

What to watch: ECB taking a breather, France's budget falls short and China's resilience

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In summary

ECB taking a breather, but more cuts likely ahead. The ECB is expected to pause at its meeting on 24 July, holding the deposit rate steady at 2.0% after nearly 200bps of cumulative cuts. However, we anticipate two additional cuts in September and October before the cycle concludes, driven by inflation moving below target to 1.6% and continued weak economic momentum amid tariff-related uncertainty, a strong euro and softening US demand. Risks are asymmetric: A further escalation of US tariffs could prompt the ECB to cut rates below 1.5%, while a more resilient Eurozone economy – one that absorbs our baseline tariff assumption of 12% and the uncertainty shock better than expected – could justify a prolonged pause. In addition to euro strength, rising long-term bond yields are becoming a growing concern for policymakers. This could spark a debate on slowing the pace of quantitative tightening (QT). Halting QT could lower long-end yields by an estimated 20bps, strengthening the case for recalibration – especially as tighter financial conditions pose an added risk to an already fragile recovery.

France's budget falls short. Prime Minister Bayrou unveiled an ambitious fiscal package of EUR44bn – almost half in the form of tax hikes – to reduce the public deficit from -5.8% GDP in 2024 to -4.6% GDP in 2026. If implemented, it would knock -0.6pp off GDP growth in 2026. Without fiscal consolidation, France would need to grow by +2.3% to stabilize the debt-to-GDP ratio, which remains unlikely. But the fiscal package falls short in two ways: First, it relies on optimistic assumptions on healthcare saving and tax collection. Second, there is no clear and consistent strategy of structural spending cuts to achieve the target deficit of -2.8% GDP by 2029. Ultimately, it has a close to zero chance of passing Parliament and the most likely scenario remains a watered-down budget, or the absence of budget under a prolonged "Special Law", which would generate half the savings (EUR20bn), reducing the deficit to 5.1% in 2026 from -5.5% expected in 2025.

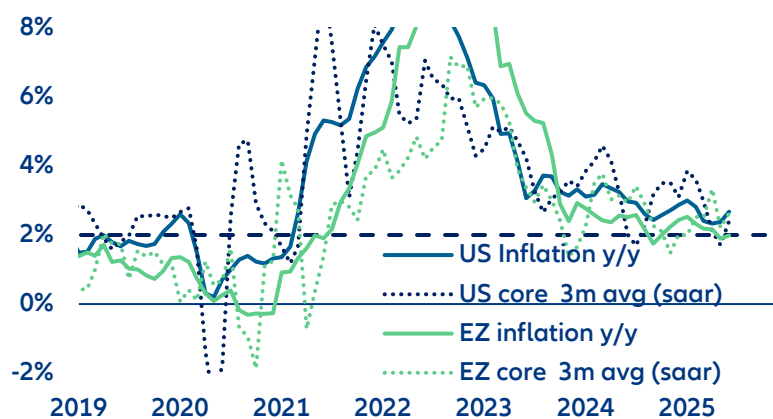
China: Can the recovery last? The Chinese economy performed better than expected in the first half of the year, pushing up our full-year growth forecast to +4.8% (from +4.5%). But we keep 2026 at +4.2% as US tariffs will eventually bite and the domestic demand recovery could lose steam. The consumer trade-in scheme, which amounts to 0.2% of GDP, likely unlocked another 0.5% of GDP worth of household savings, keeping private consumption artificially high. Durable goods such as consumer electronics, personal household products and furniture have thus seen growth of beyond +30%. Yet, car sales have been much more modest and oversupply has led to strong deflationary pressures (-25% between mid-2021 and end-2024). To avoid continued deflation (we expect inflation at 0.2% in 2025), policy efforts should further shift from the supply to the demand side, as well as focus on stabilizing housing prices. In the long run, services could become a driver for domestic demand. The Politburo meeting by the end of July will provide hints on the policy direction for the rest of the year, while the China-EU Summit on 24-25 July as well as the 12 August deadline for the trade war truce with the US may influence how much external demand will continue to contribute to China's economy.

ECB taking a breather, but more cuts likely ahead

The ECB is set to take a breather next week after lowering the policy rate almost continuously from 4% to 2%. But further cuts in the second half of the year are not off the table. At its next meeting on 24 July, the ECB is expected to keep the deposit rate unchanged at 2.0%, the mid-point of its self-proclaimed neutral range of 1.75%-2.25%. Market pricing echoes this as recent comments from ECB board members have emphasized that inflation is at target and that monetary transmission takes time, warranting a pause to allow the recent easing to take full effect. However, we continue to expect two additional cuts in September and October 2025, given ongoing below-target disinflation, a strong euro and a weak core economy weighed down by tariff-related uncertainty that is dampening consumption and investment in Europe. Risks are symmetric and closely tied to the evolution of the trade war. If the latest tariff threats from the White House are implemented in full, the Eurozone economy could face substantial headwinds, potentially prompting the ECB to ease even below 1.5%. Conversely, if our baseline scenario – 12% effective tariffs on the EU – proves less damaging than anticipated (though it is still a significant increase from 1.3% **before Trump's return to the White House**), the ECB may choose to hold rates at 2.0%.

