone up driven by fears of mounting losses in the subprime mortgage loans business. Bear Stearns' hedge funds suffered major losses and needed capital infusion from Bear Stearns. Unrelated hedge funds have reported unexpected losses from liquidation by existing investors. The atmosphere of fear has tarnished mortgage-backed securities as an asset class as investors continue to avoid headline risk in this sector. Bear Stearns announced that the values of their two troubled funds have gone down to almost zero. In a carefully worded letter to investors, Bear Stearns said that

both failed hedge funds have "effectively no value left" but had sufficient assets to cover their creditors. This event highlighted the severity of the situation, which could shakeout other investment bonds with lower credit ratings. If Bear was not able to manage risk in what was supposedly a triple AAA portfolio, what more if other funds invested in higher risk products?

Standard & Poor's announced in July that it would look to downgrade \$7.40 billion worth of mortgage-backed subprime securities due to increasing delinquencies, rising foreclosures, weak home prices, and lax underwriting standards. Moody's rating agency, subsequently, followed S&P's move by also announcing its plans to lower ratings on \$5.0 billion worth of CDO securities (collateralized debt obligations). Fitch later followed by putting 412 bonds on their negative watch list. Other riskier asset classes like asset-backed securities have suffered more losses driven by widening credit spreads as investors executed "flight-to-quality" trades. Investors who were not risk-averse to those types of products fear that the subprime meltdown is not over yet. They believe that margin calls for structured credit collateral will increase as more hedge funds perform de-leveraging trades in order to protect their current positions. In simple terms, many market participants believe that there will be additional forced liquidation in the coming months as more collateral plummets in market value.

Should investors worry more about inflation

continued on page 2

Market summary

from page 1

or should they take solace that the current housing market is weak and could drag down the country's future growth prospects? Will the sub-prime debacle continue to unravel? Bernanke's semiannual monetary policy testimony emphasized that inflation is still the predominant policy risk. Bernanke, however, mentioned the upside risk of stronger consumer and business investment spending that could derail their projections.

Growth

The much-awaited economic slowdown was a non-event as the magnitude provided little room for speculation. True enough, the economy slowed a bit but still showed resilience, despite intensifying problems in the housing market. Ironically, the stock market signaled optimism as most major stock indices soared to their all-time highs. Corporate earnings came in stronger than expected, driving merger and acquisition activities to record highs. Economists have continued their mandatory revision of economic forecasts as they have underestimated growth.

Fed Chairman Ben Bernanke, in recent testimony to congress, announced the Fed's central tendency forecast for 2007 growth of 2.25-2.50 percent and a stronger 2.50-2.75 percent for 2008 due to expansion of global economic growth. Although the numbers were softer than those previously announced, the Fed was more optimistic than most economists

The Fed expects the economy to post a "growth rate which is close to the economy's underlying trend". Risks include housing problems, slower consumer spending, and/or a higher spike in energy and commodity prices.

Inflation

Inflation may be measured in different ways depending on one's personal belief about price movements. While some

economists maintain that core inflation is the best indicator of inflation pressures others believe that headline inflation numbers are a better indicator of higher inflation risks. Headline inflation is seen by the fed to be a volatile component, thus an inaccurate inflation measure. Chairman Bernanke stated that the Fed finds it hard to "respond to short-term deviations in overall prices... (as) it could possibly undermine economic efficiency and the (monetary) policy's own credibility".

Energy and food prices have increased to a point that it has been lessening consumers' affection for non-basic items. Retail sales have shown signs of softening with consumers feeling the pinch of higher prices in staples. Items which are considered non-essential fell by the wayside. Sales figures for retail/department stores have suffered the most, due to higher gas prices and interest rates.

The back-to-back increases in energy and food prices are factors that have worried both the equity and bond markets. The good news was that ex-food and energy, the most current core consumer prices rose by only 0.2 percent in June which brings the yearly core CPI to around 2.20 percent. The Fed's central tendency forecast for inflation remains unchanged for both 2007 & 2008. The key takeaway is the Fed's belief that core inflation will drop to 1.75-2.00 percent next year. Chairman Bernanke is watching any spillover of rising energy and food prices into core inflation.

