

# What to watch: ECB hits pause again, Fed caught between labor and money market and vigilantes coming for credit

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## In summary

[ECB hits pause again, but QT keeps bonds on the run.](#) The ECB is expected to keep policy rates unchanged for the third consecutive meeting on 30 October, with the deposit rate remaining at 2.0%. The Governing Council seems comfortable holding rates at neutral level, given inflation is still slightly above target, despite growth stagnating – a backdrop that would usually call for more stimulus. We maintain our outlook of no policy rate changes going forward, though risks remain skewed to the downside. Weak oil prices, a strong euro and imported deflation from China pose downward pressure on inflation. Geopolitical uncertainty is curbing consumer demand, reflected in rising savings rates, and **Germany's planned fiscal stimulus to boost the region's economy in 2026 hinges on reforms.** Meanwhile, bond markets remain under pressure, given rapid quantitative tightening (QT), which releases bonds equivalent to 3.5% of GDP annually into the market, compounding elevated fiscal deficits.

[Fed: Caught between labor market and money market risks.](#) We expect another 25bps rate cut at next week's meeting as persistent labor-market weakness remains the Fed's top concern. The government shutdown entering its fourth week has already reduced Q4 annualized GDP growth by 0.45pp. In this context, policymakers are prioritizing employment risks as opposed to persistently above target inflation. However, after this cut, the Federal Funds rate will stand 50-70bps below a Taylor rule-implied level, a gap last seen in 2022 when the Fed underestimated inflation. We still expect a pause in December, followed by another 50bps of cumulative rate cuts in H1 2026, less than what markets are pricing. Chair Powell's recent hint at an early end to QT underscores that the Fed also faces intensifying funding stress on repo markets. The SOFR–IOR spread recently peaked at 15bps, reflecting tighter liquidity conditions after the USD2trn buffer in the ON RRP facility was depleted. Meanwhile, the Treasury General Account has been refilled from USD260bn to USD800bn (mainly by T-Bills issuance), draining reserves from the banking system. We view the recent repo rate spikes as signs of late-cycle tightening rather than a crisis but expect QT to stop by the end of the year, with limited effects on the US yield curve.

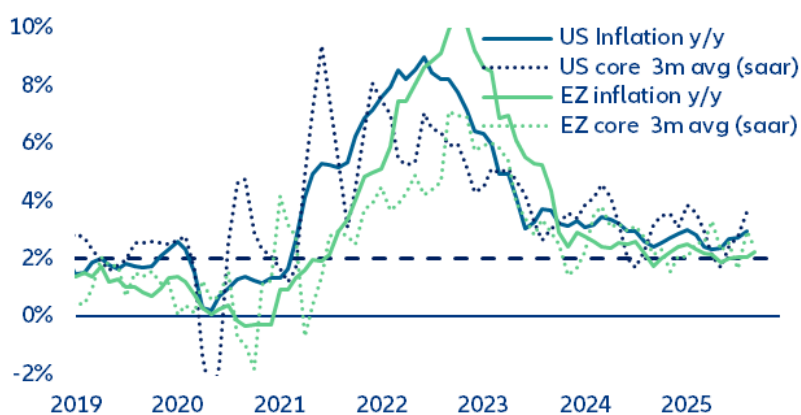
[Vigilantes coming for credit.](#) The recent widening in high-yield spreads, most notably in Euro B- ratings (56bps), illustrates the vulnerability of weaker credit quality to investor scrutiny, even more so as competition from private debt has grown. Heightened risk aversion is particularly visible in spreads relative to investment grade in the Euro market but also in USD – even if more modestly. Recent defaults have highlighted vulnerabilities in some areas of lending, albeit representative of a late-cycle phenomenon and not systemic. Despite still-high demand for yield and credit, fundamental metrics like interest coverage ratios are crucial for assessing a company's ability to service debt and point to still wider spreads. The macroeconomic outlook continues to support broader credit markets, but lower-rated companies with less financial flexibility face pressure. High-yield index spreads have risen to our near-term forecast (300bps) but we anticipate a further widening in 2026 (to 380bps for Euro and 390bps for US high yield). This calls for a more differentiated approach and a cautious stance, with a focus on quality and active credit selection, including private debt, to mitigate risks.

## ECB hits pause again, but QT keeps bonds on the run

The ECB is set to hold rates for the third time in a row. The ECB is expected to keep its deposit rate unchanged at 2.0% at its next meeting on 30 October, which the Governing Council considers a neutral level. Inflation hovers slightly above target but the economy is barely growing. A simple Taylor rule would still justify further easing but key ECB policymakers have made it clear that they want to keep some dry powder and not cut further unless there is a strong risk for a significant deviation from their baseline staff forecasts, which already see inflation dipping below target in 2026 (1.7% compared to our 1.9%). While a lot of data will come out before the meeting takes place next Thursday (inflation, PMIs, GDP, Bank Lending Survey), none of it should move the needle – at least for this meeting.

