MICHAEL J. MURPHY
State Treasurer

The QUARTERLY

Local Government Investment Pool

Third Quarter 2007

Eyes Wide Shut: The re-emergence of risk

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The Federal Open Market Committee (FOMC) decided to cut its target for fed funds to 4.50 percent during its October 2007 meeting. FOMC members also changed their tune about risk assessment to highlight a balanced risk assessment between slowing growth and rising inflation. Economic growth moderated during the first half of FY 2007 but subprime troubles in August created a much bigger problem as contagion spread to other sectors of the economy. The Fed's decision to cut rates was based on the financial disruptions that happened during this quarter. The subprime troubles unmasked a bigger problem; that of global financial institutions gorging on risky mortgage products. Investors were quickly turned off by the quality of papers floating around, creating a very illiquid market for such papers. In the Fed's own words, "(the rate cut was) … intended to forestall some of the adverse effects on the broader economy that might arise from disruptions in financial markets".

What happened this quarter? There was a fundamental change that rattled most investors. Many in the investment community were investing in paper based on the high ratings given by the ratings agencies. There was trust that AAA paper was just that, a highly-rated paper. The drama began to unfold as some papers were not what they seemed when investors tried to liquidate positions. Highly engineered financial products were wrought with errors that brought into question the basic (value) premise of what a AAA paper should be. Mortgage-backed securities went into a tailspin as the bid/offer spreads widened and investors were at a loss as to how to value those products. Financial markets panicked as global investors realized that they had a piece of the rotten pie that was going around the world. From London to Sydney, repercussions of mortgage products haunted the global investing community. Libor rates shot up to their highest historical levels and the Fed was forced to perform its "lender of last resort" function to stave off financial market disruptions. The Fed lowered its discount rate initially by half a percentage point to 5.25 percent but it did not take long to realize that they would have to do more to restore confidence, thus, another 25 basis point cut in October.

The bigger picture in all these details was the US housing market. Sales of new homes plunged by another 3.1 percent in September after an 8.35 percent decline in August, the lowest point in more than ten years. The Fed in their October meeting statement highlighted their warning that "the pace of economic expansion will likely slow in the near term, partly reflecting the intensification of the housing correction".

Homeowners were worried about their mortgage ARMS (adjustable rate mortgages) and resets coupled with plunging home values and negative equities. Banks were likewise scrambling to reduce their exposure in a more difficult to sell debt market. More than 65 percent of investors were struggling to find bids for their holdings. This was the perfect storm that made investors realize that risk was back! The era of easy money got buried under the debris of papers; among them were ABCPs (asset-backed commercial papers), CDOs

continued on page 2

Market summary

from page 1

(collateralized debt obligations), and SIVs (Structured Investment Vehicles), etc.

More bad news dominated investors' wall of worries as the nonfarm jobs in August dropped for the first time in four years. Investors, meanwhile, saw casualties coming from the mortgage industry as the biggest companies announced multiple closures of their businesses. September job numbers assuaged fears of a meltdown as payrolls grew 110,000 after an 89,000 increase in the previous month. Investors, however, expressed skepticism about how much the economy has recovered from the previous month's market turmoil. Economists were also chiming in to former FOMC chairman Greenspan's dire prediction of a 35% chance of a recession. The possibility is not far-fetched as higher borrowing costs could cause both consumers and businesses to shy away from risk just like what investors did.

Economists have started lowering economic forecasts as the rising cost of money has affected the economy's twin pillars of strength namely, jobs and consumer spending. Economic growth is estimated to be around 1.8-2.0 percent. Investors are watching if growth will be severely affected by the credit crunch. Big retail stores such as Wal-Mart and Target have already warned that their retails numbers would not meet analysts' expectations for the succeeding quarters. Home Depot and Lowe's have announced disastrous sales numbers which could be an ominous sign to what the fourth quarter could bring. Consumer confidence has remained near their lowest level since October 2005 coming in at 95.6 in September of this year.

The FOMC minutes, clearly, stated that "further actions would depend on how economic prospects were affected by evolving market developments" but further rate cuts will depend on economic data. Fed officials were more confident that inflation could sustain a rate between 1-2 percent, the Fed's comfort range. The only caveat that the minutes stated regarding inflation was the risk that the dollar could continue to depreciate significantly. A lower dollar could raise the risk of higher import prices on energy and commodity products. This current situation prompted the Fed to examine the risk of renewed pressure on inflation.

The Bond Market

Financial markets have been looking closely at LIBOR rates and spreads for clues as to the depth and width of the current financial disruption. Investors are keen to examine if pressure has abated through commercial paper transactions and new supply issuance. The Fed's further rate moves could define a solid trading range and favor yield curve strategies. Rate movements will mimic changes in economic indicators. Fed fund futures have priced-in another 25 basis point rate cut for the last quarter of CY 2007 but the market is uncertain how the interplay of growth and inflation will affect the Fed's future course of action.

