

Economy

During the second quarter of 2010, the U.S. economy exhibited somewhat of a departure from what during the first quarter appeared to be momentum towards sustainable increases in the rate of economic expansion. The initial estimate of first quarter GDP growth indicated that the U.S. economy would expand at a rate of 2.8%. As the vast majority of economic indicators continued to show improvement during the quarter, that number was revised upward to 3.0% in May. Late in the second quarter, however, the final reading on the first quarter GDP growth revised the number back downward to 2.7%, reflecting a larger trade gap and a smaller gain in consumer spending. A report on consumer spending released in May showed that purchases in April were unchanged from the prior month, snapping a streak of six consecutive increases. The May consumer spending report, released at the end of the quarter, reflected a return to consumer spending growth. The 0.2% increase, however, was the smallest since October of 2009.

The Consumer

Trepidation on the part of the consumer can be seen in the Conference Board's reports on consumer confidence during the second quarter. Following two consecutive increases in the measure, the reading declined to 52.9 in June. The result was below the lowest economist forecast and gave back essentially all of the second quarter's previous increases. The most material declines in consumer confidence were concentrated in the Gulf Coast regions that have been most directly affected by the worst oil spill in U.S. history. The April 20 well blowout that destroyed the Deepwater Horizon drilling rig and killed eleven of its crew has polluted beaches, caused significant job losses, and strangled much of the industry in the area.

The Labor Market

While specific events have exacerbated the problem in certain regions of the country, overall U.S. consumer sentiment remains largely focused on the employment picture. Consumers are not-so-patiently waiting for consistent, sustained jobs growth before they even consider increasing their spending habits, which account for and support over two-thirds of the U.S. economy. Employers added a total of 746,000 jobs through the first two months of the second quarter, with 433,000 of those jobs coming in the most recent report for May. Although the May jobs addition was the largest single-month add since September 1997, it was still a relative disappointment. A large majority of those jobs (411,000) are attributed to a spike in government hiring of temporary workers for the 2010 census. Economists had projected a median gain of 536,000. A less-than-forecast gain in

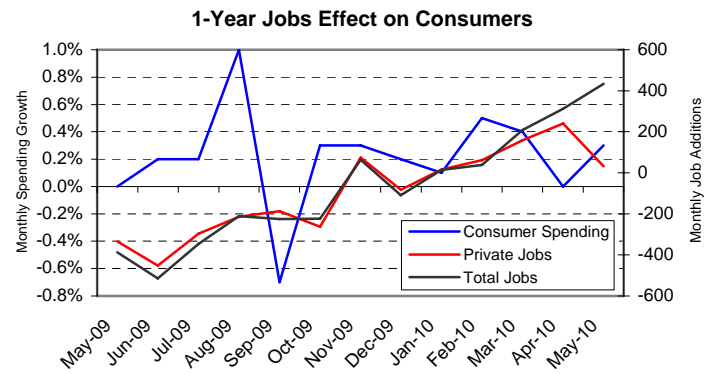
private payrolls, which exclude government jobs, of 41,000 followed an increase of 218,000 in April that was revised downward from 231,000. The unwinding of census employment may continue to distort employment figures for several months. For this reason, economists are beginning to rely on private payrolls as a gauge of the state of the labor market for the balance of 2010.

Housing Market

The expiration of the government tax credit brings with it the very real risk of a deeper-than-expected retrenchment in the housing market. The largest month over month increase in new home sales of 14.7% in April quickly gave way to the broadest month over month decline on record in May. This sharp swing in the housing market outlook has been mirrored in the recent performance of homebuilder stocks. The slump in these shares since late April has exceeded the retreat in the broader market on concern the damage from the end of the government stimulus, mounting foreclosures, and unemployment may cause renewed weakness.

Outlook

Toward the end of the first quarter, economists, investors, and consumers alike were witnessing a ramping-up in corporate spending on the back of a surge in corporate profits. Most expected this to translate into a return to investment in both physical and human capital, as previous profits had been almost strictly a result of cost-cutting measures. This was expected to be the catalyst for sustainable improvement in the labor market that could quickly translate into consumer spending, and thusly, economic growth. Unfortunately, the situation has become somewhat more tenuous, and some corporations are beginning to reduce staff and remove their focus from growth, back to a acutely more defensive posture.