Headline inflation is at target but base effects, a strong euro and weaker energy prices will push it to 1.6% soon. Headline inflation printed exactly at the ECB target of 2.0% y/y in June while core inflation continued its decline to 2.3% y/y, the lowest since October 2021. Looking at the latest monthly changes, headline inflation stands at an annualized change of 1.0% over the past three months and core inflation at 2.5% (Figure 1). Energy inflation is still pushing headline down strongly, with the oil price in euro terms being 24% lower than a year ago. On the other hand, services inflation remains sticky, with little signs of deceleration on a sequential basis. However, leading indicators suggest a gradual easing of these pressures. According to purchasing manager surveys, input prices in the services industry are rising at the lowest pace in six months, with a reading of 58.1 in June. While still elevated, this is still markedly higher than the pre-pandemic 10y average of 55.2. On a more positive note, wage growth has dropped to the lowest value since November 2021 – only 2.5% y/y in May – according to the Indeed wage tracker. Base effects, a strong euro and weaker energy prices, as well as demand-side headwinds from the trade war, are likely to ease inflation pressures further, resulting in inflation dropping to 1.6% over the next couple of months.

Figure 1: Eurozone and US inflation, annual headline and sequential core, %

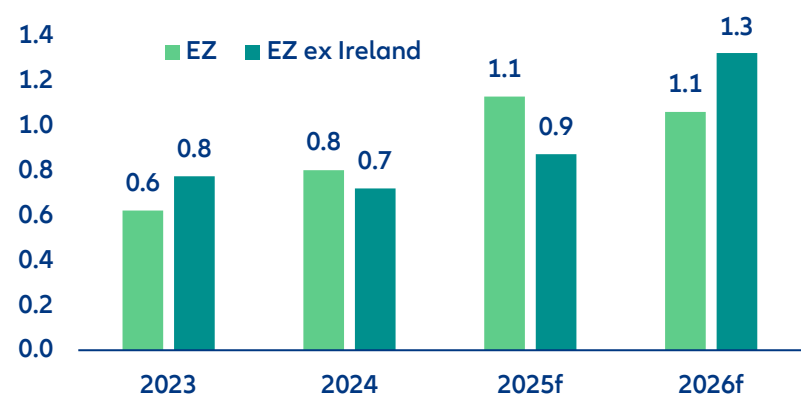


Sources: LSEG Datastream, Allianz Research

Weaker economic growth is looming as uncertainty and the end of export frontloading to the US will hamper domestic and foreign demand. While we do not expect tariffs to rise further, they still stand at 12% compared to 1.3% before Trump was inaugurated. On top of this, the euro has appreciated by 12% against the dollar year-to-date, which threatens EUR530bn worth of exports to the US annually, or 3.5% of Eurozone GDP (2024). Moreover, rising uncertainty threatens consumer and investment demand. Our proprietary leading indicator Z-score remains at -0.5 with all underlying components in negative territory. Economic growth in the Eurozone is expected to stay around zero in Q2 and Q3. In 2025, annual GDP growth should reach +1.2% but only because of the exceptionally strong Q1 print, which was driven by frontloading effects and distorted by extreme growth figures in Ireland due to the tax-optimization strategies by large multinational corporations. Excluding Ireland, Eurozone GDP is projected

to grow by just +0.9% in 2025, widening the already negative output gap, as potential growth is estimated to be around 1.0–1.5% (Figure 2).

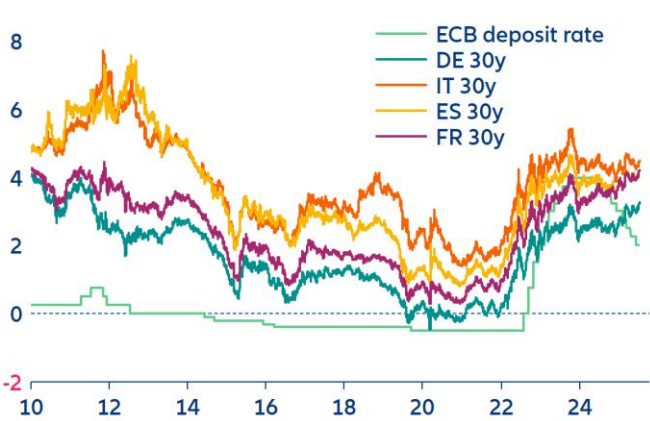
Figure 2: Eurozone GDP growth with and without Ireland, %