The Fed at its October meeting recognized the partial normalization of the financial markets intermediation process. They acknowledged that financial strains have quite moderated but noted that there has been continued stress in the credit markets. The Fed opined that their rate cuts could somehow forestall the fallout from the subprime debacle and over time promote the return of an orderly market. Investors will probably monitor current economic developments more intensely in order to gauge the Fed's propensity to cut rates in the future. The Fed's current neutral directive on rates suggests that they are inclined to hold further rate cuts barring further financial shock or economic deterioration.

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

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360-902-9020

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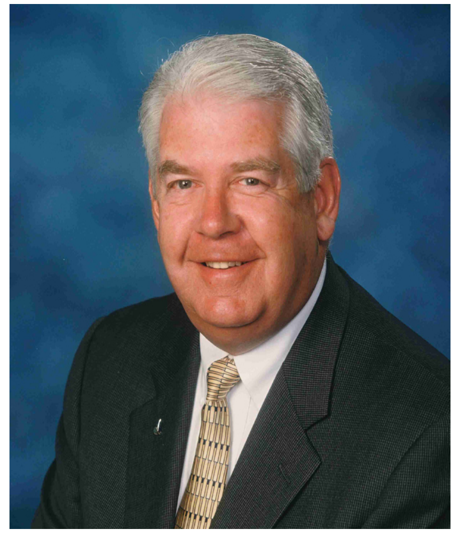
360-902-9021

Treasurer Michael J. Murphy receives national honors

September 17, 2007 the National Association of State Treasurers (NAST) presented their most prestigious award – the Harlan Boyles Distinguished Service Award - to Washington State Treasurer, Michael J. Murphy. The presentation was made during NAST's Annual Conference being held in Sun River, Oregon.

Named after former North Carolina State Treasurer Harlan Boyles, the award represents the highest achievement in public service and community stewardship. Harlan Boyles served twenty-four years in public service and exemplified the highest ideals of integrity and hard work – never losing sight of the fact that state treasurers are guardians of the public purse.



Treasurer Michael J. Murphy

Save the Dates:

The 2008 Conferences are coming soon!

April 9-11, 2008
WMTA
Cambells Resorts
Lake Chelan

Sept.16-19, 2008
WFOA
Yakima

Welcome ....

We are excited to announce our latest edition to the Investment section at OST. We will let her tell you about herself in her own words.

My name is Kari Sample; I live in McCleary, Wa. I am married to my wonderful husband, Ryan, for six years. We have a beautiful 3 ½ year old daughter named Janessa. We enjoy all the aspects of the outdoors. Some of our hobbies include: Camping, ATV riding, and Hunting.

I am really excited to take on the task as Fiscal Analyst 2 position in the Investment section. I think it will be a great learning experience. I also want to use my knowledge I have accumulated through the past few years with work and school. I have an AA in Accounting from Grays Harbor College and hope to further my education in the near future.

I was formerly employed by Simpson Door Company for the past 8 ½ years. I started there as a production worker while attending college and eventually took on an Accounting Clerk position in the office.

Thank you everyone for the warm welcome.

Kari 's primary duties will involve administration of the OST CD programs. However, she will also serve as one of the back-ups for the LGIP desk so you may be speaking to her at some time.

LGIP Yields – Where did the 5.25% go?

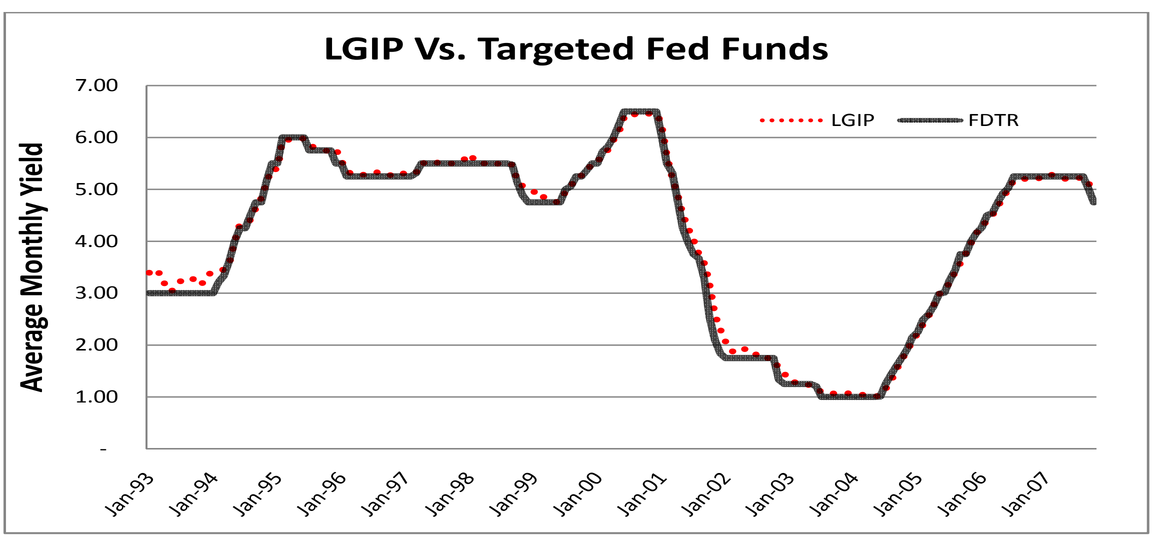
After having an LGIP yield very close to 5.25% from July 2006 through August 2007 the LGIP gross yield fell to 5.16% in September and to 4.95% in October. You may be asking yourself why the decline in yield and also how fast and how far will it decline? Those are both good questions and we would love to be able to give you a definitive answer but to a great extent that is beyond our control.

