MICHAEL J. MURPHY
State Treasurer

The QUARTERLY

Local Government Investment Pool

Liquidity Crunch

Third Quarter 2008

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The Federal Reserve, during its October 29 meeting, decided to trim its benchmark interest rate by half a percentage point in an effort to resuscitate the stalled US economy. The federal funds rate now stands at 1.00 percent matching its historical low during the last easing cycle in 2003. The FOMC Committee highlighted that "downside risk to growth remain" as the main reason for them to cut rates aggressively. For most investors, the economy feels like it is in recession already since the current financial crisis threatened to take the global economy hostage to illiquidity. This global credit crisis began with the collapse of the US mortgage-backed securities market, and was exacerbated by credit derivatives. Credit default swaps used by many financial institutions in order to hedge their risk exposure, became worthless when Lehman Brothers (who underwrote $400 billion contracts) declared bankruptcy.

Central banks all over the world have taken steps to improve credit conditions by implementing coordinated policy actions such as rate cuts, liquidity measures to bring down LIBOR levels, and other extreme measures like different credit/swap guarantees. The US Treasury was given legislative support to execute a rescue to the financial system via the $700 billion Troubled Asset Relief Program, or commonly called TARP. The TARP program was designed as a vehicle to do a combined asset purchase/capital injection rescue to troubled financial companies that were deemed too big to fail. European and Asian governments also instituted similar programs in order to rescue similar local institutions that were at-risk of defaulting as well. The global crisis was basically rooted to the desire of many financial institutions to boost earnings growth by employing leverage trades. In fact, even a country such as Iceland became the model of "what-not-to-do" as the country's financial institutions borrowed 12 times the country's GDP bringing the country to its knees. A host of other countries in Europe employed similar borrowing in foreign currencies due to lower interest rates. When trades unraveled, commercial banks were unprepared for the massive losses and write-downs.

Illiquidity was brought about by a confluence of negative factors related to bad assets. Financial institutions around the world became so enamored by profitable mortgage/securitized products. Unfortunately, when those turned sour it severely weakened their capital base. More aggressive institutions became insolvent and declared bankruptcy which further aggravated other mortgage-related products. Weakened capital positions, in turn, prevented banks and dealers from adding more paper to their balance sheets. Finally, a point was reached when nobody wanted to lend and no one trusted their counterparties' ability to execute trades, bringing down the basic function of these dealers/banks which is, financial intermediation.

Delevering has been the buzz word of late as banks are seeking to strengthen their capital positions. The Federal Reserve has opened different facilities through its discount window, securities lending, open market operations, and other money market facilities in order to unclog the system. Investors are watching intently to see if these programs are successful in liquefying the global financial markets.

Economic outlook worsens

The economy suffered its worst decline since

continued on page 2

Market summary

from page 1

2001, registering a negative 0.3 percent GDP decline for the third quarter. There is no question that the US economy will be in a recessionary mode in 2009 but economists are now debating the severity of the downturn and the ability of the economy to recover. The biggest factor that has created a lot of worries was the big drop in consumer spending. Consumer spending dropped 3.1 percent, its first decline since 1991. Consumers have been hit by shrinking wealth (housing, stock market, and personal income), higher unemployment, and tighter credit. Unemployment has been most negative as initial 2009 unemployment rate forecast could go higher than 8 percent. Layoff announcements have been a constant theme this quarter across a broad swath of industries and cutbacks in business spending might hasten layoffs.

The Fed has reiterated that the downside economic risks are rising. The seize-up in the credit markets has had a deleterious effect of working its way into different aspects of economic activity. Consumers, businesses, state and local government entities have a difficult time obtaining credit. The entire US economic system is based on credit and without the availability of money; it is akin to a heart functioning with the main arteries clogged.

The Bond Market Outlook

The bond market suffered from illiquidity due to investors' desire to hoard cash. Market dislocations were all over the curve especially in the agency sector. Investors preferred to park their money in the more liquid treasury products than agency papers with yields over 150 basis points higher. Uncertainties regarding government guarantees, and the multitude of programs attempting to liquefy the markets, have made investors stay on the sidelines waiting to see what, if anything, would work. The TARP program, which will allow the Treasury to infuse capital to troubled assets, has been under scrutiny as to what form it will take. It remains to be seen how the Fed's efforts to ramp up liquidity in the marketplace will affect the financial system. Currently, despite attempts to pump liquidity, credit conditions remain extremely tight as seen through Libor-OIS levels and TED spreads. Effective fed funds rate are still below targeted fed funds rate by 50 basis points which basically signals an abnormal credit environment.