Sources: LSEG Datastream, Allianz Research

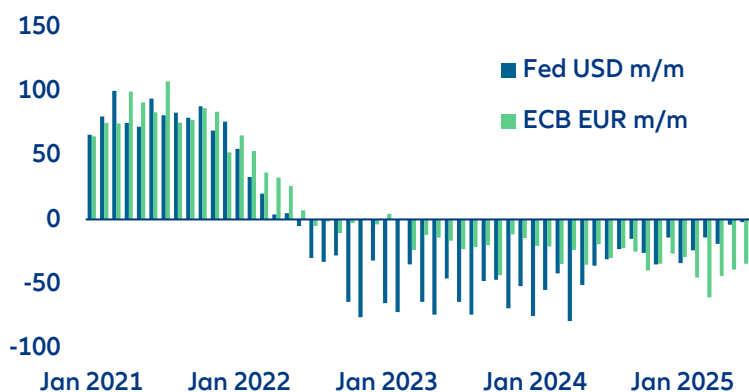
Higher long-term government bond yields are also a growing concern for policymakers, raising the prospect of a discussion about slowing QT. The appreciation of the euro has already prompted concern among some ECB officials. But adding to policymakers’ headaches are rising long-term government bond yields. In both France and Germany, 30-year yields have recently reached their highest levels since 2011 – despite a full year of monetary policy easing (Figure 3). While this increase is partly driven by global factors – such as rising US 30-year yields – and unusual selling by Dutch pension funds, there is little doubt that the ECB’s rapid quantitative tightening (QT) is also playing a role. The ECB is currently running QT at an average pace of EUR51bn per month in 2025, of which EUR42bn are government bonds (Figure 4). In contrast, the Fed has almost fully halted QT in the Treasury market, reducing its pace to just USD5bn per month. Using our proprietary fair-value model as a reference, halting QT could lower long-end Eurozone government bond yields by approximately 20bps. This may bring renewed attention to the debate on whether the current pace of QT remains appropriate in the face of tightening financial conditions.

Figure 3: 30y government bond yields and ECB deposit rate, %



Sources: LSEG Datastream, Allianz Research

Figure 4: ECB and FED quantitative policy, m/m delta of government bond holdings, bn



Sources: LSEG Datastream, Allianz Research

France's budget falls short

France's new fiscal package promises around EUR44bn of savings (close to expectations) but more tax hikes than expected to bring the deficit to -4.6% GDP in 2026, with a -0.6pp hit to GDP likely in 2026 if passed. The Prime Minister announced a salvo of measures to reduce the fiscal deficit from -5.5% of GDP expected this year to -4.6% next year – a sizeable fiscal adjustment to try to fix France's precarious fiscal position. Almost half of the plan is based on spending cuts, while the other half is made up of tax hikes (see Table 1), more than was expected considering the Prime Minister's previous promise of "no generalized tax hikes". They include a freeze in personal income tax brackets (including the CSG¹), which could affect some low-income households that currently do not pay income taxes. The Prime Minister also confirmed a beefed-up version of the surtax on high-income individuals, but did not provide further details, leaving the specifics to both chambers of Parliament. The big surprise was the elimination of two public holidays (Easter Monday and 8 May), which, in the short term, is akin to a reduction in hourly wage, or, equivalently an increase in social contributions for employees. A tax on small value parcels was also floated. On the spending side, the Prime Minister confirmed the widely-expected freeze in social benefits (including state pensions), central government spending excluding defense (including a reduction in public sector workforce) and transfers to local governments. On healthcare spending, the PM announced EUR5bn of savings, achieved through a mix of streamlining, tighter controls on sick leave and lower reimbursements of prescription drugs. If fully implemented, the fiscal package could cut a sizable -0.6pp off French GDP in 2026.

Table 1: Breakdown of planned budget savings for 2026 (target: EUR44bn)

Primary spending			Taxes		
	EUR bn	% GDP		EUR bn	% GDP
Freeze in social benefits (pensions, housing aid, etc)	5.0	0.2	Elimination of two public holidays	3.2	0.1
Freeze in public sector wages (excl defense)	1.0	0.0	Reduction or removal of inefficient tax loopholes	5.3	0.2
Reduction in public sector workforce (attrition + job cuts)	3.5	0.1	Fight against tax and welfare fraud	4.0	0.1
Streamlining of public agencies & decentralized services	2.6	0.1	Temporary surtax on high-income individuals	2.8	0.1
Streamlining and tighter control of healthcare spending	5.0	0.2	Windfall tax on corporate superprofits	3.0	0.1
Lower transfers to local governments	5.3	0.2	Freeze in personal income tax brackets	1.4	0.0
TOTAL	22.4	0.8	TOTAL	19.7	0.7
Impact GDP growth		-0.4	Impact GDP growth		-0.2

Sources: French Government, IPP, OFCE, Allianz Research

Note: we classify the elimination of the two public holidays as a "tax hike" in this simple spending/tax decomposition table, even though it not one strictly speaking. However, in the short term, it is likely to lead to a reduction in hourly wage, which is equivalent to social contribution – or tax – hike for employees.

