

First Quarter 2005 Fixed Income Review

The U.S. bond market returned -0.48% for 1Q:2005 (Lehman Aggregate Index). Stocks (as measured by the S&P 500) lost 2.5%. Bond returns were hurt by rising interest rates and by wider credit spreads, two-fifths of which was caused by the sharply larger credit spread for one issuer — General Motors/General Motors Acceptance Corporation (GM/GMAC).

U.S. Treasury bonds returned -0.42% in 1Q: 2005. All parts of the yield curve rose in yield except the 30-yr segment, which saw yields fall 7 basis points (bp). Yields rose a curve-worst 71 bp (0.71%) for 2-year maturities, 70 (bp) for 3-year Treasuries, 56 bp rise in the 5-year sector and a 26 bp rise for 10-year Treasuries. The market responded orderly to a gradual rise in inflation expectations. Oil is the spectacular contributor to 2005's inflation: at \$58/barrel, oil gets headlines, and there are still analysts who are only now raising their forecasts for 2005 average oil prices to near current levels.

Mortgage-backed securities (MBS) outperformed Treasuries in the first quarter of 2005 by 0.05% (adjusting for duration differences), with an absolute total rate of return of -0.12%. A rise in 10-year Treasury yields led to the expectation of lower refinance activity. However, this positive effect on MBS returns was mostly offset by the negative effect of a sharp flattening of the yield curve. The main driver of relatively good returns was the “flight to quality” effect of investors moving out of corporate securities and into mortgage-backed securities.

Investment-grade corporate bonds posted a -1.13% absolute return in 1Q:2005 which equated to -62 bp in excess return. While corporate profits continued to be

strong, the rate of profit improvement slowed.

Additionally, the profit warning sent by General Motors late in the quarter was a catalyst for a revaluation of credit risk. Volatility, which had been very low, accelerated as corporate credit spreads widened. Additionally, investment performance was worse the lower the credit quality of the company. This can be easily seen by looking at the returns by credit quality buckets. Aaa-rated companies returned -.31%, Aa-rated bonds -.66%, A-rated bonds -.72%, and finally Baa-rated bonds lagged noticeably at -1.55%.

High-yield bonds underperformed other major sectors — the Lehman U.S. High Yield Index's -1.61% return represented about minus 94 bp of excess return. The best-performing sector was “B”-rated bonds; they posted excess returns of -69 bp versus Treasuries (adjusted for differences in duration) versus the nearly-identical underperformances of BB-rated bonds and CCC-rated bonds: -107 bp and -109 bp, respectively.

Outlook

Recent statistics (GDP, retail sales, consumer spending, Institute of Supply Management) confirm the outlook we communicated last quarter-end; the economy will be strong in 2005, with approximate 3 1/2%-4% GDP growth expected by most economists. Profits at most large corporations have continued to recover nicely from recession levels, and most industries have been successful at passing on increased commodity prices. Since a healthier amount of fear has been priced into the corporate bond market, in our opinion this is a better environment for buying corporate bonds than was the case at 12/31/2004.

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