As we have pointed out in previous newsletters, the LGIP yield follows the targeted fed funds rate very closely. The graph below shows the close relationship between the targeted fed funds rate and the net LGIP yield over a 15-year period. Most of the time it is difficult to see two lines in the graph as the average difference between them is only 5 basis points (bp). The average monthly yield of the LGIP was 4.15% while the average of the targeted fed funds rate was 4.10%.

Two valid questions at this point would now be why does this relationship exist and what are the expectations for the targeted funds rate? The answer to the first is relatively simple and straight forward. The vast majority of the LGIP investments are confined to very short maturities. The yields of those investments are based primarily on the current targeted fed funds rate. Since the average maturity of the LGIP is very short, generally 30 to 60 days, the portfolio reprices rather quickly to any changes in the fed funds rate. As for expectations for the targeted funds rate the answer becomes more difficult and complex.

The Federal Open Market Committee (FOMC), which determines the targeted fed funds rate, meets 8 times a year. They have a dual role of fostering economic growth while ensuring that inflation remains at low levels. Thus, when trying to stimulate economic growth the FOMC will lower the funds rate and will raise it when trying to keep inflation in check. As can be seen from the graph there have been some wide fluctuations in the funds rate over the last six years, from a high of 6.50% down to 1.00% and then back up to 5.25%. At the September 18 FOMC meeting the targeted funds rate was lowered by 50 bp to 4.75% and then again on October 31 to 4.50%. This explains the decline in the LGIP yield.

You might be asking why the LGIP didn't fall immediately to 4.75% when the Fed eased? The answer lies in the weighted average maturity of the LGIP investments. The portfolio contains securities with maturities ranging from overnight to 13 months. While current investments are being made in the lower rate environment, the portfolio contains securities with yields above 5.00% that do not mature until next year. The LGIP yields will be boosted by those securities until they mature. Thus while the LGIP yield will eventually approach the targeted funds rate it will happen over a matter of weeks or a couple of months. If the FOMC continues to ease the LGIP yield will continue to decline but in a lagged fashion.



From the LGIP Administrator's Desk:

By Robbi Stedman

Happy Fall everybody! It is always amazing how quickly the seasons change and how fast it gets dark! Anyway, the first LGIP item on my list is updating of accounts. I would recommend to every participant to take a moment and make sure that their accounts are up to date. As I go through them I know many are outdated. If you need help or need to know who is actually authorized on your account please don't hesitate to contact me. Our authorization forms can be found on our website: *www.tre.wa.gov*.

I currently serve on the board for WMTA as the ex-officio representative of the State Treasurer's Office and recently assumed the chair of the WMTA Scholarship Committee. Every year at our annual conference we hold an auction to raise money for our scholarship program which supports the education of local governments. I just wanted to take the opportunity to encourage people to apply for our scholarships. You can find the applications on our website at *www.wmta-online.com*. Elizabeth Alba recently received a scholarship for travel to a WTMA training opportunity and this is what she had to say, "Thank you very much. I appreciate WMTA's willingness to work with me to further my education."

You need to be a member to receive a scholarship, but the amount a person would receive in scholarships far outweighs the cost of membership. If you want to attend the WMTA Conference and just don't have it in your budget, just apply! We WANT to give away money! That is what we raise it for. Again if you have any questions about this please don't hesitate to contact me.

Finally, in other LGIP news we started our new contract with Bank of America as of July 1, 2007. We anticipated that under the new contract our banking fees would be lowered. So far this has proven to be the case, which is good news for your rebate!

News ....in brief

Save the Dates:

The 52nd annual WFOA conference held in Kennewick was a big success. It was the largest Eastern Washington attendance the conference has seen. We received positive feedback from our investment tracks with Deanne Woodring of Davidson Fixed Income and Mark Evans of Vining Sparks. Next year WFOA stays on the east side of the state but moves to Yakima. The dates are September 16-19th 2008.