¹ Contribution sociale generalisee.

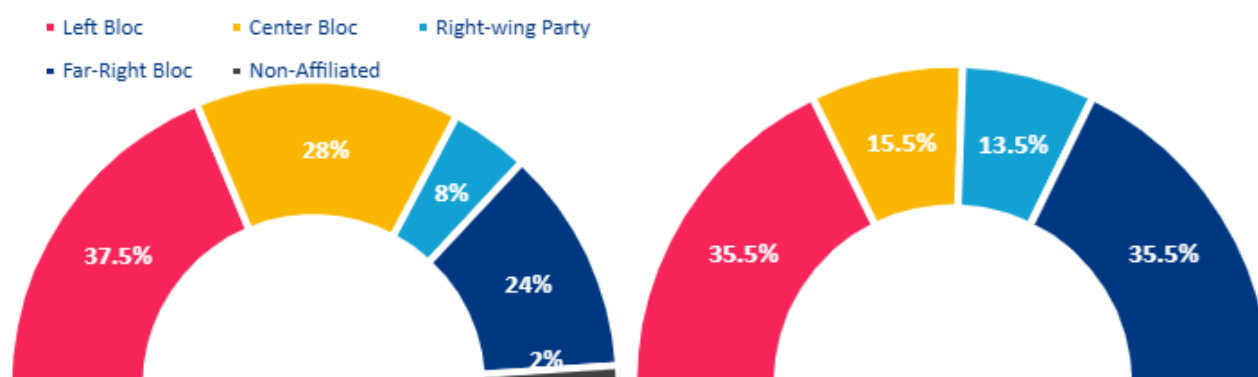
The fiscal package falls short in two ways: First, it relies on optimistic assumptions on healthcare savings and tax collection. Second, there is no clear and consistent strategy of structural spending cuts to achieve the deficit target of -2.8% of GDP by 2029. No details were provided on fiscal measures after 2026, whether these will include a renewed freeze of government spending and income tax brackets, new taxes or the continuation of the windfall **tax on corporate “super-profits”**. **And beyond these short-term fixes**, the absence of a clear medium-term strategy undermines the credibility of the fiscal plan. The government could have announced an ambitious overhaul of public spending to generate substantial and more permanent savings, including measures such as auditing local government finances, more local government tax power to incentivize better financial management, a well-coordinated trajectory of headcount reductions among central government civil servants, a revamped public sector pension system, a reduction in public subsidies and tax breaks to non-essential charities. Moreover, the current plan relies too heavily on tax hikes in a country that already boasts one of the highest fiscal-pressure ratios. This runs the risk of i) undershooting tax collections as private agents try to escape the tax hikes (through tax optimization or tax **fraud**) and ii) **undermining France’s potential growth by de-incentivizing investment for corporates and labor supply for households**. In particular, the elimination of two bank holidays and the freeze of income tax brackets increase the (already high) tax burden on labor and may discourage work. The Prime Minister had previously vowed to encourage more work (i.e. increase the employment rate) by not over-burdening labor with taxation and revamping the financing model of the French social security system. The EUR5bn target of healthcare spending cuts may also fall short in the absence of a more structural overhaul².

Moreover, to stabilize its debt, France needs to reduce the headline deficit below -2.8% of GDP or generate real GDP growth of +2.3%, which is very unlikely to be achieved, let alone sustained. **The government’s estimation** that a -2.8% GDP deficit will stabilize the debt-to-GDP ratio is based on the optimistic assumption that nominal GDP growth will be higher than the effective interest rate paid on the debt. However, history points to nominal GDP growth and interest rates being roughly equal on average (2.9% both on average since 2002). Under these assumptions, to stabilize the debt, the government would need to run a balanced primary balance (i.e. before payments of interest), or a -2.2% headline deficit. The alternative is to rely on higher GDP growth, but we estimate that real GDP growth would need to be at least +2.3% in 2026 to stabilize the debt-to-GDP ratio, in the absence of consolidation measures. This is far above any plausible forecast: We expect French GDP growth at +1.1% next year, and around +1-1.2% beyond that. This means France cannot expect to rely on higher growth to stabilize debt: large savings measures are essential.