The agency market will continue its underperformance in the near-term due to supply of competing products that are guaranteed by the US government. FDIC-bank debt papers have been guaranteed up to three years in order to help these institutions in their recapitalization. These papers are more explicitly guaranteed by the US governments which make them more attractive than agency papers (better spreads to treasury). Agency spreads are now repricing based on supply and the perceived explicitness of the guarantee. Investors believe that these papers will only cater to investor-specific needs and their corresponding investment policies. These papers are not a substitute to agency debt. Nonetheless, price discovery will affect the agency market as soon as known factors come out such as size of issuance and the market for such products.

Another factor that contributes to agency underperformance is the balance sheet restrictions of most broker-dealers. Their books have been stuffed with agency products at a time when they should be recapitalizing their finances. Broker-dealers' waning appetite to carry more agency papers in their books are contributing to wider bid-offer spreads. Compounding this situation is the continuous selling of foreign investors in the agency space. Foreign investors have been net sellers of agency papers this quarter making investors uneasy about further adding to their portfolio holdings.

The bright side to all this dire news is that agency papers provide decent spread in a 1 percent fed funds environment. Positive carry and unwillingness of issuers to come out with LIBOR-plus valuations (expensive funding levels) which would limit supply will also put a backstop to further spread widening. Agency-Libor valuations remain at their historically cheapest level which is very difficult to ignore. ■

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MICHAEL J. MURPHY
State Treasurer

State of Washington
Office of the Treasurer

December 3, 2008

To All Public Treasurers:

As this will be the last LGIP Newsletter of my tenure as your treasurer, I want to take this opportunity to thank all of you for your support of the LGIP.

My history with LGIP began as a staffer way back in 1986. For those of you who are old enough to remember that far back, that is when we devised a system to calculate average daily balance per customer and distribute on accreted value of the portfolio on a monthly basis. Twenty-two years and three terms of office later this same process is still in use today!

And, while we use the same process today, our costs for the last two years have been less than one basis point! That is due to your participation and the economies of scale - and some sound investment strategies by our Investment Team (if I do say so myself).

I am very proud of the LGIP and, as I sail (or more accurately drive) off into the Arizona sunset, I am thankful for the fond memories of the LGIP and the folks who make it work. Special thanks to current and past LGIP Board members and to Doug Extine, Robbi Stedman, and the Investment Team.

During these past 12 years we have operated under the philosophy that the people of the Great State of Washington are our priority and we have worked very hard to operate always – and in all ways - in the people's best interest.

With the LGIP I think we have succeeded.

Sincerely,

MICHAEL J. MURPHY
STATE TREASURER

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LGIP – Lagging the Fed?

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Save the Dates:

The 2009 Conferences are coming soon!

April15-17, 2009
WMTA
Lake Chelan

Sept.22-25, 2009
WFOA
Bellevue

LGIP participants have read in the Quarterly and those listening to OST at conferences have heard that the best proxy for the LGIP yield is the targeted fed funds rate. Although the LGIP yields will lag any changes in that rate the monthly yields will follow the targeted fed funds rate. This relationship has held true for the entire 22-year history of the LGIP. When the Fed began lowering rates last September from 5.25% reaching 2.00% in late June the LGIP yields predictably followed, steadily dropping from 5.12% in September 2007 to 2.28% in July 2008. However, the LGIP yields have risen in each of the last three months, reaching 2.47% in October 2008, while at the same time the targeted funds rate was lowered to 1.50% in early October and 1.00% late in the month. Why the divergence, and will it continue are natural questions.

The market has encountered bank failures, a credit-market collapse, and a liquidity crisis. Needless to say, volatility has become the norm. Dislocations have become the major theme. The London Interbank Offered Rate (LIBOR), which typically does not depart very much from the fed funds rate, climbed quickly due to the lack of liquidity—rising over 200 basis points in a month. One- and three-month LIBOR rates peaked at 4.59% and 4.82%, respectively, on October 10, 2008. While the relationship between LIBOR and the targeted funds rate has been significantly abnormal, the same as held true about the relationship between the effective and the targeted fed funds rates, but in the opposite direction. The effective rate, while volatile at times, has historically traded very close to the targeted rate when averaged over say, a two-week period of time. In the 6-week time period between September 22 and November 3 the effective funds rate traded 62 bp below the targeted rate. The LGIP portfolio contains floating rate notes that reset based on the effective funds rate and variable rate notes and interest bearing demand deposit accounts that reset based on LIBOR. The dislocations of those indices have had a significant impact on the relationship between the LGIP and the targeted funds rate, as well as our ability to relatively accurately predict the anticipated LGIP yield for the current month. However, those dislocations are not the only reason. The volatility in the US Agency market was also a culprit.