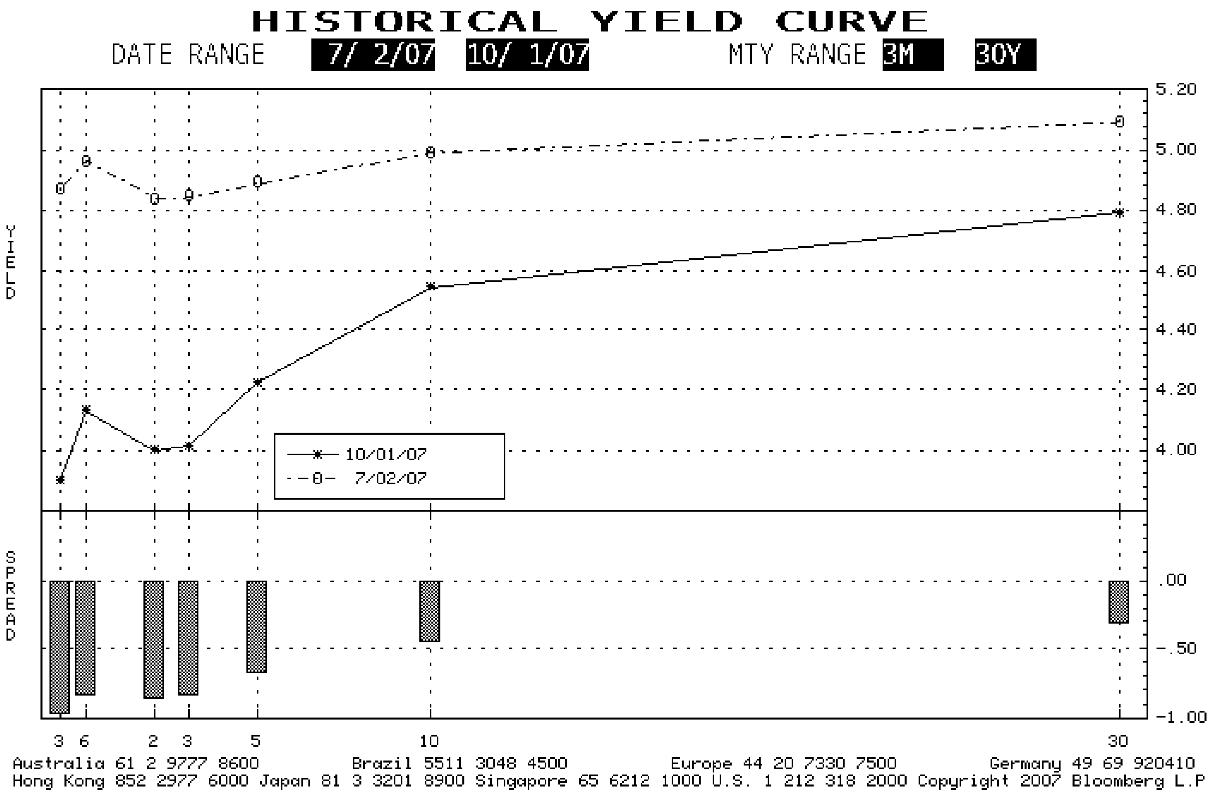
The 2008 WMTA Conference will be held April 9-11, at Campbell's Resort in Chelan. Make your reservations early! WMTA provides a great opportunity for continuing education through roundtable style classes and the chance to network with your peers. Don't miss the Investment Boot Camp with Jon Highum and Deanne Woodring for a roundtable. Mark your calendars!

Union Bank as new custody bank

We are pleased to announce the successful conversion to Union Bank of California as OST's new custody and securities lending provider. The contract, which includes both the state portfolio as well as the LGIP, began on October 1, 2007 and runs for four years, with the possibility of a two-year extension.

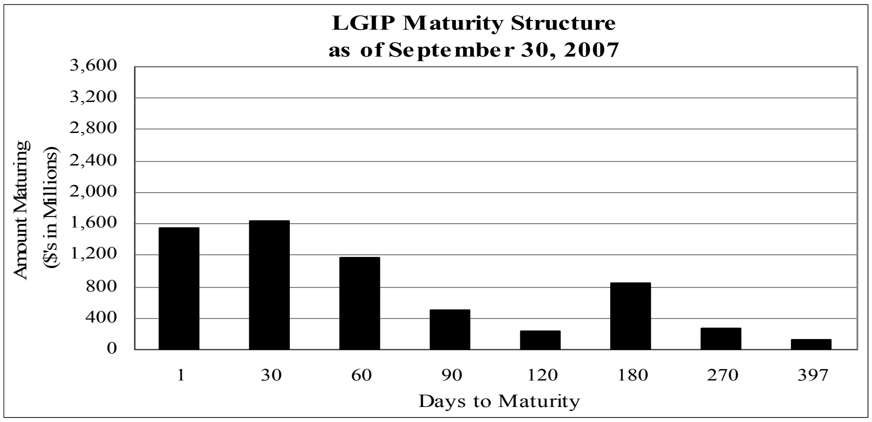
LGIP Has Record Balance:

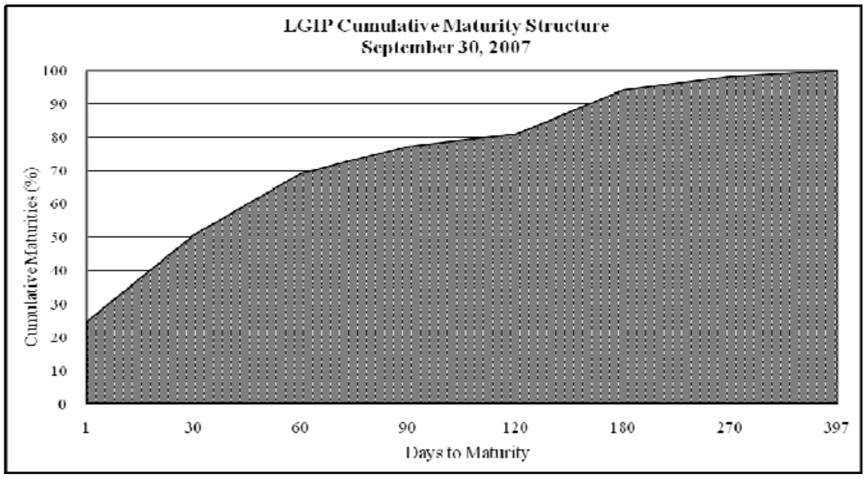
For the first time in its 21 year history the Local Government Investment Pool broke the $7 billion mark at October month end. The balance as of October 31 was $7.3 billion. The combined total of the Treasury and LGIP also reached record levels.