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 started pricing-in a scenario of a "perma-hold" on the fed funds rate. The second quarter for the bond market saw a brutal performance on a total return basis as

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Market summary

bonds were bid all throughout the quarter. Ten-year yields increased nearly 25 basis points to cross the 5.00 percent level while the two-year yields traded between 4.82-5.00 percent. Many investors suffered from the Bear Stearns “fallout”, which created a contagion effect on many corporate bond portfolios. Credit spreads widened versus swaps. Agency bullets and callables have suffered as well since most trades were executed as flight-to-quality bids favoring treasury notes. The curve steepened during the period as most investors believed that there could be other headline risks associated with the subprime market.

Fed Fund futures have experienced a swing from investors pricing in a rate cut by August to pricing in no moves till the first quarter of 2008. Until investors find solid evidence regarding growth and inflation, the market seems to suggest a long period of range trading and placing curve trades to satisfy investors’ needs. Many market players believe that the market could be in for another period of event-driven trading as the subprime problem continues to haunt investors.

LGIP Returns

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

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 and Agency discount notes in the short end of the market and maintain a small ladder of US Treasury and Agencies in the one-year area. The weighted average maturity of the portfolio is around 47 days. While this is longer than during the time period when the Fed was tightening at every meeting, it is still slightly on the short side of neutral. The average daily balance of the portfolio in June 2007 of \$6.2 billion was nearly \$900 million higher than a year earlier.

LGIP Holiday Schedule for 2007

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

<i>Monday</i>	<i>September 3</i>	<i>Labor Day</i>
<i>Monday</i>	<i>October 8</i>	<i>Columbus Day</i>
<i>Monday</i>	<i>November 12</i>	<i>Veterans Day (observed)</i>
<i>Thurs/Fri</i>	<i>November 22-23</i>	<i>Thanksgiving Holiday</i>
<i>Tuesday</i>	<i>December 25</i>	<i>Christmas</i>

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
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360-902-9020

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LOCAL specialist
360-902-9021

Save the Dates:

The 2008 Conferences are coming soon!

September 19-21, 2007
WFOA Conference
Kennewick

April 9-11, 2008
WMTA
Cambells Resorts
Lake Chelan

Treasurer Murphy Names Union Bank of California as Apparent Successful Vendor for OST Custody and Lending Services

State Treasurer Michael J. Murphy announced Union Bank of California, N.A. (Union Bank) as the apparent successful vendor to provide custody and lending services for OST portfolios. The award comes after a competitive Request for Proposal (RFP) process, which began in early April 2007. If successful contract negotiations can be completed, Union Bank would begin providing custody and securities lending services on October 1, 2007. This would apply to the over \$10 billion in funds under

the management of OST, including \$5.7 billion in the LGIP. “Union Bank put together a strong proposal and I look forward to a good partnership with them,” Treasurer Murphy said. “I have received positive feedback regarding their performance as the statewide custody provider and am confident that they will continue that in the contract with OST, as well.”

WFOA is right around the corner...

The 52nd Annual WFOA Conference in Kennewick, Washington, is September 19-21. Make your reservations now! Once again OST has put together an Investment Track for the conference with two nationally recognized speakers. In the following section you will find the course titles and descriptions. For more information regarding the 52 Annual WFOA Conference please visit their website at www.wfoa.org. Please join us!

Investment Fundamentals

9/20/2007 1:00 PM to 1:50 PM

Speaker: Deanne Woodring – Managing Director, DA Davidson

Our intention in presenting a fixed income investment topics for Public Fund Investment Officers to provide a thought provoking session that covers overall fixed income portfolio management tools and strategies. This will be a two part session.

Basic Portfolio Strategies for Operating and Project Funds

- I. Your Challenges
 - a. Interest Rates Change
 - b. Liquidity Needs Change
 - c. Internal Tools to Monitor Investment Performance
 - d. Budgeting Concerns that are Impacted by Interest Rate Changes
- II. Historical Interest Rate Review
- III. Yield Curve Shapes and Changes
- IV. What Impacts Interest Rates and the Yield Curve
- V. Cash Management Investing
(To be continued next session)

Investment Program Fundamental Continued...

9/20/2007 2:00 PM to 2:50 PM

Deanne Woodring – Managing Director, DA Davidson

Part Two:

- VI. What is Risk to You?
- VII. Investor Solutions – Market Benchmark
 - a. Disciplined Investment Strategy
 - b. Establish Guidelines
 - c. Communication
- VII. What Do You Need to Sleep At Night
 - a. Investment Policy Approved by Board
 - b. Procedures approved by Auditor
 - c. An Investment Strategy
 - d. Advisor , Brokers or Managers?
- IX. Investment Policy
- X. Investment Procedures
- XI. Investment Strategy
- XII. What are your Choices for Advice?

