

INSTITUTIONAL LIQUIDITY FUNDS

Market Insights: November 2008

Taxable Market**Overview**

Market headwinds and problems in the credit markets remained persistent in November, although market liquidity increased as a result of numerous facilities implemented by the Fed over the past few months. The three-month LIBOR continued to decrease, starting the month at 2.85% and closing at 2.21%. Following a similar pattern, the one-month LIBOR started the month at 2.35%, dropping to 1.40%. Despite LIBOR's decline, from a historical standpoint, there is a dislocation from the normalized spread to the Fed funds target rate. At the end of November, LIBOR made the year-end calendar flip, causing the one-month LIBOR to spike 50 basis points. This move reinforced the potential pressures for bank funding over year-end.

The Fed did not meet in November, leaving the Federal Funds target rate unchanged at 1.0%. The daily Fed funds effective rate has traded significantly through the Fed funds target rate during November as a result of a surge of excess reserves in the banking system. The Fed funds effective rate average was 0.39% during the month, with a high rate of only 0.62%.

Economic data remained largely dismal. ISM manufacturing plunged to a 26-year low, registering 38.9%. The unemployment picture continued to worsen, with the unemployment rate jumping to 6.5%. Meanwhile, non-farm payrolls posted a loss of 247,000 jobs, with significant downward revisions to prior month's reports.

At the same time, inflation numbers continued to improve, with PPI and CPI declining 2.8% and 1.0%, respectively. The economy has rapidly shifted from one marked by fears of

inflation and general slowing to one of actual concerns about a potential deflationary environment. Deflationary fears are being fueled largely by the housing market collapse, with the S&P/Case-Shiller Home Price Index¹ down 17.4% nationally. Meanwhile, durable goods orders dropped 6.2% and retail sales slipped 2.8%.

In terms of GDP, third quarter GDP was revised to a -0.5% contraction, and expectations for fourth quarter numbers are even bleaker.

Looking ahead, the market widely anticipates additional easing at the upcoming December 16 FOMC meeting.

Strategy**Prime and Money Market Portfolios**

During November, in the Prime and Money Market Portfolios, we continued to maintain a relatively high cash balance in overnight maturities. In light of the events in the economy, our primary focus was to build liquidity and preserve capital. We purchased select asset-backed commercial paper in the 1-month range. We were comfortable with the liquidity in this asset class given the Asset-Backed Commercial Paper Money Market Liquidity Facility, which allows investors³ to sell ABCP to the Federal Reserve Bank of Boston through eligible borrowers. At the same time, we sought to maintain a shorter duration stance in an effort to maintain a high degree of liquidity and capital preservation.

At month-end, the WAM in the Prime and Money Market Portfolios were 15 days and 23 days, respectively.

¹ The S&P/Case-Shiller Home Price Index measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States.

Government and Government Securities Portfolios

For the Government Portfolio, we continued to roll significant amounts of overnight repos in order to maximize liquidity and maintain a short WAM. In addition, we selectively purchased 1-month and shorter agency discount notes. At month-end, the Government Portfolio's WAM was 13 days.

For the Government Securities Portfolio, we maintained a conservative WAM. We selectively purchased 1-month and shorter agency discount notes in an effort to continue to maintain high levels of liquidity, while remaining at a short duration. In an effort to diversify the portfolio, we continued to seek attractive, but scarce Tennessee Valley Authority (TVA) paper, when available. At month-end, the Portfolio's WAM was 11 days.

Treasury Portfolio

In the Treasury Portfolio, we continued to maintain a short WAM by rolling significant amounts of overnight repos. In addition, we selectively purchased small amounts 1-6 month Treasury Bills. At month end, the Treasury Portfolio's WAM was 30 days.

Treasury Securities Portfolio

In the newly launched Treasury Securities Portfolio, we will hold Treasury bills, but not repos. The focus is to stay short given the attractiveness, in our view, of the Treasury bill market, focusing the majority of our purchases on 1-month and shorter Treasury bills. At month end, the Treasury Securities Portfolio's WAM was 21 days.

Outlook

We will continue to structure the Portfolios to reflect the tenuous situation in the credit market. We remain attentive to maintaining liquidity and capital preservation due to the relatively illiquid market of recent months.

- Jonas Kolk, Michael Cha

Tax-Exempt Market

Overview

The slope of the municipal yield curve steepened significantly during November, with the yield on short maturities hovering near historic lows and 30-year high-grade muni yields, as a percentage of Treasury yields, at historic record highs, getting close to the 150% ratio level. Clearly, the shift in relative yields is partially due to the ongoing flight to quality/flight from risk pulling Treasury yields and the short-end of the municipal yield curve lower. New-issue par value volume in November fell 22% from last year, as the municipal market continued to grapple with the fallout from the credit crisis forcing the market to rely on

retail investors to scoop up bonds. Activity may start to pick up in December as yields are expected to decline before a slowdown towards the end of the year in which banks begin preparing for fiscal year-end.

Yields continued to fall in most segments of the short-term market, although not as dramatically as witnessed in October. The SIFMA Index¹ of weekly variable rate securities dropped 79 basis points in November to 1.03%, down from 1.82% at the end of October and down from a high of 7.96% on September 24. The Bond Buyer One-Year Note Index² slipped 80 basis points in the month from 2.00% on October 30 to 1.20% at November month-end. While the broader market remains volatile and consumer confidence is still weak, the municipal market appears to be headed in a more positive direction. The tone remains consistent in Variable Rate Demand Obligations (VRDOs) heading into the final month of the year. The cautious tone around the market should stay in place as fiscal year-ends come into play in December.

Strategy

Protecting the safety and liquidity of the Portfolio's assets remained our first priority. In the recent turbulent markets, our emphasis has been on managing exposure to institutions under stress. Given recent developments in the short-term credit markets, we believe the following points are relevant when assessing the current positioning of the Morgan Stanley Institutional Liquidity Funds Tax-Exempt Portfolio:

- 1) We continue to invest in tax-exempt securities, including Variable Rate Demand Obligations (VRDOs), where our credit and risk teams have confidence in the quality of the issuer, the structure of the program, and the financial strength of the supporting institutions.
- 2) We have identified and eliminated any securities enhanced by the troubled mono-line insurers that do not have the benefit of additional guarantees or protection, such as the presence of an irrevocable Letter of Credit.
- 3) The Funds have no exposure to auction rate securities.

At month-end, the Portfolio's WAM was 30 days.

1 The SIFMA Index is issued weekly and is compiled from the weekly interest rate resets of tax-exempt variable rate issues included in a database maintained by Municipal Market Data which meet specific criteria established from time to time by The Bond Market Association.®

2 The Bond Buyer One-Year Note Index is based on estimated yields for theoretical new one-year note issues from 10 state and local issuers: California, Colorado, Idaho, Los Angeles County, Michigan, New Jersey, New York City (RANs), Pennsylvania, Texas and Wisconsin. The index is an unweighted average of the average estimated bid-side yields for the 10 issues.

Outlook

During this period of market upheaval, we continue to diligently seek any new developments that may impact the Portfolio. We will also continue to closely monitor the implications of the slowing economy on municipal government balance sheets.

- Kathy Stromberg, Paul Daggy

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