Above-target inflation justifies the current policy stance but weak economic growth does not. Headline inflation increased to 2.2% y/y in September (up from 2.0% for the previous three months), with core inflation also inching up to 2.4% y/y (compared with 2.3% for the previous four months). Sequentially, core inflation is also still clearly above target, with the three-month annualized rate at 2.6% – a measure that strips out base effects and volatile energy components (Figure 1). From that perspective, the ECB will feel reaffirmed to keep policy rates unchanged – even though they will have one more inflation print at hand next week. On the other hand, the economy looks bleak and not at a level justifying a neutral policy stance but rather additional easing: Geopolitical uncertainty is scaring consumers into increasing savings rates, PMI data do not show a strong acceleration and the output gap is still negative after years of subdued growth. Near-term estimates for the next two quarters are close to zero growth as well and even annual growth for 2025 – expected at +1.2% by both Allianz Research and the ECB – looks artificially high due to the extraordinary volatility of the Irish economy, driven by tax optimization. Excluding Ireland, Eurozone growth is expected at +0.7% this year, again clearly below the potential growth rate of around +1.1%.

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



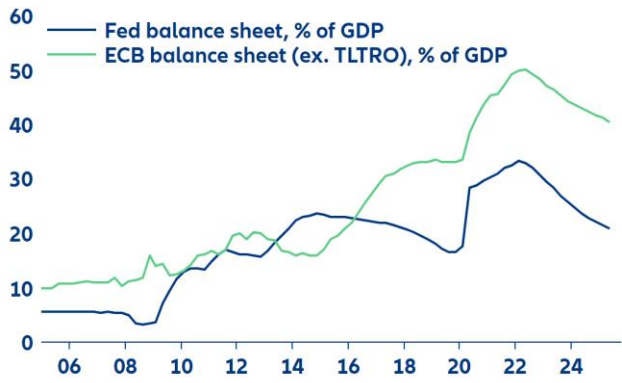
Sources: LSEG Datastream, Allianz Research

Downside risks outweigh upsides as weak oil prices, a strong euro, imported deflation from China, geopolitical uncertainty and [Germany's slow reform process](#) weigh on the outlook. Downside risks currently dominate. Weak oil prices and ongoing deflation in China could lower the inflation rate in Europe below current estimates. The strong euro, not only against the dollar (+12% ytd) but also against the Chinese yuan (+10% ytd), raises this risk of imported deflation. Geopolitics and economic uncertainty limit the willingness of consumers to stimulate demand – another downside risk to both inflation and growth. Understandably, the ECB is reluctant to lower policy rates when Eurozone's biggest economy, Germany, is about to unleash billions of additional fiscal stimulus, which should boost growth in the region as a whole starting in 2026. However, that impact depends on critical reforms to ensure stimulus funds are deployed effectively and quickly.

Quantitative tightening at high speed should come into focus, especially if the Fed will end this era soon. Long-end bond yields have stabilized at high levels, but the ECB's aggressive pace of quantitative tightening (QT) remains a key driver to the upside. Currently, the ECB is reducing its total bond holdings by an average of EUR46bn per month (of which EUR38bn are government bonds), compared to just USD18bn (USD3bn government bonds) for the Fed (Figure 2). This rapid runoff in sovereign bond holdings could create upside risks to longer-term yields and

counteract the looser policy stance implied by lower short-term policy rates. The current pace of QT spills vast amounts of government bonds to the market at an equivalent of 3.5% of GDP on average for the Eurozone but with significant differences across countries (Figure 3). Outstanding debt and the capital key, which served as an anchor for the ECB to weigh quantitative tools across countries, lead to a wide range from 0.9% in Luxembourg to 4.3% in Portugal. For France this is particularly severe because on top of net bond issuance from a fiscal deficit of around 5% of GDP, investors have to buy another 3.4% of GDP stemming from QT. Given the trend of slowing QT at the Fed, BoE and BoJ, this issue will soon move to the center of the policy debate. Figures 2 and 3, however, also show that the ECB still has much more bonds on its books and given [high losses in the past](#) it is certainly eager to run them down further if market conditions allow.

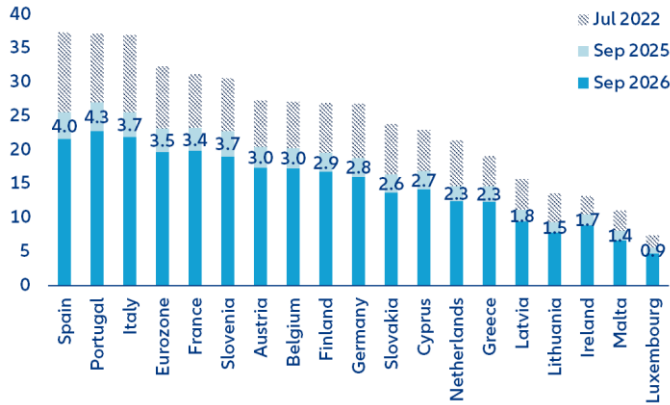
Figure 2: Central bank balance sheets in % of GDP



Sources: LSEG Datastream, Allianz Research

Notes: The Fed has capped quantitative tightening of US Treasuries to USD5bn and Mortgage-Backed Securities to USD35bn per month since April 2025. The effective run-down is much lower and has slowed to USD18bn per month on average since then, significantly lower than the EUR48bn per month by the ECB (which includes government bonds and other fixed income instruments).