US Agency Market Update

9/20/2007 3:10 PM to 4:00 PM

Mark Evans – Executive VP, Vining Sparks

With agency debt representing the largest holding in most government investment portfolios, investment managers need to stay abreast of the latest market information. This session will provide an in-depth market update on the agencies and will include discussions of current spread relationships, market expectations, and areas of opportunity.

Relative Value Analysis

9/20/2007 4:10 PM to 5:00 PM

Mark Evans – Executive VP, Vining Sparks

Market conditions, differences in structures, and constantly changing spreads make it both important and difficult to compare securities. This session will focus on investment decision and comparison process and will provide insight into finding the best relative value. Concepts including yield, total return, duration, yield curves, and spreads will be covered in discussing ways to uncover best relative value.

LGIP net fees less than a basis point first time in 21 Years!

As most of you know, the end of July is our annual rebate time. The LGIP collects a monthly fee of 3.5 basis points (bp), or 0.035%, to cover the estimated costs of operating the Investment Pool and rebates to the participants any fees that were in excess of the Pool's actual expenses. During Fiscal Year (FY) 2007 the LGIP reported an average balance of \$5.666 billion with a rebate of \$1,472,397.15, which reflects a net administrative charge of less than 1 basis point (actual calculation = 0.959 bp, or 0.00959%). The net fee for FY 2007 of less than one bp is the lowest in the 21-year history of the LGIP! The LGIP's size and our determination to contain costs enables the Pool to continue to be a very competitive investment option for local governments. We would like to thank you again for your participation in the Pool.

LGIP Advisory Committee: July 27, 2007 meeting highlights

The LGIP Advisory Committee meeting was held Friday, July 27, 2007, at noon in State Treasurer Michael J. Murphy's Office, Legislative Building, Olympia, Washington. In attendance were Dani Burton, Dan Underwood, Morgan Jacobson, Toni Habegger, Linda Riffe, Carrie Lewellen, Judi Morris. OST staff included: State Treasurer Michael J. Murphy, Assistant State Treasurer Allan J. Martin, Deputy Doug Extine, and Robbi Stedman. Those absent from the meeting were: Stan Finkelstein, Barbara Stephenson, Shelly Pearson, Doug Streeter, and Mary Nelson.

Treasurer Murphy welcomed the committee and brought to attention the new committee members: Linda Riffe (Island County Treasurer) who is a WSACT appointment, and Toni Habegger (Eastern Washington University) who is a Treasurer Murphy appointment.

Doug gave an update on the performance of the LGIP. The net rates for the Pool for April, May, and June were 5.23, 5.19 and 5.21 percent, respectively. The fed funds rate is still hanging at 5.25%, and the LGIP will remain close to that level as long as that is the case. The market is pricing in an ease by the end of 2007. Currently, the portfolio has an average life in the mid forties, which is a bit longer than it has been. Discussion followed.

Robbi distributed a handout to committee members describing LGIP balances. She explained that balances from FY 2007 started out \$550 million above where they were in FY 2006 and ended the year \$1 billion over where they were in FY 2006. She then showed a graph of year over year comparisons of LGIP balances by type of participant. This showed that the extra money in the Pool was evenly distributed throughout the different entity types. Both the LGIP and state treasury accounts set balance records in FY 2007. Discussion Followed.

Doug reviewed the estimated FY 2007 budget utilizing a handout provided to committee members. Compared to the original estimate, fees collected have been higher and expenses slightly lower. Accordingly, the rebate for fiscal year 2007 of about \$1.4 million will be higher than the original estimate. The net fee could end

up being less than one basis point.

For the LGIP Administration Robbi gave an update on the migration to Bank of America's new platform. She explained that OST's treasury account was conducting some testing with some of the state's accounts. Once they are satisfied, the migration will take place. Discussion followed from the various committee members whose entities have migrated already.

Doug announced the Union Bank of California as the Apparent Successful Vendor in OST's RFP search for a custody and securities lending provider. Since OST is still in contract negotiations he couldn't discuss the specifics yet.

Shad Pruitt, OST's Operations Deputy Treasurer, came into the meeting to give an update on the LGIP's RFP for an outside auditor, which began in June. Peterson Sullivan was selected as the winner. Shad thanked the committee made up of Morgan Jacobson, Doug Streeter, and Judi Morris for all of their help in the RFP process. He asked them to make a recommendation to the committee and the committee unanimously passed a motion that selected Peterson Sullivan as the Auditor.