Typically, an easing fed funds rate would result in a negatively sloped money market yield curve. However, for several months now we have experienced a positively sloped curve that became rather extreme during October. One-week discount notes were trading in single digits, i.e., 0.05%, while 6-month discount notes were trading at over 3.00%. This occurred with targeted fed funds at 2.00% and with market expectations that the Fed would ease that rate much lower than 2.00%. This was an unusual situation. OST was able to lock-in attractive rates, at least relative to the targeted fed funds rate, in 3- to 6-month discount notes, further increasing the lag in portfolio yields relative to the targeted funds rate.

Fortunately, the LGIP participants have been the beneficiaries of the dislocations and the steepness in the US Agency yield curve. However, this is not expected to continue and there are already signs that relationships are starting to normalize. Whether and how long this takes to occur will have a large impact on how long it takes for the LGIP to again approximate the targeted fed funds rate. ■

LGIP Advisory Committee: October 17, 2008 meeting highlights

The LGIP Advisory Committee meeting was held Friday, October 17, 2008, at noon in the State Treasurer's Office, Legislative Building, Olympia, Washington. The following members were present: Barbara Stephenson, Michele Pearson, Toni Habegger, Linda Riffe, Carrie Lewellen, Dani Burton, Dan Underwood, and Judi Morris. Treasurer's Office Staff included Assistant Treasurer Allan J. Martin, Doug Extine, and Robbi Stedman. The following members were absent: Morgan Jacobson, Doug Streeter, Mary Nelson, and Stan Finkelstein.

Doug welcomed everybody to the meeting and started with a bit of a recap of the LGIP Advisory Committee's history. He talked about how this would be the last meeting under the Murphy Administration. Since the Committee serves at the discretion of the State Treasurer, the decision of whether or not to continue the Committee would be at the discretion of the next State Treasurer. Doug thanked the Advisory Committee members for their service.

Robbi spoke about the LGIP Administration. OST has received numerous calls in the past few months about the portfolio from participants. This past August and September she went out on the road and made some sight visits to different LGIP Participants. She mentioned that she tried to pick out participants that weren't at conferences or that she hadn't met yet. She was able to visit about 40 different participants during her travels. With that it was handed over to Doug to discuss the general LGIP Performance and Strategy.

Given all of the economic and financial stresses Doug thought it was very important to spend most of the meeting discussing in detail the current investment climate, the OST strategy for managing the LGIP portfolio, and the current holdings of the portfolio Numerous handouts were presented and extensive discussion followed. Several committee members expressed their appreciation for the in-depth presentation of the state of the market and of the LGIP portfolio.

Doug reviewed the actual fees, expenses, and rebate for FY 2008 utilizing a handout provided to committee members. The estimated expenses for FY 2009 are $590,000. Discussion followed.

The next meeting is tentatively scheduled for January 23. The meeting was adjourned at 2:00 p.m. ■