Figure 3: ECB ownership of government bonds in % of GDP



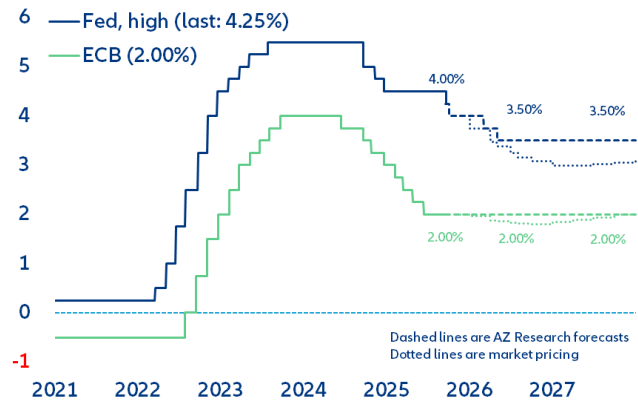
Sources: LSEG Datastream, Allianz Research

Notes: Sep 2026 bars show the level of ownership if QT continues at current speed and numbers show the additional amount of bonds spilled to the market in % of GDP in the next 12 months.

We expect the ECB to hold its deposit rate steady at 2.0%, with markets recently aligning to that view as hikes in 2027 have been priced out. We maintain our call of a 2% deposit rate for the foreseeable future, with downside risks. Markets have priced out rate hikes in 2027 again and are now largely in line with our call (Figure 4). We also maintain our forecast of 1.18 EUR/USD going forward. Interestingly, the exchange rate has moved sideways for the past months despite a narrowing short-term interest rate differential (Figure 5). This was largely driven by the US, where markets started to price in more cuts compared to Europe. Unlike in previous periods, this has not led to a

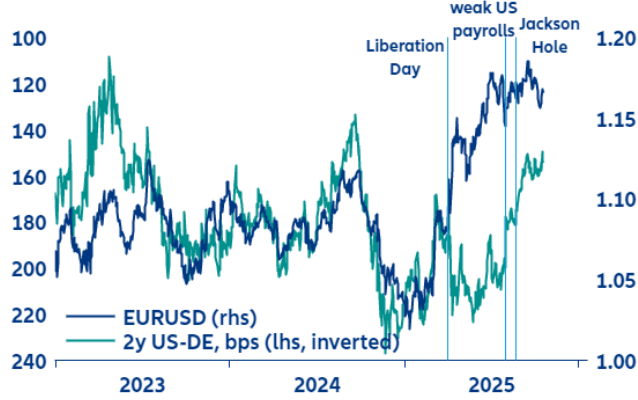
depreciation of the USD, despite lower returns. This can be attributed partly to lower inflation expectations in the US but also to a fading or even reversing, de-dollarization trend following “Liberation Day” in April.

Figure 4: ECB and Fed policy rates expected vs market expectations, %



Sources: LSEG Datastream, FED New York, Allianz Research  
 Notes: Dashed line is Allianz Research forecast, dotted line is market pricing