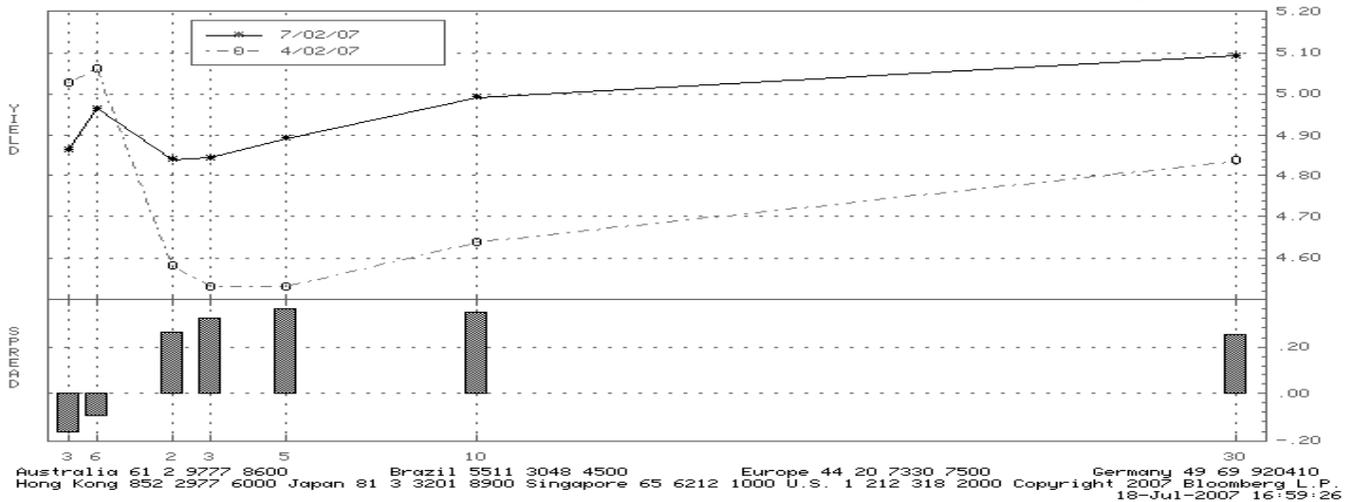
Doug discussed the upcoming investment education opportunities at the September WFOA Conference. Two speakers, Deanne Woodring of DA Davidson and Mark Evans of Vining Sparks, are scheduled to teach a total of four sessions.

The next meeting will be scheduled in October 2007. When that date has been selected, committee members will be notified.

The meeting was adjourned at 1:45 p.m.

HISTORICAL YIELD CURVE

DATE RANGE 4/ 2/07 7/ 2/07 MTY RANGE 3M 30Y



Welcome

On August 1, 2007 there will be another new face in the Washington State Treasurer's Office.

In July, Treasurer Michael J. Murphy announced that, effective August 1st, Richard A. Patrick of Mount Vernon will become Deputy State Treasurer for Debt Management. Richard (Rick) will manage the state's bond indebtedness – a position that was previously held by Assistant Treasurer, Allan J. Martin.

"Richard comes to us with excellent credentials and experience," Murphy said. "And I have every expectation he will do a great job for the people of our state."

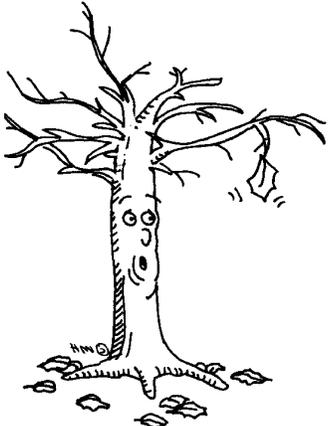


**Richard A. Patrick (Rick)
Deputy State Treasurer**

Following his graduation from high school in Federal Way, Rick attended Western Washington University where he received his BA in Business Administration and Economics in 1985. After college he worked for the City of Yelm as their clerk and treasurer until 1988 when he began working for the City of Burlington as Finance Director.