Source: Bloomberg

Recent Economic Data

ISM Manufacturing: Jun. 56.2, May 59.7...**ISM Non-Manufacturing:** May 55.4, Apr. 55.4...**Change in Non-farm Payrolls:** May 431k (H), Apr. 290k...**Unemployment Rate:** May 9.7%, Apr. 9.9%...**Trade Balance:** Apr. -40.3 bil, Mar. -40.1 bil...**Retail Sales (less autos):** May -1.1%, Apr. 0.6%...**Industrial Production:** May 1.3%, Apr. 0.6%...**Housing Starts:** May 593k, Apr. 659k...**Producer Price Index:** May -0.3%, Apr. -0.1%...**Consumer Price Index:** May -0.2%, Apr. -0.1%...**Consumer Confidence:** Jun. 52.9, May 62.7

Equity

After climbing steadily for nearly four quarters, equity markets succumbed to a consistent stream of bad headlines to undergo a correction in the second quarter of 2010. The looming specter of a double-dip recession, accelerated by events in Europe, drove the S&P 500 Index to an 11.41% quarterly decline. Beginning in the first week of May, investors worldwide embarked on a “flight to safety” in response to heightened fears that unresolved debt crises in southern Europe would rapidly infect other Western markets and economies.

Contagion quickly became a ubiquitous buzzword as commentators and policy-makers alike warned of broken budgets and bond defaults in Athens and Lisbon creating a global panic and massive sell-offs in equity markets. It became clear midway through the quarter that any investor confidence gained from impressive corporate earnings during the previous quarter would be diluted by the inexorable flow of European sovereign debt concerns. Nearly 75% of S&P 500 companies beat forecasted earnings in the first quarter of 2010, yet these encouraging fundamentals were dwarfed by the glaring macroeconomic issues emanating from across the Atlantic.

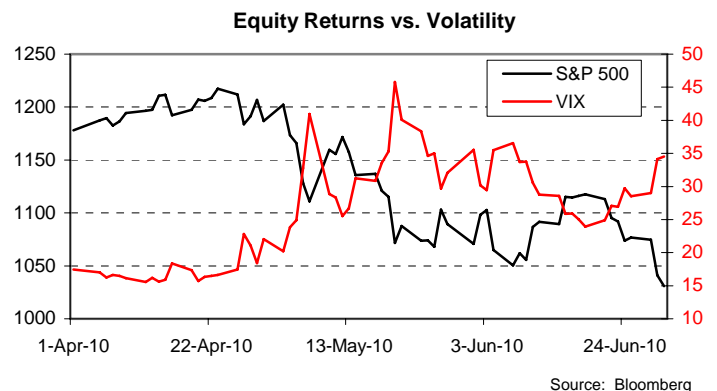
Volatility returned with a vengeance in the second quarter and reached a crescendo in early May during the beginning stages of the correction. A market plunge of historic proportions on May 6th brought a momentary 1000 point drop in the Dow Jones Industrial Average. On that day, authentic selling pressure gave way to an alleged programmatic trading error and ushered in a period of extreme volatility. In May, The Chicago Board Options Exchange Volatility Index (VIX), which tracks the value of options on U.S. stocks, experienced its largest two-week gain since inception. Such high levels of volatility amplified headline-driven price movements. The Dow Jones Industrial Average experienced two percent daily price movements in roughly one out of every four trading days in May and July. The mostly downside instability of equity markets during the second quarter stood in stark contrast to the grinding nature of first quarter gains.

One needed to look no further than energy stocks to find sector-specific volatility in the wake of the Gulf of Mexico oil spill. The environmental and economic effects of the Deepwater Horizon disaster created immediate instability within the sector. Early in the second quarter, shares of energy companies were slowly advancing, but reversed course after BP Plc confirmed oil leakage at its Gulf well. Impending U.S. government intervention was brought to fruition after President Obama ordered a six-month moratorium on all offshore drilling in the Gulf of Mexico.

Profits and share prices of affected oil drillers were projected to suffer greatly as high operating costs would not be covered by drilling revenues during the moratorium. Equity markets punished the entire sector as the S&P 500 energy industry group declined 12.21% during the quarter. Index components and main players in the disaster, Diamond Offshore Drilling, Inc. (DO) and Halliburton, Co. (HAL), saw their share prices fall by more than 28 percent and 18 percent respectively. A nearly 10 percent dip in the price of crude oil futures during the quarter added to the woes of energy firms.

Like the energy sector, shares of financial companies were driven lower in the second quarter by a momentous headline. The industry group suffered a 13.34% decline during the quarter after coming under initial heavy pressure in April when the SEC brought fraud charges against Goldman Sachs, Inc. Goldman’s federal accusers charged the hitherto venerable investment bank with creating and marketing securities linked to subprime mortgages right before the collapse of the U.S. housing market. Investors became spooked by the prospect of an industry-wide SEC witch-hunt coupled with pending legislation designed to overhaul the financial industry and indirectly cut into the trading profits of large banks.

During the turbulence of the second quarter, and as is often the case during market corrections, sectors more defensive than energy and financials offered a relative safe haven. Even during times of economic turmoil, consumers generally have inelastic demand for goods like electricity and basic household items. In turn, the utilities and consumer staples sectors outperformed the broader S&P 500 Index by 7.69% and 3.29%, respectively. As the curtains drop on the third quarter, investors will likely require evidence that European austerity plans are working and improvements in the sluggish housing and labor markets before regaining their collective appetite for risk.



