

Duration and Sector Allocation Meeting

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Duration

The economic landscape appears to be changing once again. The cost of crude oil has risen to a four-month high at over \$54 a barrel, on speculation that increasing consumption will outpace production this year. Oil has surged 14% in the past month as OPEC, The International Energy Agency and the U.S. Energy Department increased oil-use forecasts. This resurgence in oil prices exemplifies the volatility present in energy prices that has been prevalent over the past year and appears to be with us for the foreseeable future.

In recent years, the bond market has taken a keen interest in the payroll survey because participants believe the Fed has become fixated on this number and that it accurately gauges the strength of the economy. The February employment report was more robust than the market had anticipated. Non-farm payrolls expanded by 262,000 jobs, easily surpassing expectations of a 225,000 gain. While this number is not spectacular, it is above the three-month moving average of 183,000 jobs and for the first time in three months, exceeded expectations. However, the Unemployment Rate rose to 5.4% from 5.2%, underpinning the relative weakness in the labor market during this cyclical expansion.

While some economic indicators are improving, others are still showing mixed results. The Institute for Supply Management Index for Manufacturing decreased to 55.3, the fourth straight decrease. Leading Indicators fell -0.3%, Durable Goods Orders fell -0.9%, Personal Income decreased by -2.3% and Retail Sales fell -0.3%. The housing market which has been at a frenzied pace over the past several years, seems to be showing signs of gradual deceleration. Sales of new single-family homes fell 9.2% in January, the lowest level in a year. Mortgage applications fell 4.7% and existing home sales fell 1.0% in January.

These various economic indicators are suggesting that economic growth is decelerating and when combined with Federal Reserve Chairman Alan Greenspan's recent comments before Congress, makes us believe that the Fed will continue to increase interest rates at a measured pace. Even though short-term interest rates will rise as the Fed moves interest rates higher, we believe long-term rates will prove to be more stable and that the yield curve will continue to flatten. To take advantage of this, we recommend increasing duration targets to 95% of respective benchmarks and adopting a barbell strategy.

Yield Curve

Since January 2004, the yield curve from 2- to 10-years flattened 175 basis points, from 248 to 73 basis points. One of the driving factors behind this massive curve flattening was the Fed increasing the Fed Funds rate by 150 basis points to curtail inflation, aided by the inclination of foreign buyers to continue to purchase our debt. This has caused the intermediate part of the curve (3-7years) to underperform relative to the 2- and 10-year sectors of the curve (please see attached graph). We believe the intermediate part of the curve will continue to deteriorate and that a barbelled structure with an emphasis in the 2- and 10-year sectors has a better opportunity to outperform

a laddered structure going forward. Thus, we are recommending that portfolios invest new money in the 2- and 10-year sectors to take advantage of the flattening yield curve.

Recommended Duration Levels

- Taxable Bond Portfolio: 3.50
- Tax-Exempt Bond Portfolio: 3.95

Sectors

For taxable bond accounts, the recommended weighting is:

- 21% Treasuries
- 21% Agencies
- 48% Corporate Bonds
- 10% Taxable Municipal Bonds

Fannie Mae could be forced to recognize as much as \$2.8 billion in additional losses on its derivatives portfolio because of new accounting concerns. The losses would come on top of the estimated \$9.18 billion in losses related to derivatives it will have to recognize as part of its still-unfinished financial restatement. This additional loss would bring the potential size of its restatement to nearly \$12 billion and furthers our concern over the future of the agency sector. We continue to recommend that investors move 10% of their taxable bond portfolio into Taxable Municipals due to the spread premium they offer over Agencies. We are currently neutral to Agencies. If your accounts are over-weighted Agencies, we recommend reducing exposure to this sector at this time.

With Corporate bond spreads at or near historic lows, it would be prudent to reexamine portfolios to make sure that they are invested in sectors that comprise our current recommendations. Our taxable portfolios consist of not only Corporate bonds, but also Agencies, Treasuries and Taxable Municipal bonds. The Fixed Income Team sector weighting recommendation represents a 15% under-weighting in Treasuries, a neutral weighting in Agencies, a 5% over-weighting in Corporates and a 10% over-weighting in Taxable Municipals compared to the Lehman Intermediate Government/Credit Index. We favor Finance credits over Industrial credits on a relative basis due to the yield advantage they offer. It should be noted as well

that issuers continue to avoid the 2-year sector and are issuing bonds further out along the curve, mainly 5-, 10- and 30- years.

High Yield

We currently recommend no exposure to High Yield Bond funds at this time.

Relative Value

Municipals are rich to Treasuries on a relative basis. Investors continue to desire short-term maturities on fears of further interest rate increases by the Fed. Although Corporates have continued exposure to event risk, in general, Corporates remain attractive relative to Treasuries.