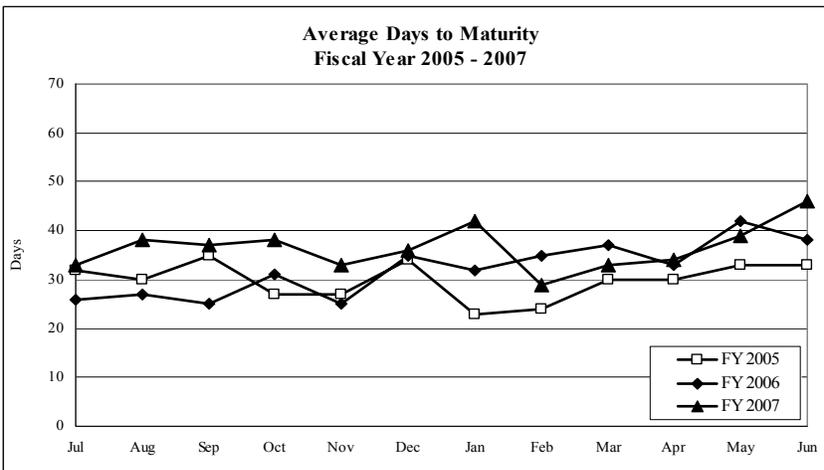
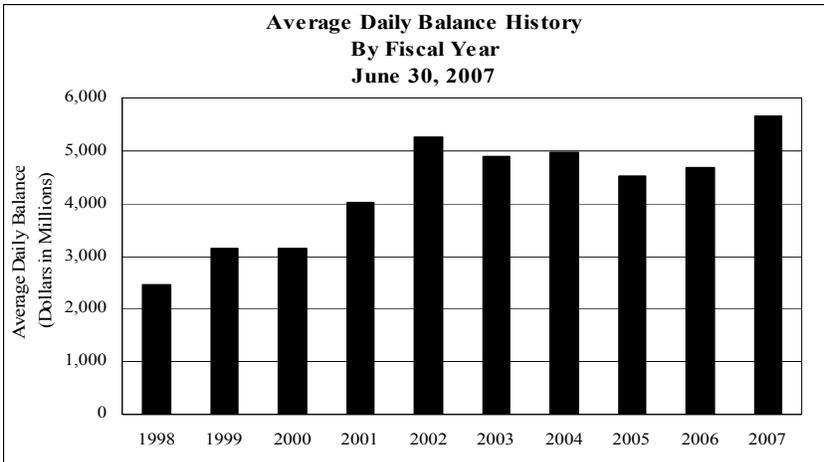
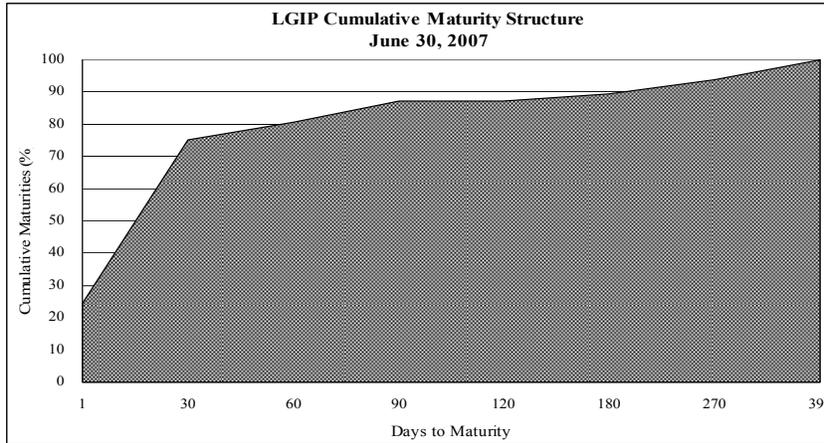
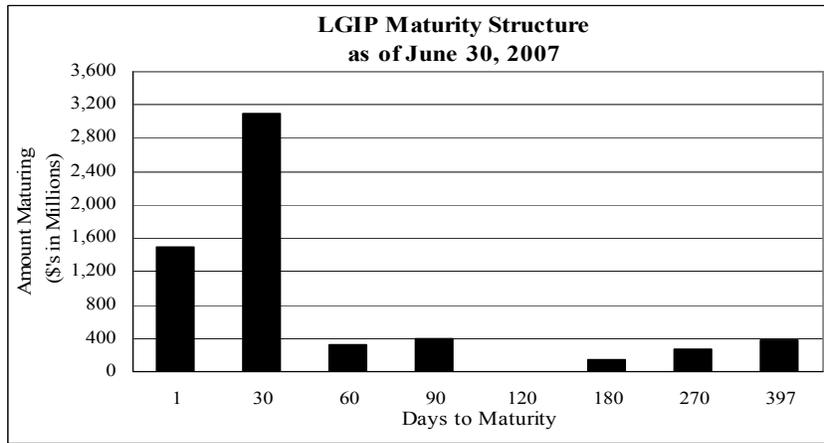
Rick is active member and former board member of the Washington Municipal Treasurers Association, a member of the Washington Finance Officers Association and a member of the Association of Public Treasurers, US and Canada.