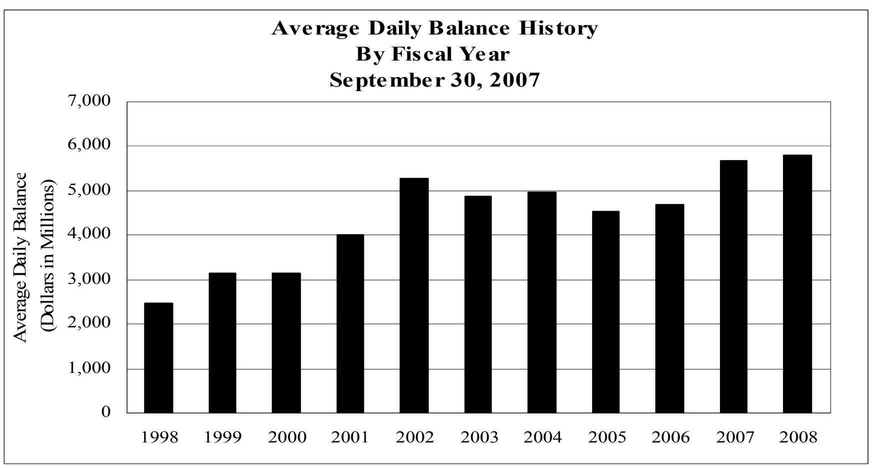


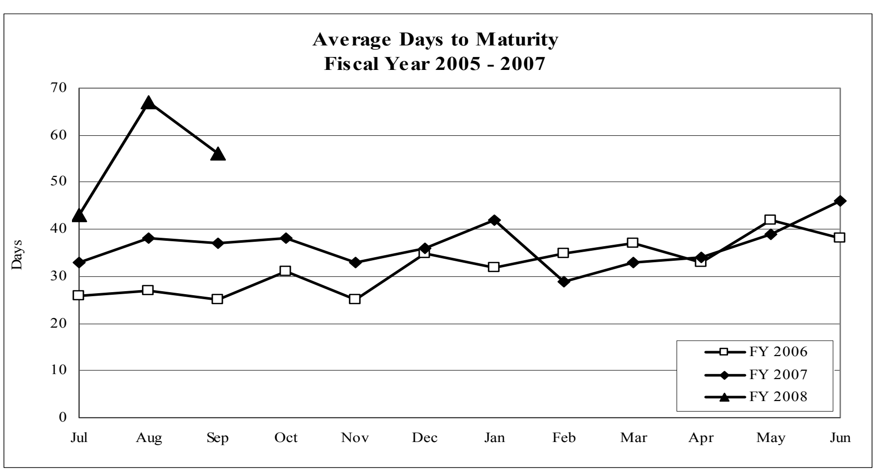
LGIP Holiday Schedule 2007-2008

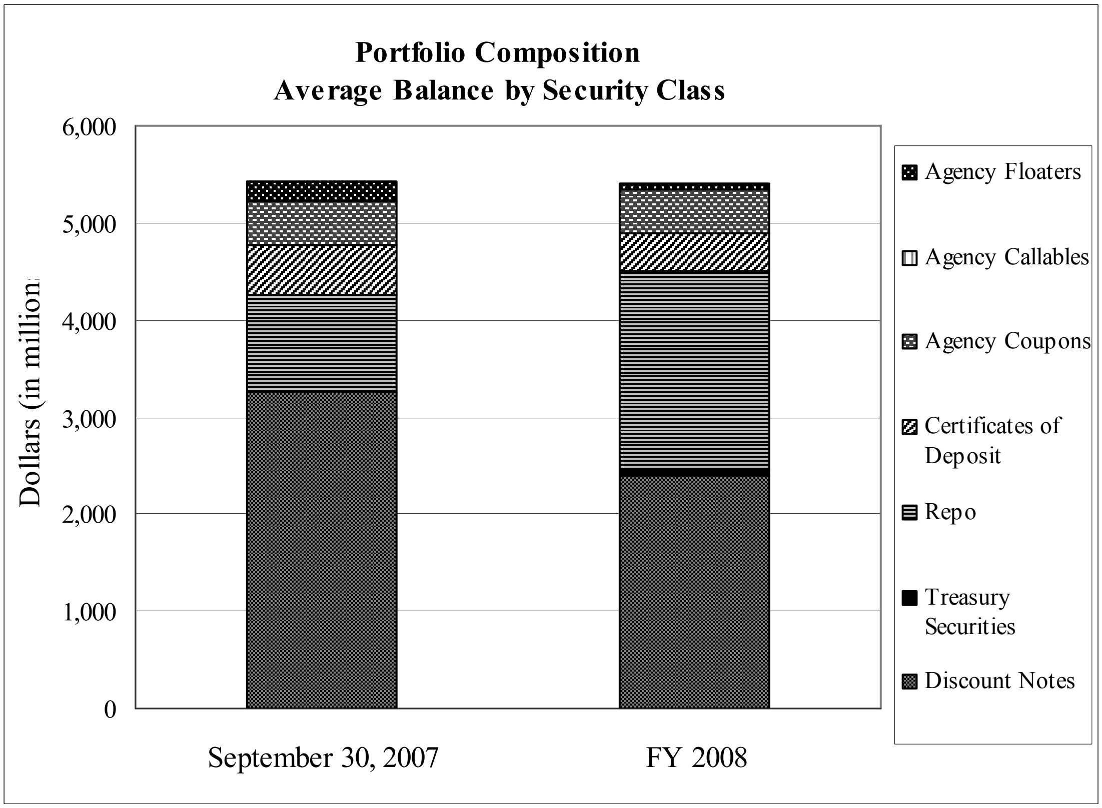
Thursday/Friday	November 22/23	Thanksgiving Holiday
Tuesday	December 25	Christmas
Tuesday	January 1	New Year’s Day
Monday	January 14	Martin Luther King’s Birthday
Monday	February 18	President’s Day
Monday	May 26	Memorial Day
Friday	July 4	Independence Day
Monday	September 1	Labor Day
Monday	October 13	Columbus Day
Tuesday	November 11	Veteran’s Day
Thursday/Friday	November 27/28	Thanksgiving Holiday
Thursday	December 25	Christmas