Fixed Income

For the past year there has been a growing disconnect between the stock and bond markets. This divergence became more obvious in the first quarter of this year. While the equity markets rallied, yields remained low; an indication that investors feared the pace of economic recovery might be slower than what equity markets were pricing. Lackluster domestic economic data, the European credit crisis, and BP's oil spill combined to bring this fear to fruition. As a result, yields have fallen across the curve and treasuries that returned 1.11% in the first quarter of this year are up 5.88% through the end of the second quarter. The yield curve has shifted downward an average of 68 basis points (bps) since the end of 2009, while simultaneously flattening. The 2- and 10-year treasury yield spread has tightened to 233 bps from 270 bps at the end of last year.

Treasury-to-agency spreads have remained tight and are at their 200-day moving average levels and below their 3-year averages. Year-to-date, the Bank of America /Merrill Lynch (BAML) Treasury-Agency Master index is up 5.49%. For the same time period, the BAML Corporate Master index returned 6.10%. Despite the flight to quality, high yield bonds managed to return 4.74% on average for the first half of 2010.

According to data compiled by Bloomberg, companies have issued less debt year-to-date compared to the same time period in 2009. Corporate offerings fell 39% in the first half of the year, while profits were up 34% in just the first quarter of this year. Since mid-2007, companies have cut costs and hoarded cash. With interest rates at historic lows and uncertainty in the economic recovery, many are using their excess cash to pay down their debt instead of focusing on capital spending. This is already resulting in more credit rating upgrades in corporate bonds. According to Bloomberg, 123 high yield companies were upgraded year-to-date, while only 81 were downgraded in that time period.

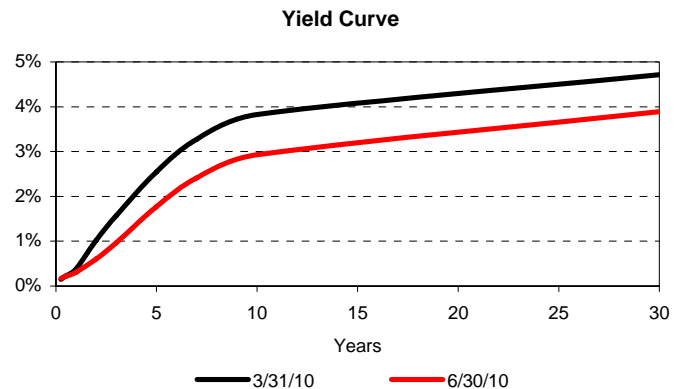
While corporate and agency spreads have remained around their 200-day moving averages, municipal bond spreads have widened drastically and are now at their 3-year average levels. Local and Federal budget deficits and high unemployment rates are the two main reasons behind this widening. According to the Nelson Rockefeller Institute of Government, more than two-thirds of states had a drop in their revenue in the past quarter from the same period in 2009. A report by the Governors Association and National Association of State Budget officers suggests that States will be faced with a budget deficit of \$296.6 billion from 2009 to 2012. In order for municipalities to close their budget gaps, they will have to either cut spending, which translates to cuts in services and layoffs, and/or increase taxes. Clearly, this could prove to be a perilous

choice against the backdrop of a fragile economy struggling with an unemployment rate of nearly 10%.

Historically, municipal defaults have been insignificant compared to defaults on corporate bonds. Based on a report by Moody's, corporations are 98 times more likely to default on their debt than municipalities over a 10-year period. It is also noteworthy to mention that unlike corporations, municipalities cannot be dissolved, so even if the municipality files for chapter 9 bankruptcy, their debt would get restructured. On a positive note, municipalities have been very successful in borrowing money in a tight credit environment. The issuance of Build America Bonds (BABs) has been met with overwhelming demand from investors, enabling municipalities to address their budget shortfalls. The BAML BAB Index is up 10.88% year-to-date, and is one of the best performing sectors in the bond market.

While the jitters in the municipal market have caused spreads to widen, we can be fairly certain that demand for tax-exempt municipal bonds is poised to rise. As baby boomers reach retirement age and taxes increase to fund budget shortfalls, demand for tax-exempt income will only increase. This demographic shift should give municipalities the opportunity to replace their more expensive debt with lower interest rate bonds.

In the face of Greece's credit rating downgrade to junk status, Spanish debt being reviewed for a downgrade by the credit agencies, and recent weaker-than-expected economic data from China, investors realize that the road to global economic recovery is going to be rocky. Going forward, if economic data continues to suggest a slowdown in the pace of economic recovery, we would expect bonds to outperform the equity markets with an extended period of low interest rates.