Bullish Factors for Bonds

- The PCE Deflator remains low at 2.2% year-over-year.
- Foreign holdings of U.S. Treasury debt have risen by 85% since 2001.
- Leading indicators declined by 0.3% for January.
- Consumer Confidence remains high.
- The Unemployment rate increased to 5.4% from 5.2%

Bearish Factors for Bonds

- The February Non-Farm Payroll number increased a more than expected 262,000.
- Final Gross Domestic Product for the 4th quarter was revised to 3.8% annualized.
- The Federal Open Market Committee will meet on March 22nd and the market expects Fed Funds to be increased by .25% to 2.75%.
- The cost of oil has risen to over \$54 a barrel from \$42 a barrel at the beginning of the year.
- Tax refunds are higher by 7.5% when compared to last year's returns.
- ISM Prices Paid remains strong at 65.5.
- ISM Non-Manufacturing remains strong at 59.8.
- The Consumer Price Index remains strong at 3.0% year-over-year.
- The Producer Price Index remains strong at 4.2% year-over-year.

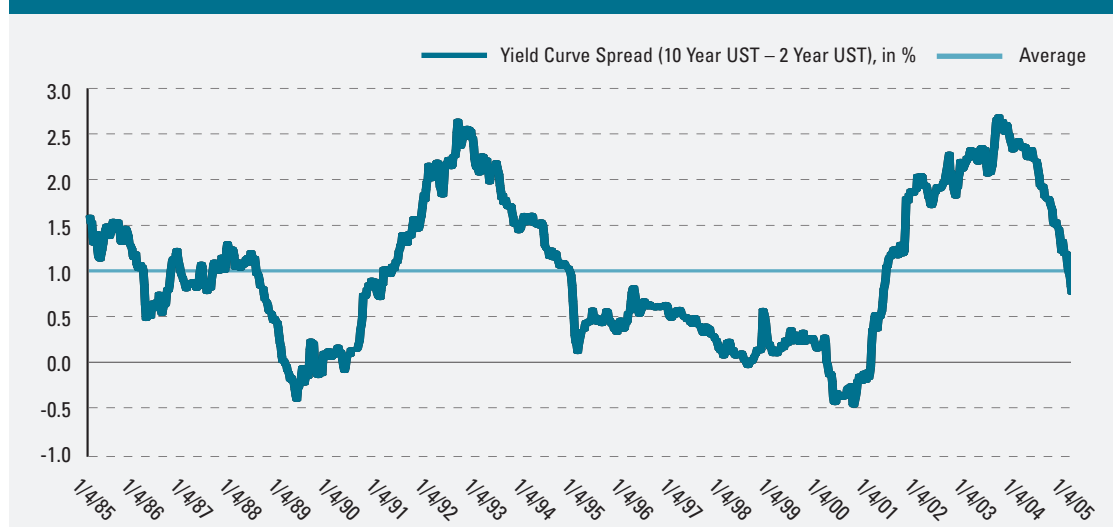
FAIR MARKET SECTOR CURVES

Title	US TSY	US Govt Agency	US Industrial A+	US A+ Finance (A)	Municipal G.O. Insured
3 MO	2.75	2.90	3.02	3.03	2.03
6 MO	2.97	3.15	3.30	3.22	2.17
1 YR	3.28	3.49	3.71	3.63	2.36
2 YR	3.59	3.79	3.92	4.00	2.59
3 YR	3.73	3.99	4.06	4.22	2.76
4 YR	3.85	4.10	4.26	4.39	2.93
5 YR	3.98	4.27	4.43	4.52	3.10
7 YR	4.15	4.47	4.61	4.78	3.39
8 YR	4.18	4.46	4.69	4.87	3.51
9 YR	4.27	4.57	4.78	4.89	3.60
10 YR	4.31	4.64	4.84	4.99	3.73
15 YR	4.51	4.93	5.22	5.42	4.13
20 YR	4.79	5.04	5.35	5.74	4.28
25 YR	4.66	5.00	5.30	5.76	4.35
30 YR	4.56	5.09	5.26	5.61	4.41

Fair Market Sector Curves Copyright 2005 Bloomberg L.P. Information as of 3/7/05.

Chart of the Month

YIELD CURVE SPREAD



The chart above shows the difference in yield between the 10 Year U.S. Treasury and the 2 Year U.S. Treasury, measured in percentage points. As the chart shows, this spread has declined considerably since reaching its peak; in other words, the yield curve has flattened. Looking ahead, we expect the yield curve to flatten further as the Federal Reserve continues to raise short term interest rates, albeit at a measured pace. It is also our belief that longer dated securities will continue to be supported by strong demand from institutional investors. If our forecast of slower economic growth is realized, it might allay investor fears of accelerating inflation. Based on these factors we will re-initiate our Barbell strategy, with more concentrated positions around the short and long sectors of the yield curve, and less emphasis on the intermediate sector.

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