Ultimately, the proposed fiscal package has a close to zero chance of passing Parliament. The most likely scenario remains a **watered-down budget, or the absence of budget under a prolonged “Special Law”**. **The** collapse of the government remains a high risk. Opposition parties have already said they will vote against the proposed budget. Both the left-wing parties and the National Rally are also threatening a no-confidence vote to take down the Bayrou government. We continue to expect a watered-down budget to be passed, with the windfall tax on super-profits, the surtax on high-income individuals and the freeze on central government spending most likely to remain in place. We still expect a deficit of -5% GDP in 2026, higher than the -4.6% targeted. Political deadlocks could prompt President Macron to dissolve the National Assembly by the winter. However, polls indicate that the new National Assembly would remain fractured (Figure 1), with the Far-Right bloc (National Rally and allies) gaining some seats but likely to fall short of an absolute majority. And other parties would likely threaten another no-confidence vote to take it down. This scenario could push France into a serious political and institutional crisis, which could lead to a fiscal crisis as **the bond market increasingly worries about France’s weakened fiscal discipline**.

² Including modernizing physician payment models, setting national health targets and implementing outcome-based budgeting. However, part of the substantial efficiency- and streamlining-based cost savings that could be achieved should be **redirected to healthcare workers’ wages and salaries**.

Figure 5: Political blocs in the National Assembly (left) and predicted by polls in case of new election (right)



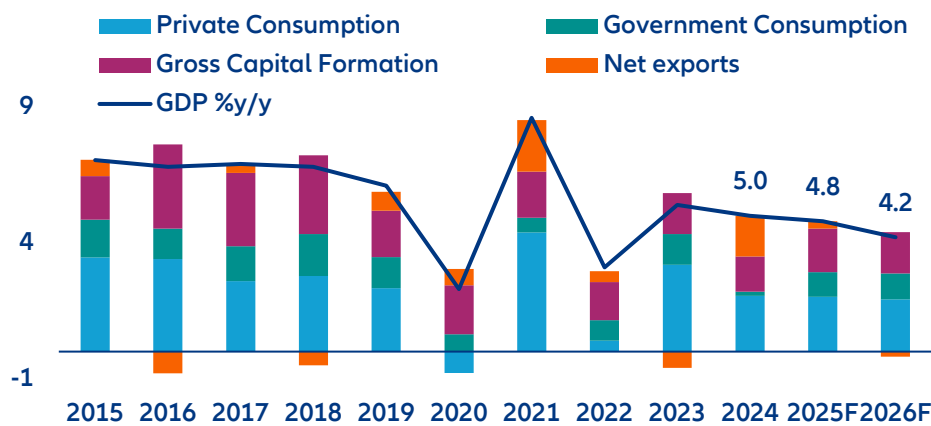
Sources: ELABE poll for BFMTV and La Tribune, Allianz Research

Under the “Special Law” we estimate that the government would generate a still sizable EUR20bn of savings in 2026, but this would be half of what it intended, taking the deficit to -5.1% GDP. In the absence of a budget, the government could rely on the “Special Law”. Under this framework, taxes would remain stable (the parties in Parliament would likely vote to index personal income tax brackets to inflation to avoid personal income tax hikes, like they did in 2024) and central government spending and transfers to local governments would be frozen. On the other hand, Social Security spending would go unchecked (for instance, automatic indexation of social benefits and pensions to inflation). Local governments may partially compensate for a freeze in state transfers through higher local taxation, particularly property tax, but their fiscal leeway has been constrained by the recentralization of public finances undertaken since 2018. We assume that local government spending would be frozen in 2025 relative to 2024. In all, we estimate that under the “Special Law”, the government would generate EUR20bn of savings in 2026 – half of what was promised via the fiscal package, but still sizeable. The deficit would thus fall to -5.1%, very close to our “watered-down budget” assumption.

China: Can the recovery last?

The Chinese economy has performed better than expected so far this year, pushing up our forecast for full-year growth to +4.8% in 2025 (from +4.5%). But we still expect a marked slowdown in the second half of the year and into 2026. **China’s GDP growth came in at +5.2% y/y in Q2 2025, down from +5.4% in Q1 but above our and consensus expectations.** This means that the Chinese economy grew by +5.3% in the first half of 2025, compared with +5% in 2024 and in excess of the official 2025 **growth target of “around 5%”**. This better-than-expected performance was supported by particularly robust external demand, as well as decent overall domestic demand. Exports rose by +5.9% y/y in H1 2025 (compared with +4.6% in 2024) as frontloading and rerouting help mitigate the impact of the US tariff hikes. Domestically, retail sales accelerated to +5% in H1 2025, compared with +3.5% in 2024, mainly thanks to **the government’s consumer goods trade-in scheme**. While the stronger-than-expected H1 mechanically raises our 2025 full-year growth forecast to +4.8% (from +4.5%), we keep 2026 at +4.2% (see Figure 6) to reflect the expected slowdown as the Chinese economy feels the hit from US tariff hikes and the recovery in domestic demand loses steam.