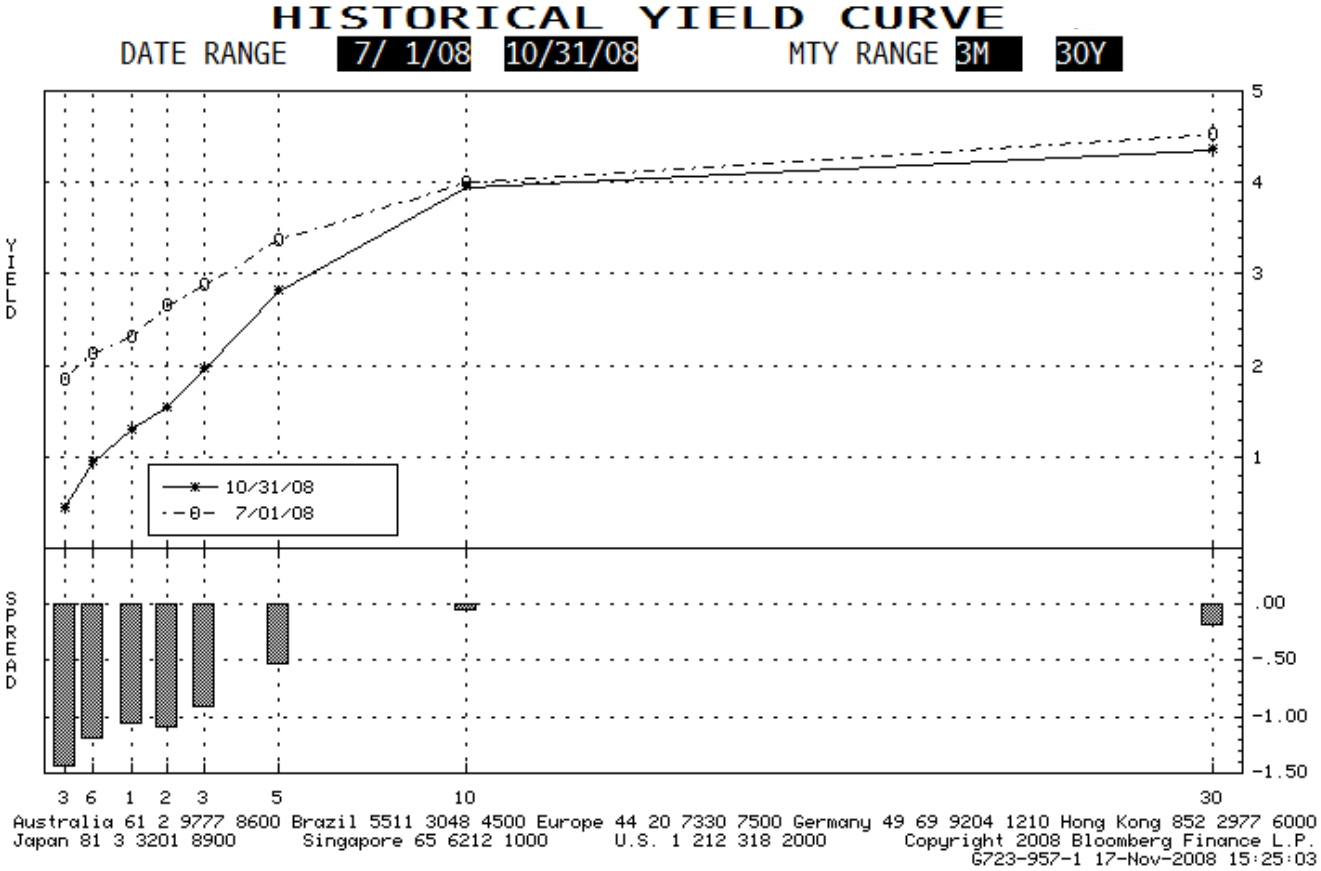
LGIP Holiday Schedule 2008-09

2008	
Thursday - Dec. 25	Christmas
2009	
Thursday - Jan. 1	New Year's Day
Monday - Jan. 19	Martin Luther King
Monday - Feb. 16	President's Day
Monday - May 25	Memorial Day
Saturday - July 3	Independence Day
Monday - Sept. 7	Labor Day
Monday - Oct. 12	Columbus Day
Wednesday - Nov. 11	Veteran's Day
Thursday/Friday - Nov. 26-27	Thanksgiving Holiday
Friday - Dec. 25	Christmas

From the LGIP Administrator's Desk:

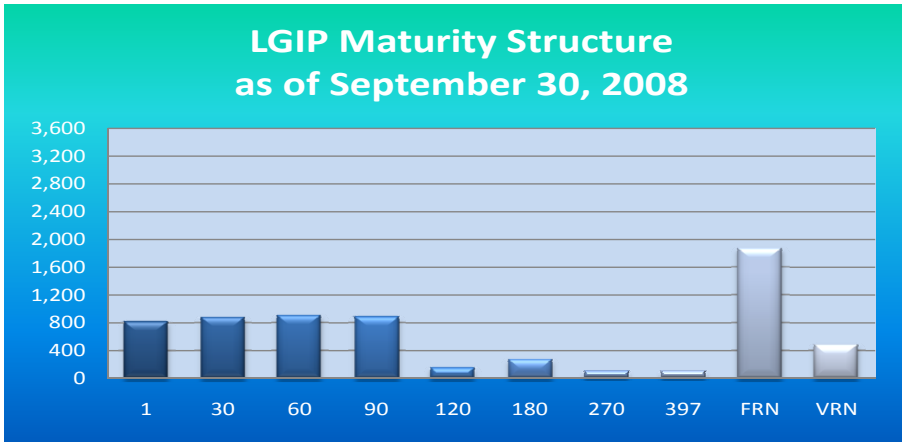
By Robbi Stedman

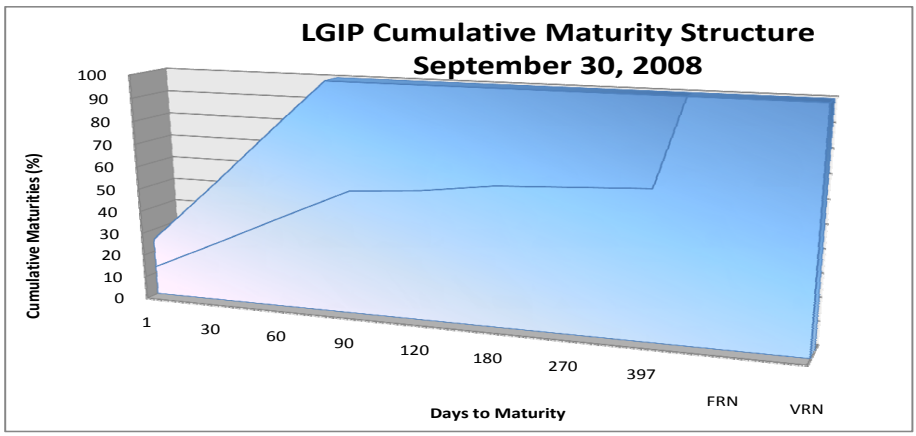
It is almost time for the Holiday Season believe it or not! To say that everything has been crazy so far this fall would be an understatement. Over the past few months we have had the opportunity to speak with many of you as you've had questions regarding the LGIP. Which brings up a good point…when you have a question don't hesitate to call us. I spent some time this summer on the road. In July and August I made my way up and down I-5 doing some LGIP Participant site visits. Of course there was no way to get to all of you, but I tried to target entities that I don't see at conferences or that I haven't had the chance to meet! In all I visited with about 40 different entities. It was awesome to get to meet some of you and see where you work. It was a great chance to talk about the LGIP, WMTA, WFOA, and just visit! So thank you to all of you who took time out of your schedules to see me. ■