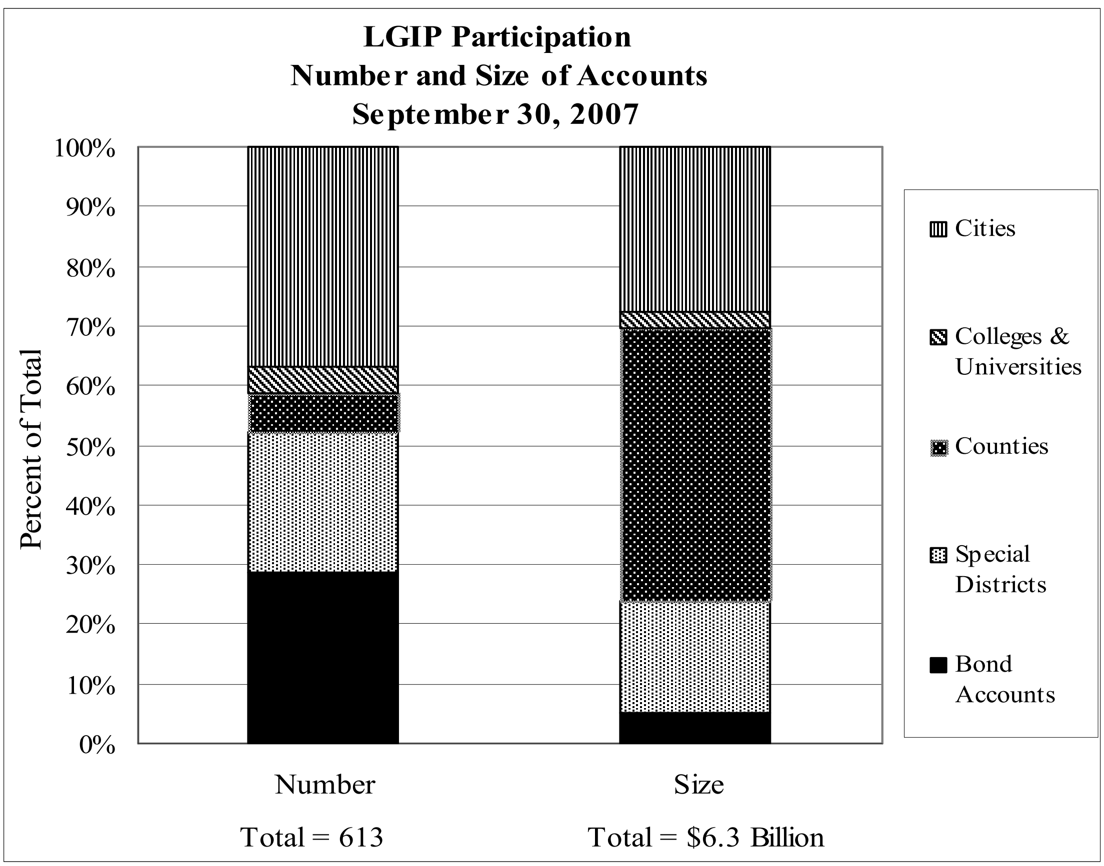

LGIP Maturity Structure
as of September 30, 2007
Amount Maturing
($'s in Millions)
3,600
3,200
2,800
2,400
2,000
1,600
1,200
800
400
0
1
30
60
90
120
180
270
397
Days to Maturity


LGIP Cumulative Maturity Structure
September 30, 2007
Cumulative Maturities (%)
100
90
80
70
60
50
40
30
20
10
0
1
30
60
90
120
180
270
397
Days to Maturity


Average Daily Balance History
By Fiscal Year
September 30, 2007
Average Daily Balance
(Dollars in Millions)
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008


Average Days to Maturity
Fiscal Year 2005 - 2007
Days
70
60
50
40
30
20
10
0
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
Apr
May
Jun
FY 2006
FY 2007
FY 2008


Portfolio Composition
Average Balance by Security Class
6,000
5,000
4,000
3,000
2,000
1,000
0
Dollars (in millions)
Agency Floaters
Agency Callables
Agency Coupons
Certificates of Deposit
Repo
Treasury Securities
Discount Notes
September 30, 2007
FY 2008


LGIP Participation
Number and Size of Accounts
September 30, 2007
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Percent of Total
Cities
Colleges & Universities
Counties
Special Districts
Bond Accounts
Number
Size
Total = 613
Total = $6.3 Billion

Washington State Local Government Investment Pool
Position and Compliance Report
as of 9/30/2007

LGIP Portfolio Holdings	Amortized Cost	Percentage of Portfolio
Agency Bullets	$ 430,702	6.84%
Agency Discount Notes	2,921,520	46.40
Agency Floating Rate Notes	219,976	3.49
Agency Variable Rate Notes	0	0.00
Certificate of Deposit	489,350	7.77
Interest Bearing Bank	385,879	6.13
Repurchase Agreements	1,848,320	29.36
U.S. Treasury Bills	0	0.00
U.S. Treasury Coupons	0	0.00
	$ 6,295,747	100.00%

Securities Lending Holdings	
Repurchase Agreements	$ -
	$ -
Total Investments & Certificates of Deposit	$ -