Historical Financial Market Data

U.S. Interest Rates

| | <u>6/30/2010</u> | <u>1 Month Ago</u> | <u>1 Month Chg (bp)</u> | <u>3 Months Ago</u> | <u>6 Months Ago</u> | <u>1 Year Ago</u> |
|------------------|------------------|--------------------|-------------------------|---------------------|---------------------|-------------------|
| 3-Month T Bill | 0.20 | 0.20 | 0 | 0.23 | 0.05 | 0.23 |
| 3-Month LIBOR | 0.53 | 0.54 | 0 | 1.19 | 0.25 | 0.60 |
| 1-Year Treasury | 0.34 | 0.38 | -5 | 0.54 | 0.49 | 0.54 |
| 3-Year Treasury | 1.00 | 1.28 | -28 | 1.15 | 1.66 | 1.65 |
| 3-Year SWAP | 1.33 | 1.66 | -33 | 1.68 | 2.06 | 2.15 |
| 5-Year Treasury | 1.80 | 2.12 | -33 | 1.66 | 2.71 | 2.57 |
| 5-Year SWAP | 2.05 | 2.43 | -38 | 2.21 | 2.98 | 2.97 |
| 10-Year Treasury | 2.96 | 3.32 | -36 | 2.70 | 3.92 | 3.56 |
| 10-Year SWAP | 3.00 | 3.37 | -37 | 2.86 | 3.97 | 3.78 |
| 30-Year Treasury | 3.94 | 4.24 | -29 | 3.54 | 4.63 | 4.35 |
| Prime Rate | 3.25 | 3.25 | 0 | 3.25 | 3.25 | 3.25 |

Foreign Interest Rates

| | <u>6/30/2010</u> | <u>1 Month Ago</u> | <u>1 Month Chg (bp)</u> | <u>3 Months Ago</u> | <u>6 Months Ago</u> | <u>1 Year Ago</u> |
|------------------|------------------|--------------------|-------------------------|---------------------|---------------------|-------------------|
| 10-Year German | 2.56 | 2.70 | -14 | 3.03 | 3.38 | 3.40 |
| 10-Year Japanese | 1.10 | 1.28 | -18 | 1.38 | 1.33 | 1.41 |
| 10-Year U.K. | 3.47 | 3.68 | -21 | 3.21 | 4.15 | 3.67 |
| 10-Year Canadian | 3.27 | 3.53 | -25 | 2.97 | 3.93 | 3.59 |

Equities

| | <u>6/30/2010</u> | <u>1 Month Ago</u> | <u>1 Month % Chg</u> | <u>3 Months Ago</u> | <u>6 Months Ago</u> | <u>1 Year Ago</u> |
|------------------------------|------------------|--------------------|----------------------|---------------------|---------------------|-------------------|
| S&P 500 | 1030.71 | 1089.41 | -5.39% | 797.87 | 1115.10 | 919.32 |
| Financials | 185.64 | 197.42 | -5.97% | 119.01 | 193.78 | 160.76 |
| Info Tech | 329.93 | 351.80 | -6.22% | 240.99 | 370.71 | 287.63 |
| Health Care | 326.88 | 333.08 | -1.86% | 283.04 | 362.22 | 306.45 |
| Cons Discretionary | 229.71 | 254.68 | -9.80% | 154.82 | 235.07 | 182.15 |
| Cons Staples | 262.64 | 270.21 | -2.80% | 218.77 | 274.30 | 238.18 |
| Industrials | 238.29 | 256.48 | -7.09% | 162.10 | 242.99 | 191.29 |
| Energy | 373.36 | 396.31 | -5.79% | 339.68 | 429.95 | 373.84 |
| Telecom | 102.04 | 102.44 | -0.39% | 102.24 | 114.64 | 104.18 |
| Materials | 172.46 | 185.64 | -7.10% | 133.71 | 199.81 | 154.48 |
| Utilities | 143.44 | 144.92 | -1.02% | 130.39 | 157.99 | 141.90 |
| S&P 400 | 711.73 | 762.76 | -6.69% | 489.00 | 726.67 | 578.14 |
| S&P 600 | 327.97 | 353.31 | -7.17% | 222.43 | 332.63 | 268.32 |
| Russell 2000 | 609.49 | 661.61 | -7.88% | 422.75 | 625.39 | 508.28 |
| NASDAQ | 2109.24 | 2257.04 | -6.55% | 1528.59 | 2269.15 | 1835.04 |
| DJIA | 9774.02 | 10136.63 | -3.58% | 7608.92 | 10428.05 | 8447.00 |
| MSCI Emerging Markets | 1348.11 | 1367.03 | -1.38% | 1056.23 | 1580.77 | 1307.16 |

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