Figure 5: EUR/USD exchange rate and short-term interest rate differential, %

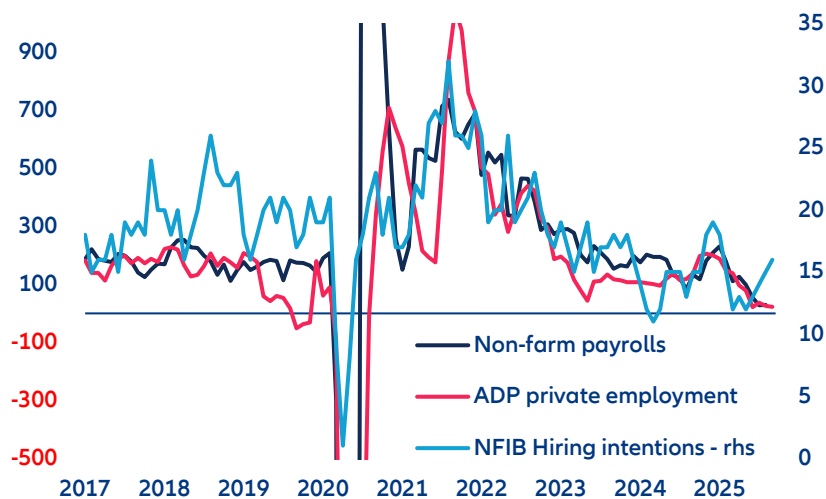


Sources: LSEG Datastream, Allianz Research

### Fed: Caught between labor market and money market risks

**We expect the Federal Reserve to deliver a 25bps rate cut at next week’s FOMC meeting as persistent weakness in the labor market remains the top concern.** Several officials, including Chair Powell, have signaled that another reduction is likely, following September’s 25bps cut. The labor market continues to show signs of strain: While official September payroll data are unavailable due to the ongoing government shutdown, private-sector surveys point to continued softness. The ADP employment report, for instance, shows weak momentum continues in private job creation (see Figure 6). Federal government payrolls also likely weakened in September because of the approximately 150,000 workers who accepted deferred resignations and will roll off the federal payroll this quarter. Meanwhile, reports suggest the administration has begun dismissing non-essential furloughed workers amid the shutdown – as warned previously – though the numbers remain limited for now. As it enters its fourth week, the shutdown is likely to have cost -0.45pp of Q4 GDP growth (-0.15pp per week), some of which will not be recoverable.

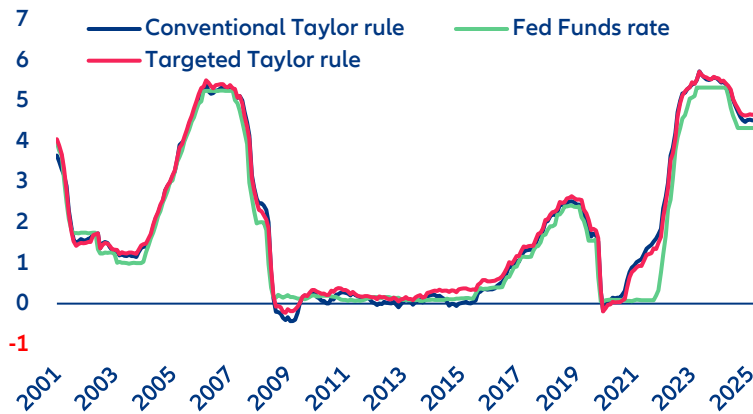
Figure 6: Job creation (ADP & establishment survey) and NFIB hiring intentions.



Sources: LSGE Datastream, Allianz Research

**The Fed is likely to maintain a dovish bias in the coming months, albeit with a more measured pace, even as inflation remains stubbornly above target.** After next week's cut, the Federal Funds rate will stand roughly 50-70bps below the level prescribed by a standard Taylor rule (Figure 7). The Taylor rule links appropriate policy rates to deviations of inflation from target and to the output gap. Such a pronounced gap between actual and rule-based policy rates has been rare, last observed only in 2022, when the Fed initially judged the inflation surge to be "transitory." In hindsight, that episode left the central bank behind the curve. Today, inflation remains elevated, with PCE inflation running at +2.7% year-over-year in August, while we estimate the output gap is still positive. The unemployment rate has barely risen despite subdued hiring, partly because tight immigration policies have sharply reduced labor-force inflows. As a result, both labor demand and supply remain constrained. Meanwhile, business tech investment continues to expand rapidly (Figure 8). We suspect accelerating AI adoption, coupled with policy uncertainty, explains part of the recent cyclical weakness in employment. Encouragingly, the Chicago Fed's alternative unemployment measure for September indicates stability or only a modest uptick. And although job creation is likely to stay subdued amid slower growth and ongoing structural shifts, the NFIB survey shows a rebound in hiring intentions from earlier lows (see Figure 6 again). Given these cross-currents, we expect the Fed to proceed more cautiously in the months ahead. Even dovish Fed Governor Waller has sounded more concerned about inflation risks, saying that the Fed should "move with care" when adjusting rates further out "to ensure [it] does not make a mistake which will be costly to correct". We continue to anticipate a pause at the December FOMC meeting, followed by an additional 50bps of cumulative cuts in H1 2026. Gradually rising unemployment and a softer growth backdrop should keep policymakers leaning toward easing, even in the face of persistent inflation pressures, though less that what is priced into financial markets (Figure 4).

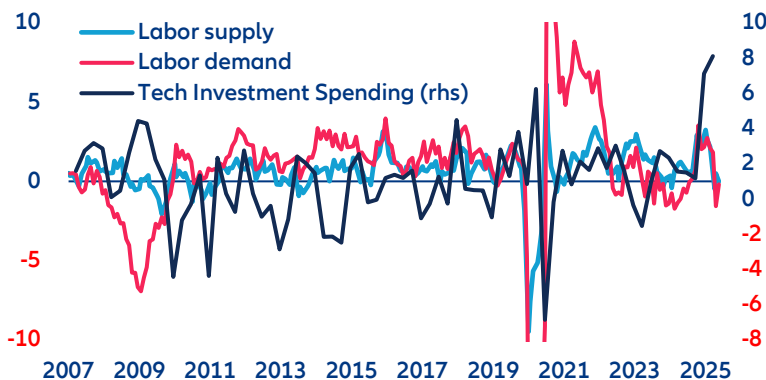
Figure 7: Actual Fed Funds rate vs rate prescribed by Taylor rules (%)



Sources: LSGE Datastream, Allianz Research

Note: In a Taylor rule, the policy rate depends on i) the natural interest rate, ii) the output gap (slack in the economy) and iii) inflation relative to the target. The natural interest rate is derived from market pricing; the output gap is derived from labor market and capacity utilization surveys; “targeted” Taylor means that the central bank gives more weight to demand-driven inflation than supply-driven inflation. The latest data are September for the conventional rule (assuming PCE inflation at 2.7% - steady from August) and August for the targeted rule.