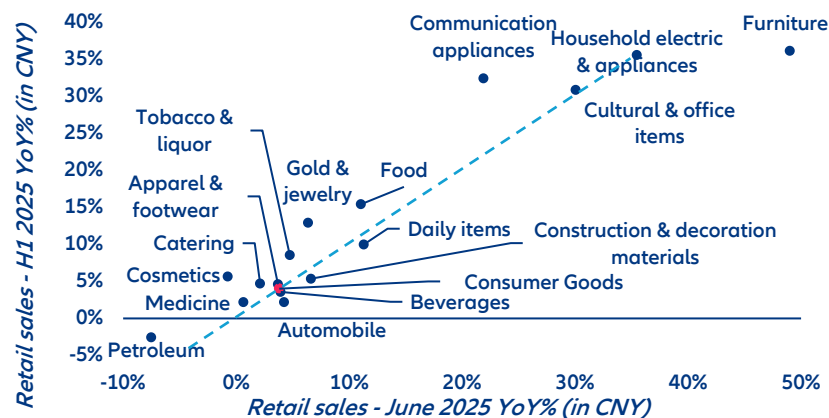
Figure 6: China GDP growth (%) and contributions by component (pp)



Sources: national sources, Allianz Research

The consumer goods trade-in scheme is likely adding 0.7% of GDP. This support, along with frontloading ahead of US tariffs, has kept private consumption artificially high. But these tailwinds will not last forever. The size of the consumer goods trade-in scheme was doubled to RMB300bn this year, amounting to 0.2% of GDP. We estimate that the scheme has likely helped unlock 0.5% of GDP worth of household savings. Durable goods such as consumer electronics, personal household products and furniture have seen tremendous growth of beyond +30% this year, in contrast to the low-single-digit growth seen for essential goods like beverages or medicines or categories such as automobiles (+2%), catering and apparel (+5% for both). Consumers have also been frontloading orders for products such as consumer electronics and telecom appliances amid high tariff tensions between the US and China. The divergence suggests that demand is mostly policy-driven and not underpinned by a strong economic cycle. The trade-in scheme is likely to continue for the rest of the year but will not be able to lift domestic demand forever, especially if incentives are not accompanied by a substantial recovery of consumer confidence.

Figure 7: Consumer goods retail sales 2025 momentum in China, per category of spending breakdown

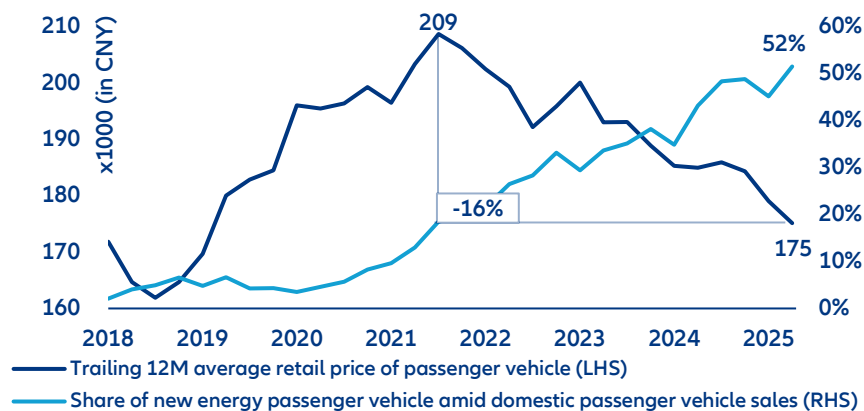


Sources: National Bureau of Statistics of China, Allianz Research

Consumption subsidies have not helped address industrial overcapacities and deflationary pressures – the auto sector is a case in point. Electric vehicles (EVs) now account for over half of passenger vehicle retail sales in China, compared to less than 5% before 2020. The sector's outstanding expansion has been driven by strong local policies, i.e. broadscale subsidy schemes (boosting demand) and tax cuts (supporting corporates). Such a political push gradually led to a saturation of EV supply, intensified by numerous new joiners from the software and telecom industries over the past five years, ultimately sparking a price war that pushed the average retail price of passenger cars down -25% between mid-2021 and end-2024 (-16% on a 12-month average basis, see Figure 8). This deflationary momentum plays against the government's intention of a consumption boost, suggesting a likely

extension of incentives. However, the first half of 2025 indicates a stabilization phase across the auto industry, with capacity utilization falling below its five-year average (71.3% in Q2 25vs. 73.8%), the result of the insolvencies of certain small manufacturers. This could help slow the current downtrend of prices.