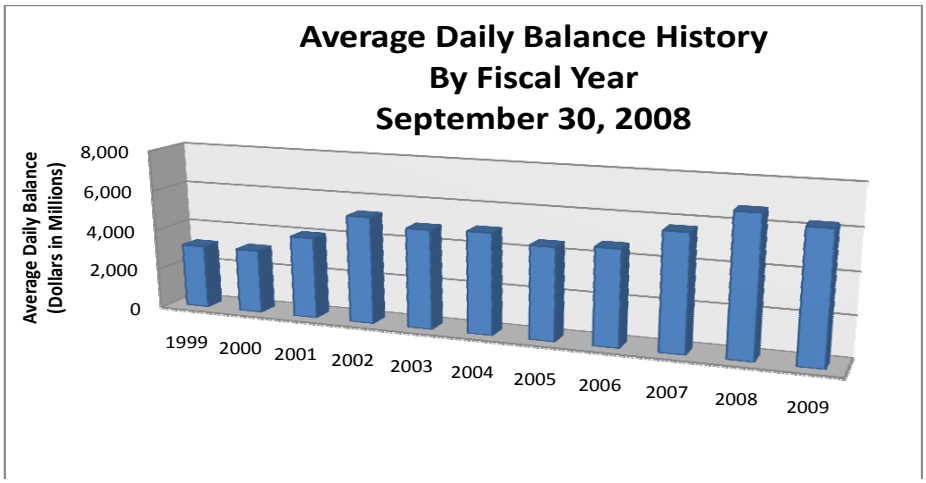


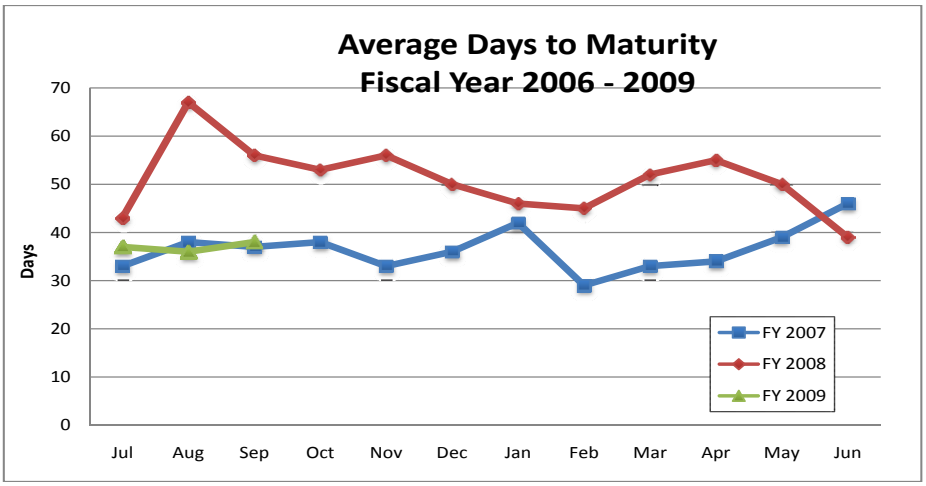
News .....in brief

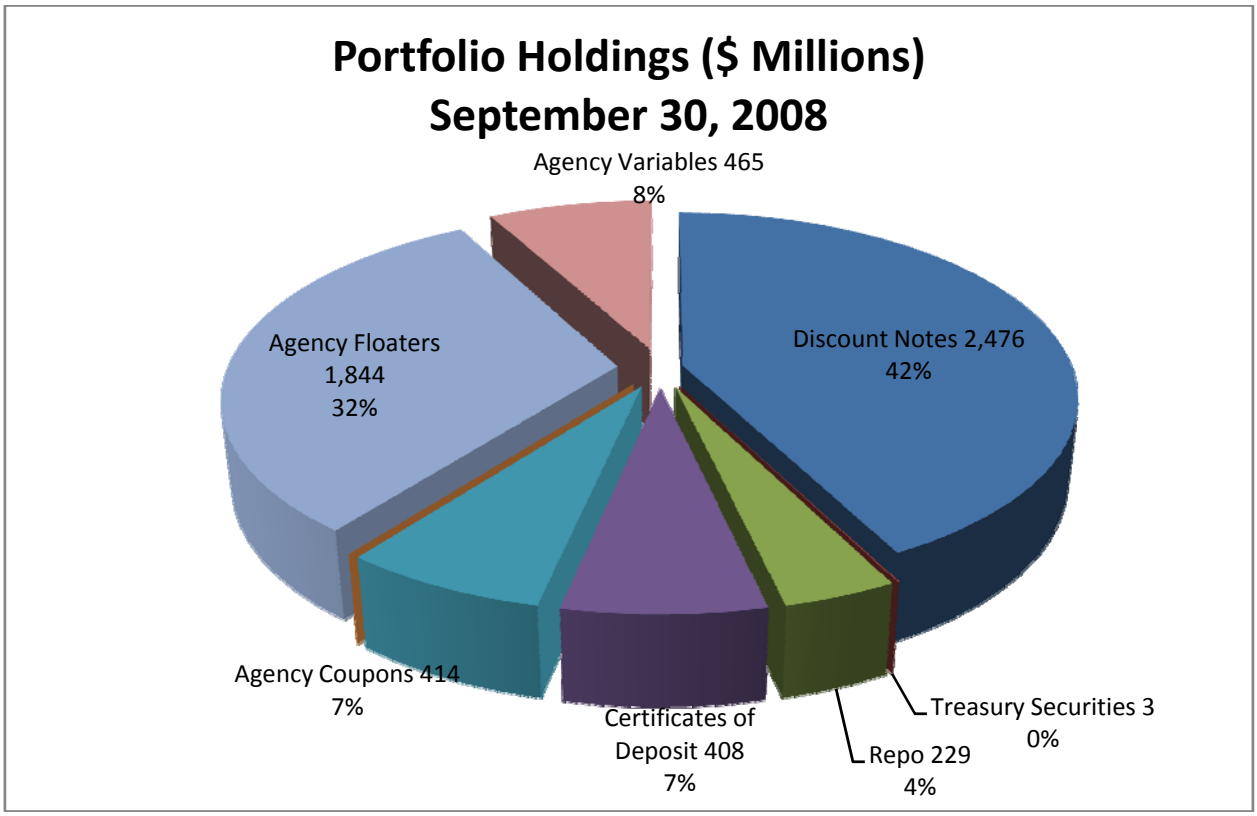
On Wednesday, August 13, 2008, Deputy Treasurer Doug Extine was installed on the Board of Directors of the Association of Public Treasurers of the United States and Canada (APT US&C) during their 43rd Annual Conference in Grand Rapids, Michigan. In addition to serving on the board Doug also chairs the APT US&C Investment Practices Committee.