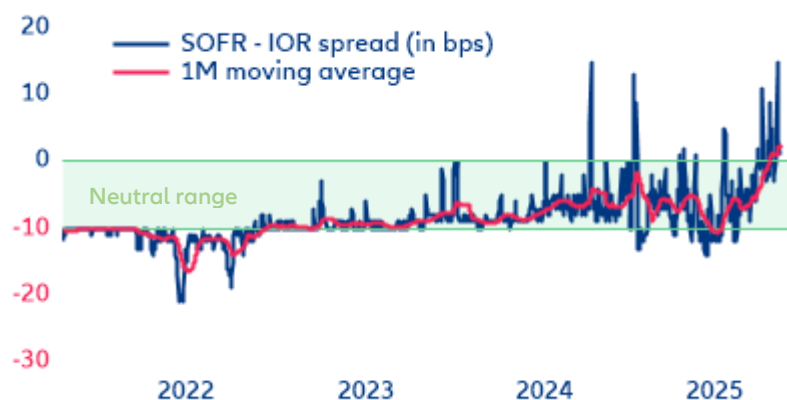
Figure 8: Labor supply, labor demand (% 6m annualized growth) and tech investment (% quarterly annualized growth)



Sources: LSGE Datastream, Allianz Research

**End of QT talk is not a sign of crisis but a late-cycle tightening event.** In addition to the policy rate, the outlook for quantitative tightening (QT) will also be in focus at next week’s meeting, following Chair Powell’s recent hint at an early end to QT (Figure 2). What might at first glance appear to be a dovish pivot aimed at containing long-term yields is actually targeting the US money market. Powell himself linked his QT remarks to “some signs [...] that liquidity conditions are gradually tightening, including a general firming of repo rates [...].” In fact, some money market rates have recently spiked above the Fed-administered upper bounds such as the Interest Reserve (IOR) (Figure 9). Such overshooting is rare and indicates liquidity is running low. The simultaneous occurrence of stress among US regional banks has revived memories of the Silicon Valley Bank crisis of 2023. We do not believe that the announcement of the end of QT should be interpreted as a crisis response; not every friction in the repo market amounts to a liquidity crisis. Instead, we view recent developments in the US repo market as a clear late-cycle tightening event.

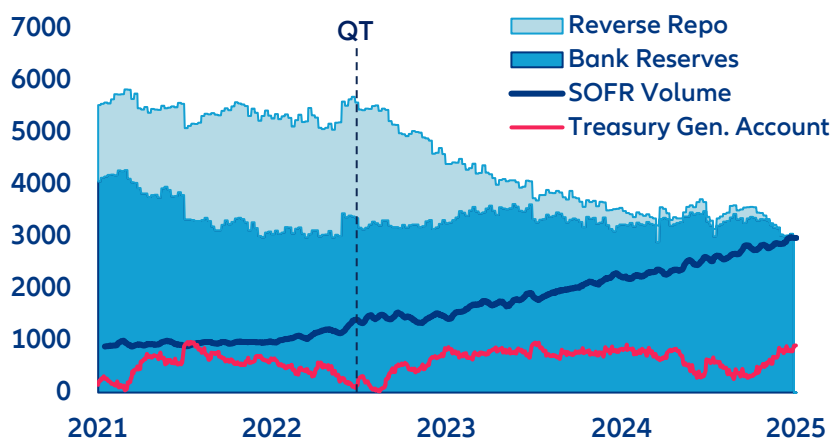
Figure 9: Repo markets rates indicate rising liquidity tensions



Sources: LSEG Datastream, Allianz Research

**Banks have become the marginal provider of liquidity.** When the Fed began reducing its balance sheet in mid-2022, the USD2trn excess liquidity parked in the Overnight Reverse Repo Facility (ON RRP) acted as a liquidity buffer. Money market funds (MMFs) could withdraw funds from ON RRP and lend them in the repo market, keeping repo rates well below the Fed’s interest rate for reserve balances (IOR). Today, the ON RRP has been depleted, and banks have taken over the role of marginal liquidity providers (Figure 10). Unlike MMFs or other non-bank entities, banks face significant balance sheet costs (regulatory capital requirements, liquidity coverage ratios, G-SIB surcharges), which raise the lower bound of repo rates (e.g. Secured Overnight Financing Rate, or SOFR). When strong market frictions are present (such as large issuances or quarter-end window dressing), repo rates can rise above the Fed’s IOR. The SOFR–IOR spread turned positive as early as September 2025, reflecting the change supply structure in the repo market and indicating scarce and expensive liquidity.

