

Liquidity Market Update

As 2008 came to a close, it was fitting that the dramatic events of the year continued until the very end. At the December 16 meeting of the Federal Open Market Committee (FOMC), the federal funds target rate, the benchmark interest rate, was reduced from 1.00% to a range of between 0.00% and 0.25%. This marks the first time in FOMC history that a zero interest rate policy is being pursued.

In the press release that accompanied this historic action, the Fed stated the following: “The focus of the committee’s policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve’s balance sheet at a high level.” This quantitative easing from the Fed has already begun with the direct purchasing of Agency debt and mortgage-backed securities. Additionally, the Fed is evaluating whether it should buy Treasury securities on the long end of the curve.

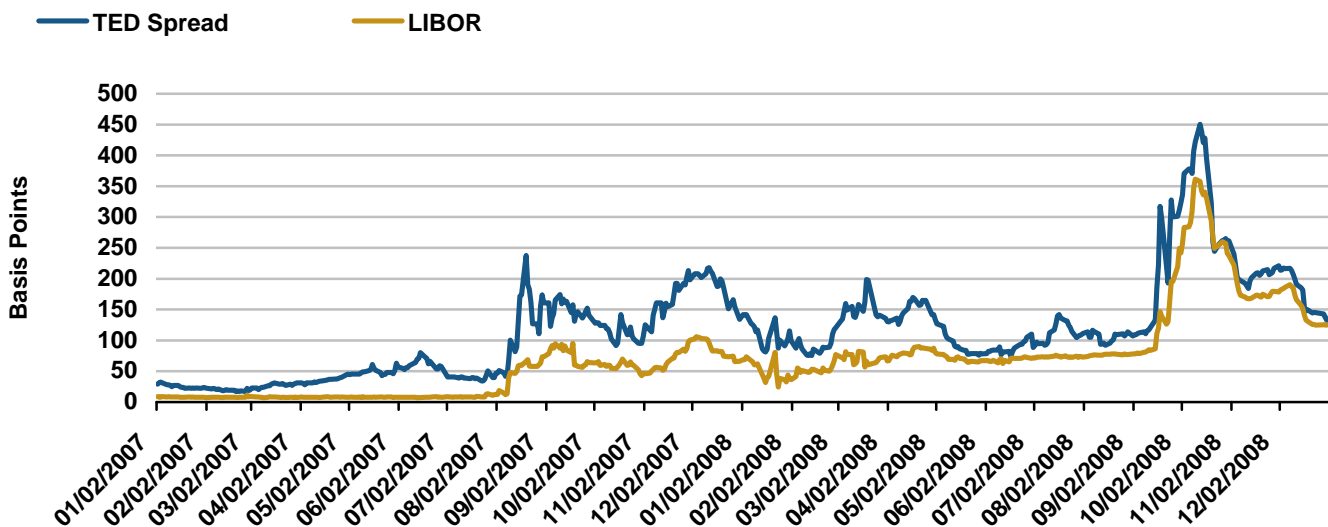
In other market news, almost every measure of the economy has been decidedly worse over the past month. Unemployment rose throughout December, finishing at a 16-year high of 7.2%. The ISM factory index fell to its lowest level in almost

30 years as manufacturing in the United States shrank rapidly during December. This index also reflects that the difficult economic conditions are worsening overseas as there is less demand for U.S. goods across the globe. Additionally, the housing market continues to look bleak. Despite historically low mortgage rates, home sales continue to fall. Home starts have also fallen to lows not seen in 50 years.

Finally, some automakers in the United States and overseas reported declines of more than 30% in sales for December. Sales were hurt by a combination of tight credit conditions and low levels of consumer confidence.

Credit spreads widened to historic levels following the collapse of Lehman Brothers in mid-September. As noted in gold on table 1, LIBOR, the rate that banks say they charge each other for three-month loans in dollars, rose to a peak of 4.82% in the weeks following Lehman’s demise. It closed the year at 1.43%, a drop of 339 basis points. As shown in blue on table 1, the TED Spread, the difference between what banks and the Treasury pay to borrow money for three months, also hit a high of 4.64% on October 10. On December 31 it had fallen 329 basis points to finish the year at 1.35%. It should be noted that while these spreads have fallen dramatically over

Table 1: 3-Month USD LIBOR-OIS and 3-Month TED Spread



Source: Bloomberg, as of January 13, 2009

Past performance is no guarantee of future results.

the last three months, they are still elevated relative to their historic norms.

Another major development during December was the dramatic flood of assets into Treasury debt pushing yields to historic lows. In the month we saw Treasury auctions with the following results: 4-week Bills at 0.0%, 3-month Bills at 0.05%, 2-year Notes at 0.92% and 5-year Notes at 1.54%. These results, along with all-time low yields at the longer end of the curve, are indicative of the extreme anxiety that is gripping the marketplace coupled with a move toward complete avoidance of risk by investors.

With the current FOMC policy having just begun and the ongoing negative economic news, it is the belief of Columbia Management that the current challenging market environment could be in place for some time.

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