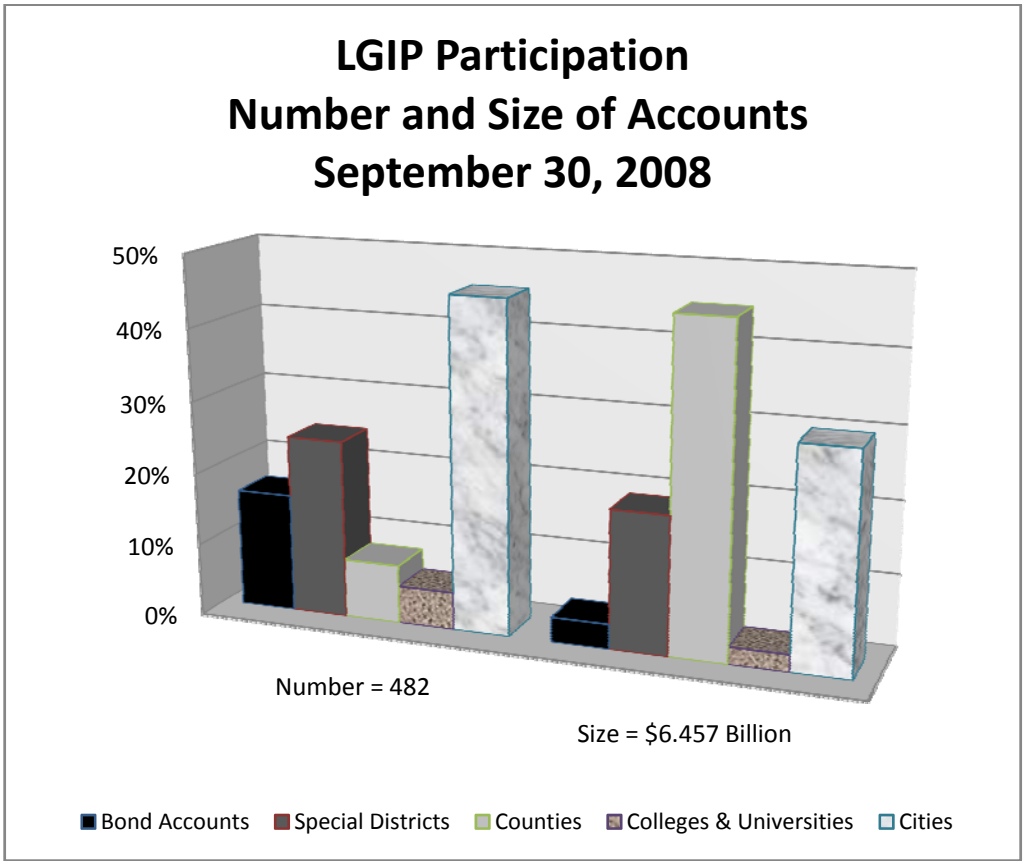

LGIP Maturity Structure
as of September 30, 2008
3,600
3,200
2,800
2,400
2,000
1,600
1,200
800
400
0
1
30
60
90
120
180
270
397
FRN
VRN


LGIP Cumulative Maturity Structure
September 30, 2008
Cumulative Maturities (%)
100
90
80
70
60
50
40
30
20
10
0
1
30
60
90
120
180
270
397
FRN
VRN
Days to Maturity


Average Daily Balance History
By Fiscal Year
September 30, 2008
Average Daily Balance
(Dollars in Millions)
8,000
6,000
4,000
2,000
0
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009


Average Days to Maturity
Fiscal Year 2006 - 2009
Days
70
60
50
40
30
20
10
0
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
Apr
May
Jun
FY 2007
FY 2008
FY 2009


Portfolio Holdings ($ Millions)
September 30, 2008
Agency Variables 465
8%
Discount Notes 2,476
42%
Agency Floaters
1,844
32%
Agency Coupons 414
7%
Certificates of
Deposit 408
7%
Repo 229
4%
Treasury Securities 3
0%


LGIP Participation
Number and Size of Accounts
September 30, 2008
50%
40%
30%
20%
10%
0%
Number = 482
Size = $6.457 Billion
Bond Accounts
Special Districts
Counties
Colleges & Universities
Cities

Washington State Local Government Investment Pool
Position and Compliance Report
as of 9/30/3008

LGIP Portfolio Holdings

	Amortized Cost	Percentage of Portfolio
Agency Bullets	$ 390,054	6.05%
Agency Discount Notes	2,376,274	36.87
Agency Floating Rate Notes	1,869,799	29.01
Agency Variable Rate Notes	484,841	7.52
Certificate of Deposit	504,500	7.83
Interest Bearing Bank	719,521	11.16
Repurchase Agreements	100,000	1.55
	$ 6,444,989	100.00%