Figure 10: QT has altered liquidity dynamics in US money market (in USD bn)



Sources: LSEG Datastream, New York Fed, Allianz Research

**The recent spike in repo rates is a sign of rising fragility but not systemic risk.** On 16 October, the SOFR–IOR spread reached a peak of 15bps. Rather than a sign of systemic crisis, we see this as a typical coincidence of market frictions amid structurally scarce liquidity. The sand in the gears is the massive issuance of US T-bills to refill the Treasury General Account (from USD260bn to USD800bn recently). This issuance absorbs significant reserves from the banking system while simultaneously mobilizing liquidity from money market funds to purchase the new T-bills that would otherwise have been lent in the repo market. As a result, supply in the repo market falls, while primary dealers demand liquidity to fund the influx of T-bills, causing the price of liquidity to rise rapidly. But thanks to the Fed’s **Standing Repo Facility (SRF)**, a safety valve introduced in 2019, this liquidity crunch is contained and remained confined to these technical factors in the money market, without causing interbank market stress (stable FRA-OIS

spread) or spillover into the swap market. However, it shows that with liquidity supply shifting from ON RRP to the banking sector, the balance has become more fragile, and any continuation of QT increases the volatility of money market rates, which effectively tightens funding conditions.

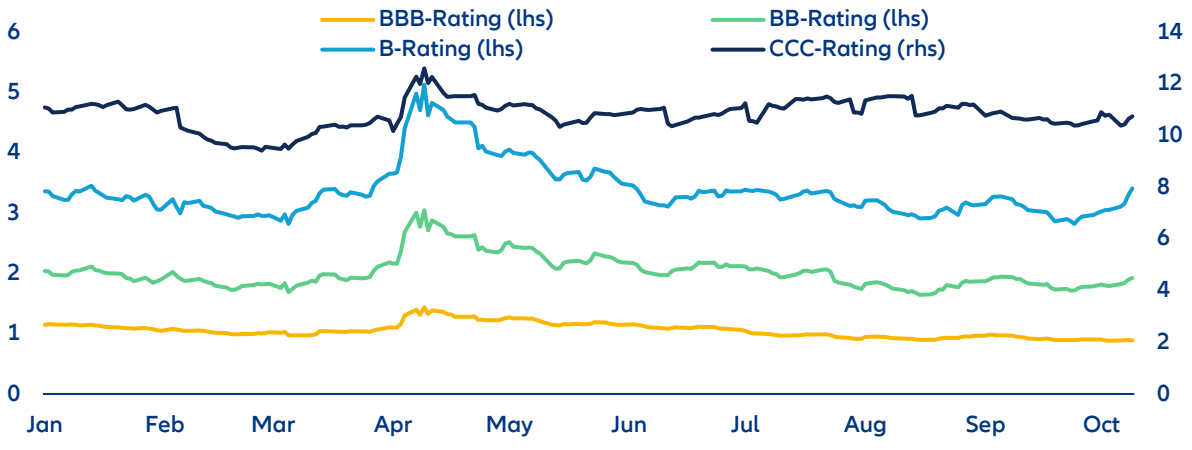
**We therefore expect the Fed to announce an end to QT by year-end, but this does not mean a return of QE.** With bank reserves comprising 13% of bank assets, we believe the neutral threshold has already been reached. The risk of draining too many reserves and thus endangering financial stability outweighs the benefits of QT while the recent spikes in repo rates have shown that the margin for error is shrinking. Ending QT does not automatically mean a return to QE. In our view, the Fed will aim for a stable balance sheet and use the SRF to fine-tune short-term rate volatility. QE would only occur if the drain of liquidity has already been excessive, so that repo rates continue to spike. The SOFR–IOR spread consistently trades above 10bps, and the SRF proves insufficient to stabilize short-term funding. QE would become a policy-error correction tool.

**The end of QT will have limited effects on the US yield curve.** For long-term rates, QT has been a significant factor behind the rise in long-term US yields since 2022. For 10-year Treasuries, around 30bps can be attributed to the reversal of the QE-driven duration extraction, but the effect has decreased since the beginning of the year. We do not expect a significant impact on the long end of the curve beyond what has already been priced after Powell’s announcement. However, the end of QT will improve the market’s capacity to absorb US Treasuries and create room to continue the strong issuance activity, especially at the short end, which could have some flattening effect on the US yield curve.

### Vigilantes coming for credit

After hovering around record lows, Euro high-yield spreads are widening, making beta-carry trades less attractive for investors. For most of 2025, only the riskiest corporate bonds (CCC-rating) did not see the tightening dynamic that followed the “Liberation Day” shock in April, staying elevated at around 10% spread to Bunds. However, over the past four weeks, other low ratings i.e. BB and B-ratings, have also started to widen by c.27bps and c.56bps, while investment-grade spreads remain much better anchored, widening a mere 3bps over the same period. Interestingly, USD high-yield spreads have been widening slightly less but USD investment grade spreads have widened by 7bps, from a lower level, which is 2-3x the move of their Euro peers.