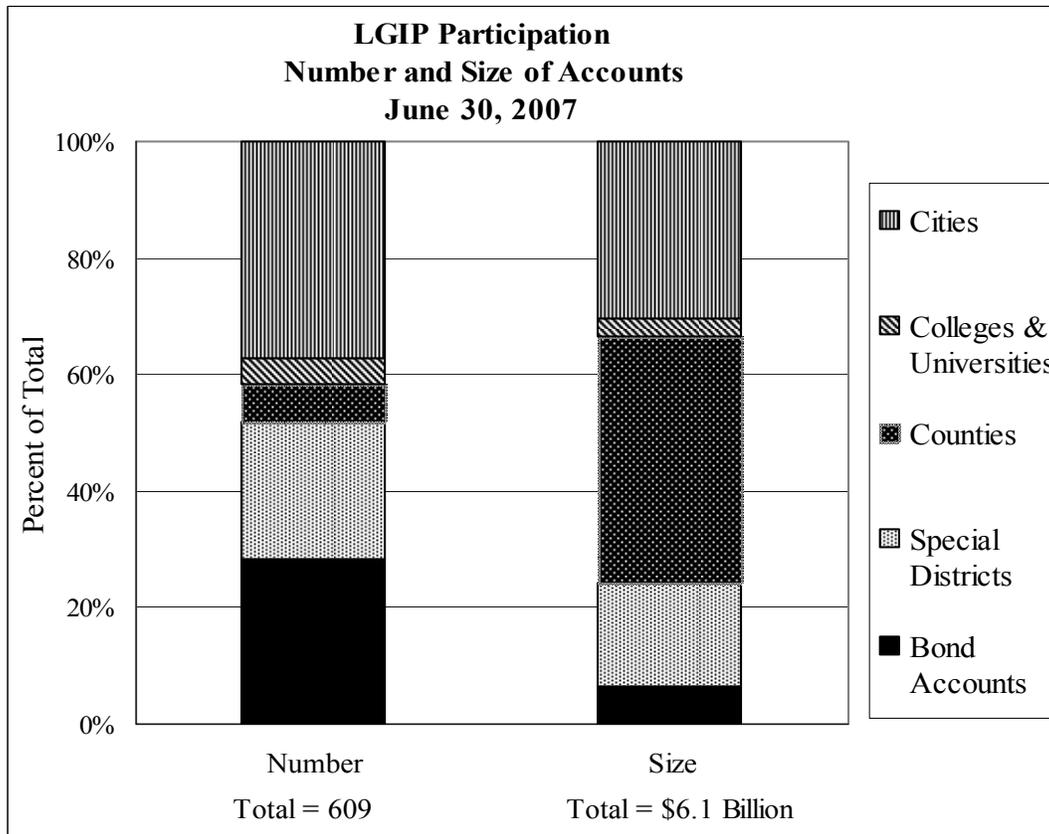
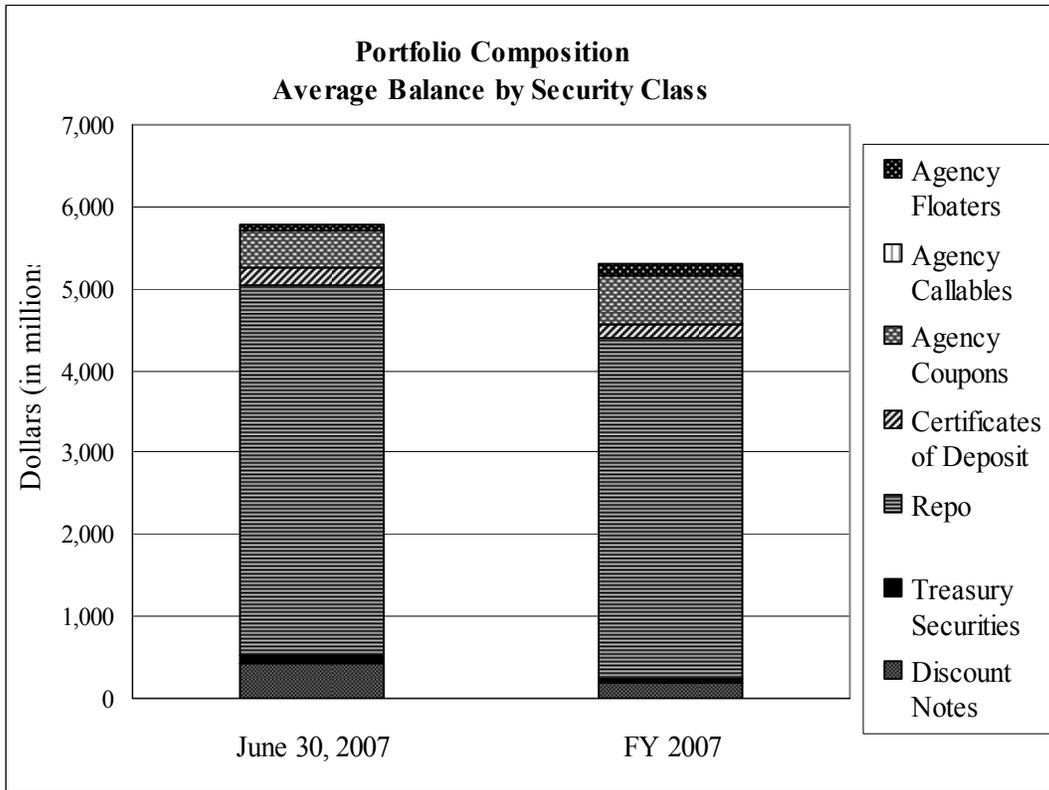
He is married to Janet Mercier (from Yelm) who is Administrative Secretary for the Superintendent of the Conway School District. They have two children, Cody (13) and Carly (11).