Figure 8: New energy vehicle market share and average retail price of passenger vehicles in China

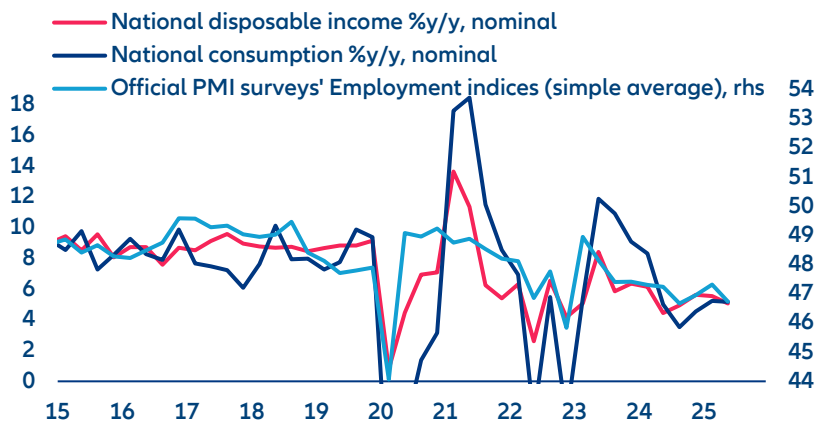


Sources: CAAM, Allianz Research

Stepping out of deflation needs demand-side stimulus. But ultimately consumer sentiment needs to improve to sustain the recovery in private consumption. Inflation in China averaged -0.1% in the first half of the year, with core inflation also at a low 0.5%. Recent official communications suggest that the Chinese leadership is increasingly concerned about deflation. In this context, appreciation pressures on the RMB have been contained, with the currency gaining less than 2% against the USD³ since the beginning of the year. Further appreciation of the CNY against the USD in the coming quarters is likely to be moderate and gradual. Meanwhile, the minutes of the Q2 PBOC Monetary Policy Committee meeting struck a less dovish tone than the previous one, highlighting worries that additional monetary easing risks further increasing overinvestment and overcapacity, thus exacerbating deflationary pressures. To structurally step out of deflation, the focus of policy support should further shift from the supply side to the demand side. The rebound in household consumption has been capped at +5.2% y/y in H1 2025, compared with +4% in H2 2024 and +6.7% in H1 2024 (see Figure 9). Still-weak household sentiment partly explains this moderate recovery: **China's consumer** confidence index has hovered around 88 this year, the average since April 2022 and much lower than the prior long-term average of 111. A soft labor market is one of the culprits (judging from the employment indices of PMI surveys – see Figure 9) and may prompt additional policy easing in the second half of this year.

³ Thus depreciating by nearly 6% in CFETS basket terms, supporting export competitiveness.

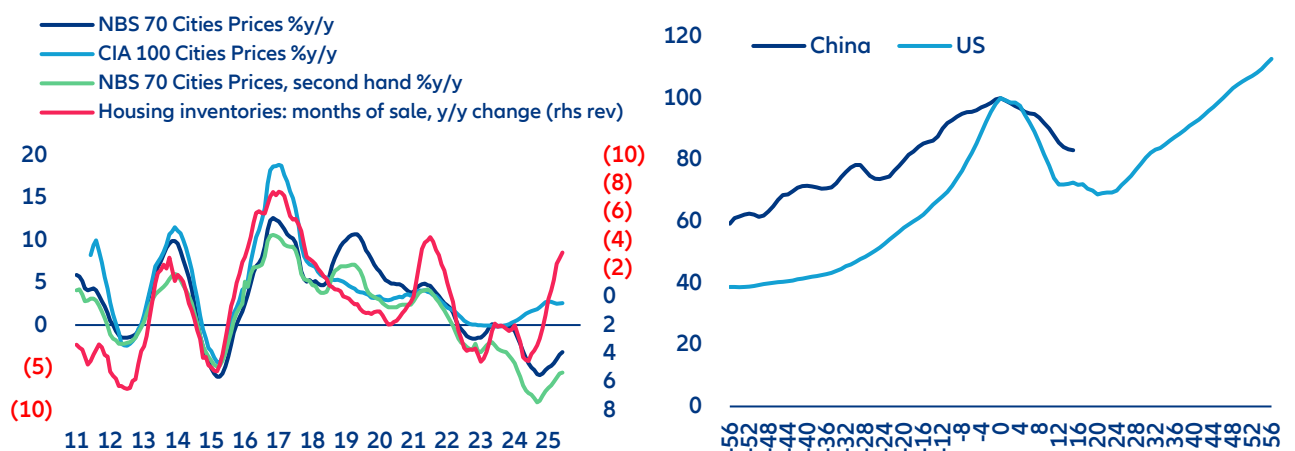
Figure 9: China household disposable income growth and household consumption growth, survey employment indices