Figure 11: Euro corporate spreads to Bunds by rating (pps)

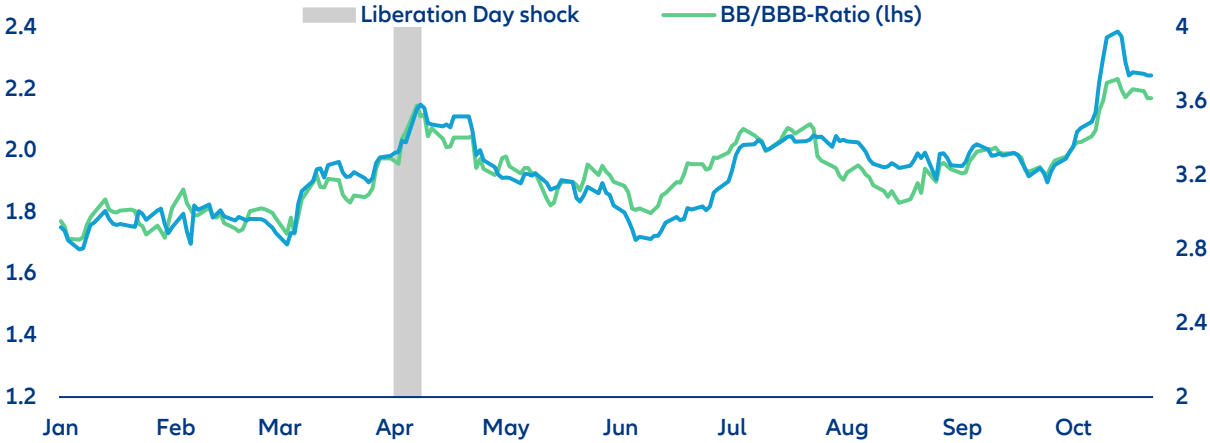


Sources: Bloomberg, Allianz Research

**A relative perspective reveals** that for the Euro market **even more differentiation is kicking in and this attention is overdue.** Due to the generally high correlation within the corporate bonds market, it is most telling to look at the sensitivity relative to the safer credit in investment grade (here we take BBB-ratings). The ratio of high yield to investment grade spreads now exceeds the levels seen during the "Liberation Day" shock (currently at 2.2x for BB and 3.7x for B-ratings). In the USD market, due to the more notable widening in investment grade, the differentiation is less pronounced but clearly visible. This movement appears to be driven by more discrimination and risk

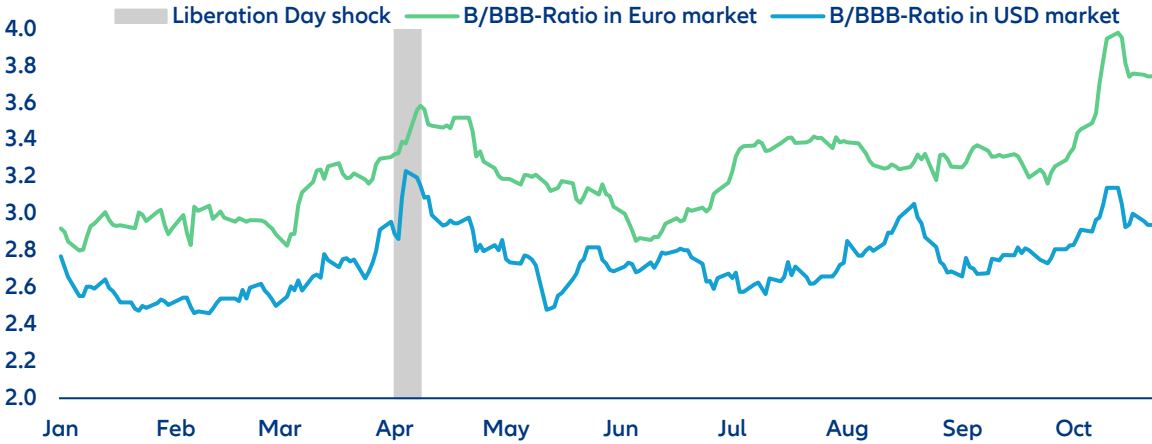
awareness, especially in less resilient sectors vulnerable to the cycle and tariffs. While such differentiation is welcome, it raises the question of whether more is to come, especially as defaults have recently made headlines and added to the dynamic.