WMTA Offers Fall Training

Washington Municipal Treasurer's Association will be providing non-conference training opportunity this coming fall. The training will be held Friday October 5, 2007 at Fort Worden State Park and Conference Center in Port Townsend. Further details will be provided as they become known. If you would like to attend this training or know somebody that would please contact Michael Legarsky at 360-379-4403. There are also scholarship opportunities available for this session, if you are interested in those please contact Robbi Stedman at (360) 902-9013. For more information regarding this training and other information please visit WMTA's website at www.wmta-online.com.





**Washington State Local Government Investment Pool
Position and Compliance Report
as of 6/30/2007**

LGIP Portfolio Holdings	Amortized Cost	Percentage of Portfolio
Agency Bullets	\$ 444,445	7.30%
Agency Discount Notes	992,344	16.29
Agency Floating Rate Notes	49,999	0.00
Agency Variable Rate Notes	0	0.82
Certificate of Deposit	255,350	4.19
Interest Bearing Bank	378,726	6.22
Repurchase Agreements	3,820,672	62.72
U.S. Treasury Bills	0	2.46
U.S. Treasury Coupons	149,795	0.00
	<u>\$ 6,091,331</u>	<u>100.00%</u>

Securities Lending Holdings

Repurchase Agreements	91,105
	<u>\$ 91,105</u>

Total Investments &

Certificates of Deposit	<u>\$ 6,182,436</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

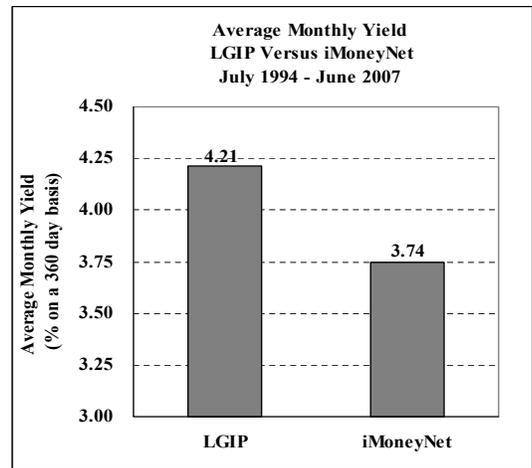
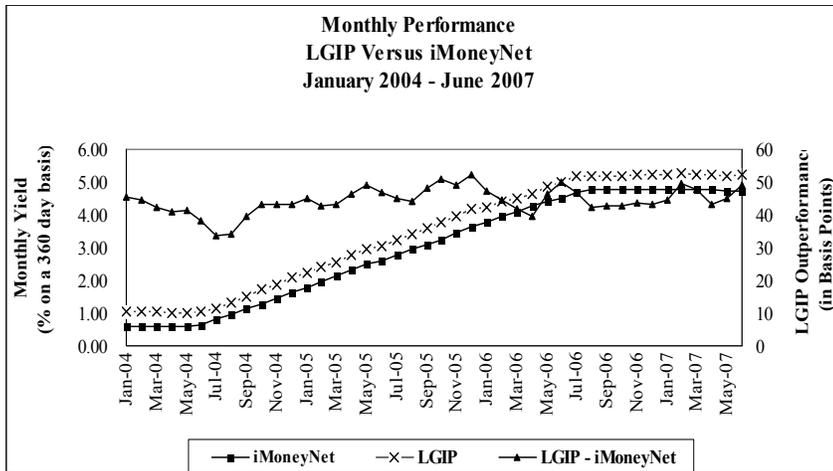
	Holdings	Percentage of Portfolio	Policy Limitations Percentage
Floating Rate and Variable	\$ 49,999	0.82%	30%
Variable Rate Notes > 397	0	0.00%	10%
Other Structured Notes	25,000	0.00%	10%
Term Repo > 30 Days	0	0.00%	30%
Certificate of Deposit	255,350	4.19%	10%
Bankers' Acceptances	0	0.00%	20%
Commercial Paper	0	0.00%	25%
Reverse Repo	0	0.00%	30%
Security Lending + Reverse Repo	88,754	1.46%	30%