Sources: National Bureau of Statistics of China, Allianz Research

The property sector is **another cornerstone for household sentiment. But don't expect an old-style broad-based stimulus** as policymakers will mainly focus on stabilizing housing prices. Since peaking in Q3 2021, nominal residential property prices have declined by nearly -20% in China. With **at least 70% of Chinese households' wealth** parked in real estate, the housing crisis is weighing on household sentiment and their spending ability and behaviors. June data **show that China's real estate sector remains in destocking** mode, with housing starts and completions contracting by -15-20% since the beginning of the year, while sales saw a milder -4% decline. In theory, this should be supportive for prices (see Figure 10, left) and indeed, in y/y terms, the pace of decline in housing prices has been narrowing (-3% y/y in June, compared with -5% at the end of 2024). However, sequentially in m/m terms, housing prices have now shown two months of declines (after five months of stabilization between December 2024 and April 2025). In this context, expectations are rising that authorities will deliver more measures to try and revive the housing sector. However, we see limited likelihood that they would resort to a repeat of the 2015-2018 stimulus (e.g. the cash-based shantytown renovation program), and instead focus on reinforcing already implemented measures: further mortgage rate cuts, continued purchases of unused land and unsold housing by local governments, as well as urban village renovation and urban infrastructure programs. Even if they are successful in stabilizing housing prices, a comparison with the US housing crisis suggests that a forceful recovery in housing prices is very unlikely in the coming year or two (see Figure 10, right).

Figure 10: China housing prices %y/y and inventories (left) and nominal residential property prices across real estate crises in China and the US* (right)

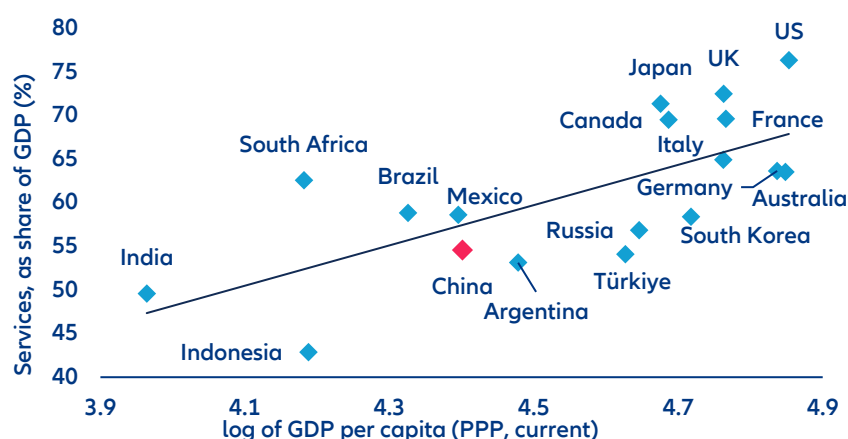


* The chart shows quarterly data, with 0 on the x-axis corresponding to when nominal residential property prices peaked (Q3 2021 for China and Q1 2006 for the US).

Sources: National Bureau of Statistics of China, LSEG Datastream, Allianz Research

Services: a long-term driver for domestic demand that is not fully tapped. The services sector has been outperforming the rest of the economy this year, growing by +6.1% y/y in real terms in the past three months. That said, as a share of overall GDP, services value-added represent less than 55% in China, a level that may be considered somewhat low for the country's development level and compared to peers (see Figure 11). Given ongoing headwinds against China's domestic demand and as short-term support measures will eventually fade, tapping into the continued development of the services sector could be a long-term driver for private consumption. A few policy developments suggest that this is on authorities' minds: the State Council's "special action plan" in March highlighted the importance of promoting services consumption, the April Politburo meeting also gave emphasis to that and the elderly care industry and the PBOC set up a RMB500bn relending tool in May to support these sectors.

Figure 11: Services value-added as share of GDP (%) vs. GDP per capita (PPP current) – latest yearly values



Sources: World Bank, Allianz Research

The next few months will bring several policy events to watch. In the very short-term, a Politburo meeting by the end of the month will provide hints regarding the policy direction for the rest of the year. The China-EU Summit taking in place in Beijing on 24-25 July as well as the 12 August deadline for the trade war truce with the US may influence how much external demand will continue to contribute to China's economy. Finally, in October-November this year, the Central Committee will release themes and priorities of the next five-year plan (2025-2026).

These assessments are, as always, subject to the disclaimer provided below.

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