Size Limitations

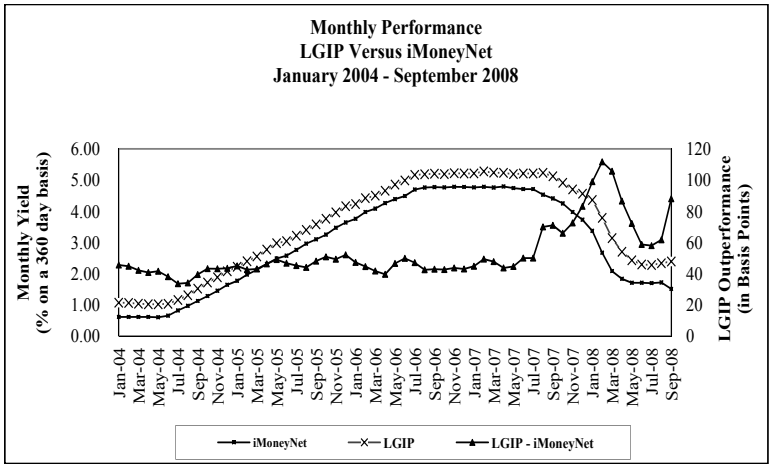
		Percentage of Portfolio	Policy Limitations Percentage
Floating Rate and Variable	$ 2,354,640	36.53%	50%
Variable Rate Notes > 397	0	0.00%	10%
Other Structured Notes	0	0.00%	30%
Term Repo > 30 Days	0	0.00%	30%
Certificate of Deposit	504,500	7.83%	10%
Bankers' Acceptances	0	0.00%	20%
Commercial Paper	0	0.00%	25%
Reverse Repo	0	0.00%	30%
Security Lending + Reverse Repo	0	0.00%	30%

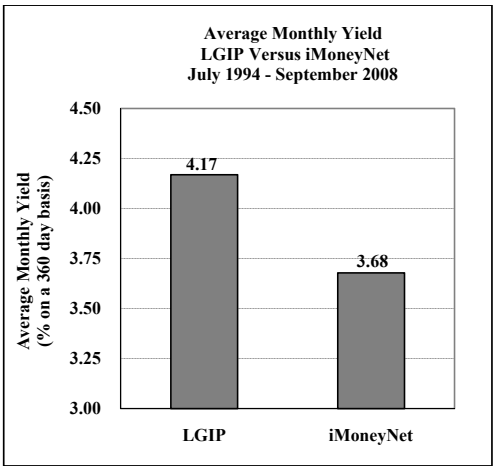
Maturity Limitations

	Currently	Policy Limitations
Weighted Average Maturity	38 day(s)	90 day(s)
Maximum Maturity		
Bullet Maturities	325 day(s)	397 day(s)
Floating Rate and Variable Rate Notes	717 day(s)	762 day(s)
Repos	1 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 2008 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 2008. 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 $262.59 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

	September 30, 2008	Total Repo Percentage (20% limit)	Average D-T-M (30 day limit)	Projected Redemptions 10/1/2008	Projected Position 10/1/2008
BNP Paribas	$ 100,000	2.00%	1	$ 100,000	$ 0
Total	$ 100,000			$ 100,000	$ 0

Local Government Investment Pool

STATEMENT OF NET ASSETS

September 30, 2008

(in Thousands)

Assets		
Investments, at Amortized Cost:		
Repurchase Agreements	$	100,000
U.S. Agency Securities		5,120,968
Total Investments (Settlement & Trade Date Basis)		5,220,968
Interest Bearing Bank Deposits	$	719,521
Certificates of Deposit		504,500
Cash		1
Interest Receivable		12,786
Total Other Assets	$	1,236,808
Total Assets	$	6,457,776
Liabilities		
Accrued Expenses	$	195
Total Liabilities	$	195
Net Assets	$	6,457,581
Total Amortized Cost - Settlement Date Basis	$	6,444,989

QUARTER AT A GLANCE

July 1, 2008 to September 30, 2008

(in Thousands)

Total investment purchases:	$	20,539,010
Total investment sales:	$	1,165,197
Total investment maturities:	$	19,810,520
Total net income:	$	37,919
Net of realized gains and losses:	$	117
Net Portfolio yield (360-day basis):		
July		2.2758%
August		2.3328%
September		2.3891%
Average weighted days to maturity:		39 days

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