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

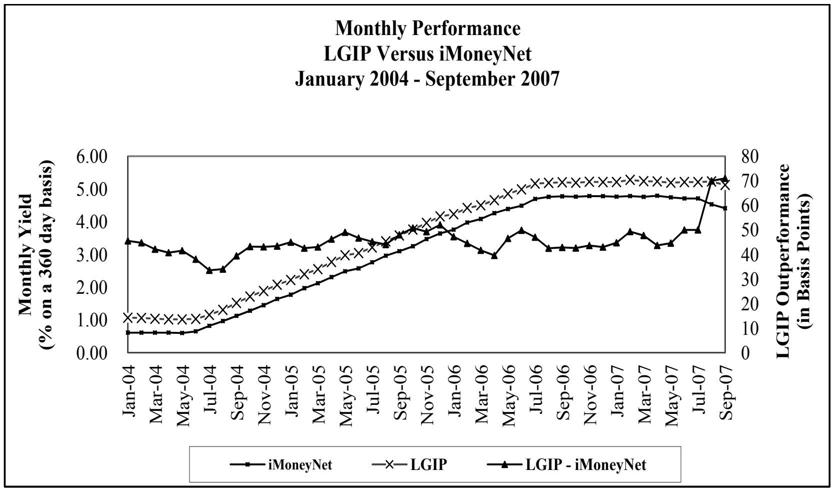
		Percentage of Portfolio	Policy Limitations Percentage
Floating Rate and Variable	$ 219,976	3.49%	30%
Variable Rate Notes > 397	0	0.00%	10%
Other Structured Notes	0	0.00%	10%
Term Repo > 30 Days	0	0.00%	30%
Certificate of Deposit	489,350	7.77%	10%
Bankers' Acceptances	0	0.00%	20%
Commercial Paper	0	0.00%	25%
Reverse Repo	0	0.00%	30%
Security Lending + Reverse Repo	0	0.00%	30%

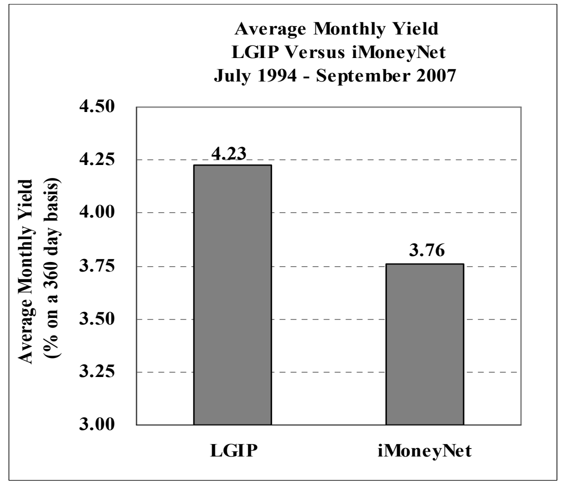
Maturity Limitations

	Currently	Policy Limitations
Weighted Average Maturity	56 day(s)	90 day(s)
Maximum Maturity		
Bullet Maturities	355 day(s)	397 day(s)
Floating Rate and Variable Rate Notes	521 day(s)	762 day(s)
Repos	5 day(s)	180 day(s)
Reverse Repos	0 day(s)	90 day(s)

continued on page 10

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





The chart on the left shows a monthly comparison from January 2004 through September 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 September 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 $230.74 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., West borough, 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

	September 30, 2007	Total Repo Percentage (20% limit)	Average D-T-M (30 day limit)	Projected Redemptions 10/1/2007	Projected Position 10/1/2007
Banc America Securities	$ 300,000	4.77%	5	$ 0	$ 300,000
BNP Paribas	500,000	7.94%	2	200,000	300,000
Cantor Fitzgerald	150,000	2.38%	1	150,000	0
Citigroup Global Markets Inc.	300,000	4.77%	2	0	300,000
Greenwich	500,000	7.94%	1	500,000	0
Lehman Brothers Inc	98,320	1.56%	1	98,320	0
Total	$ 1,848,320			$ 948,320	$ 900,000

Local Government Investment Pool

STATEMENT OF NET ASSETS

September 30, 2007

(in Thousands)

Assets		
Investments, at Amortized Cost:		
Repurchase Agreements	$	1,848,320
U.S. Agency Securities		3,572,198
Total Excluding Securities Purchased But Not Settled	$	5,420,518
Total Investments (Settlement Date Basis)	$	5,420,518
Due from Brokers - Securities Purchased But Not Settled, at Amortized Cost:		
U.S. Agency Securities		78,463
Total Due from Brokers		78,463
Total Investments (Trade Date Basis)		5,498,981
Interest Bearing Bank Deposits	$	385,879
Certificates of Deposit		489,350
Cash		1,452
Interest Receivable		11,475
Total Other Assets	$	888,156
Total Assets	$	6,387,137
Liabilities		
Accrued Expenses	$	272
Investment Trades Pending Payable		78,684
Total Liabilities	$	78,956
Net Assets	$	6,308,181
Total Amortized Cost - Settlement Date Basis	$	6,295,747

QUARTER AT A GLANCE

July 1, 2007 to September 30, 2007

(in Thousands)

Total investment purchases:	$	63,416,623
Total investment sales:	$	268,052
Total investment maturities:	$	62,996,949
Total net income:	$	77,271
Net of realized gains and losses:	$	377
Net Portfolio yield (360-day basis):		
	July	5.2053%
	August	5.2265%
	September	5.1232%
Average weighted days to maturity:		56 days

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OLYMPIA WA 98504-0200

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