Maturity Limitations

	Currently	Policy Limitations
Weighted Average Maturity	46 day(s)	90 day(s)
Maximum Maturity		
Bullet Maturities	381 day(s)	397 day(s)
Floating Rate and Variable Rate Notes	18 day(s)	762 day(s)
Repos	16 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 June 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 June 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 \$224.01 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

	June 30, 2007	Total Repo Percentage (20% limit)	Average D-T-M (30 day limit)	Projected Redemptions 7/02/2007	Projected Position 7/02/2007
Banc America Securities	\$ 500,000	8.21%	10	\$ 200,000	\$ 300,000
Barclays Capital Inc.	300,000	4.93%	5	0	300,000
Bear Stearns & Co.	100,000	1.64%	6	0	100,000
BNP Paribas	1,090,000	17.89%	3	940,000	150,000
Cantor Fitzgerald	700,000	11.49%	3	500,000	200,000
Greenwich	400,000	6.57%	11	0	400,000
Lehman Brothers Inc	330,672	5.43%	2	330,672	0
Morgan Stanley Dean Witter	491,105	8.06%	9	91,105	400,000
Total	\$ 3,911,777			\$ 2,061,777	\$ 1,850,000

Local Government Investment Pool
STATEMENT OF NET ASSETS
June 30, 2007
(in Thousands)

Assets

Investments, at Amortized Cost:	
Repurchase Agreements	\$ 3,820,672
U.S. Agency Securities	1,486,788
U.S. Treasury Securities	<u>149,795</u>
Total Excluding Securities Lending and Securities Purchased But Not Settled	\$ 5,457,255
 Securities Lending Investments, at amortized cost:	
Repurchase Agreements	\$ 91,105
Total Securities Lending	<u>91,105</u>
Total Investments (Settlement Date Basis)	\$ 5,548,360
 Due from Brokers - Securities Purchased But Not Settled, at Amortized Cost:	
U.S. Agency Securities	<u>98,770</u>
Total Due from Brokers	<u>98,770</u>
Total Investments (Trade Date Basis)	5,647,130
 Interest Bearing Bank Deposits	\$ 378,726
Certificates of Deposit	255,350
Cash
Interest Receivable	<u>21,659</u>
Total Other Assets	\$ 655,735
Total Assets	\$ 6,302,865

Liabilities

Accrued Expenses	\$ 750
Obligations under Securities Lending Agreement	91,105
Investment Trades Pending Payable	<u>98,770</u>
Total Liabilities	\$ 190,625

Net Assets

Net Assets	\$ 6,112,240
 Total Amortized Cost - Settlement Date Basis	 \$ 6,182,436

QUARTER AT A GLANCE
April 1, 2007 to June 30, 2007
(in Thousands)

Total investment purchases:	\$ 44,520,452
Total investment sales:	\$ 58,471
Total investment maturities:	\$ 44,252,101
Total net income:	\$ 82,469
Net of realized gains and losses:	\$ 22
Net Portfolio yield (360-day basis):	
	April 5.2260%
	May 5.1936%
	June 5.2068%
 Average weighted days to maturity:	 46 days

WASHINGTON STATE LOCAL GOVERNMENT INVESTMENT POOL
OFFICE OF THE STATE TREASURER
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