Figure 12: Euro corporate spreads relative to BBB (pps)



Sources: Bloomberg, Allianz Research

Figure 13: USD corporate spreads relative to BBB (pps)

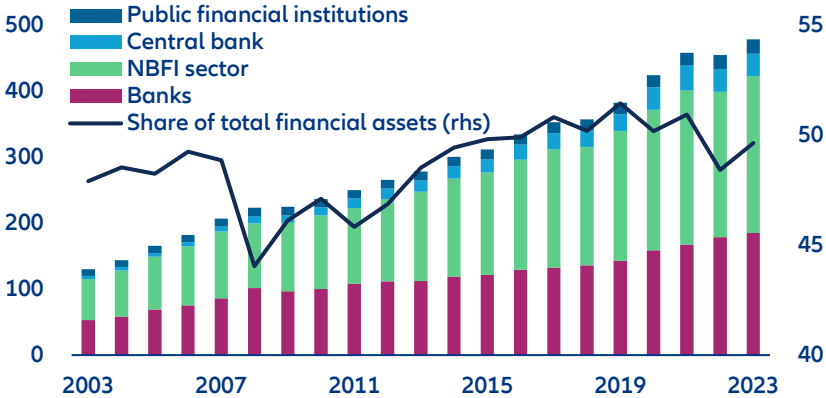


Sources: Bloomberg, Allianz Research

**Recent credit events put the spotlight on risk transmission from private to public markets, indicating stress signals, though not contagion.** As differentiation widens in traded credit, recent events have shown that pressure is not confined to public markets but is emerging across the broader credit ecosystem. Since the global financial crisis, the balance of credit creation has shifted steadily toward non-bank financial institutions (NBFIs), whose share of global credit and finance climbed from around 43% to nearly 50% by 2023 (FSB 2024). This evolution helps explain why recent pressures extend beyond public markets into the broader ecosystem of private lenders and investment funds. The bankruptcy of First Brands and loan losses disclosed by regional banks such as Zions and Western Alliance triggered repricing across linked bank and private-credit exposures, exposing vulnerabilities but also demonstrating that stress remains contained. These developments underscored the tight coupling between banks and non-bank financial institutions (NBFIs). The IMF’s October 2025 Global Financial Stability Report estimates that bank exposures to non-banks amount to roughly USD4.5trn across the US and Europe, with some commitments exceeding Tier 1 capital. Such linkages mean that, under simultaneous funding or redemption pressures, stress in private credit could transmit into traded markets and test broader system buffers. For now, these

remain stress signals rather than contagion. Market reactions have been orderly, yet borrower fundamentals in private credit are softening. Average interest-coverage ratios have declined from 2.2x to 1.7x over the past three years (Lincoln data), while refinancing costs have risen, pressuring cash flows and leaving smaller, more rate-sensitive borrowers vulnerable. A regional bank has already absorbed a notable write-down without market fallout, and leading private-credit managers have contained losses through seniority and control rights. Overall, these events remind investors that while system resilience endures, it is being gradually tested as credit conditions normalize and markets shift from liquidity-driven stability toward fundamentals-based differentiation.

Figure 14: NBFi as a share of total global financial assets

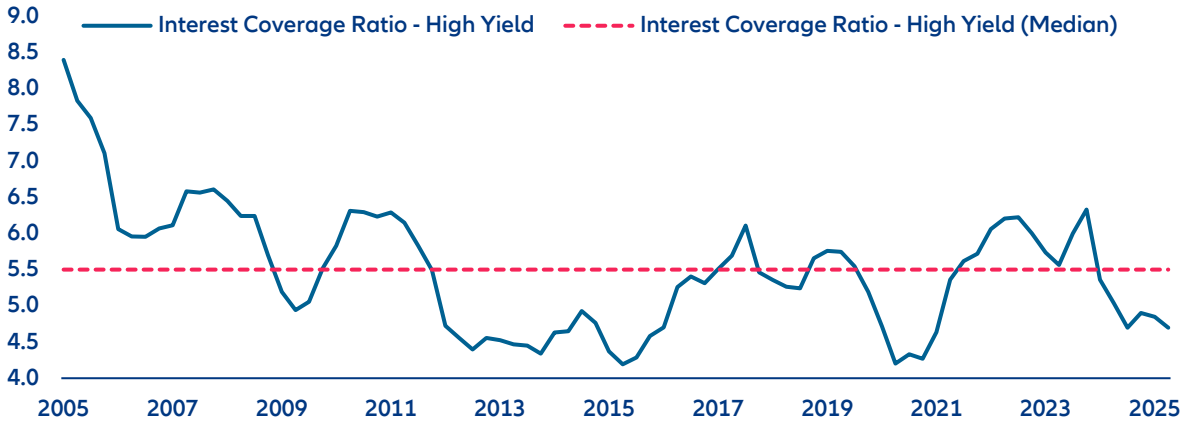


Sources: Financial Stability Board, Allianz Research. NBFi includes insurance corporations, pension funds, OFIs and financial auxiliaries.

**As we expect demand to fade amid rising risk awareness, the next anchor should be fundamental credit metrics.**

Record-high bid-cover ratios for new issuances and the compression of new issue spreads upon initial trading demonstrate investors' strong appetite for credit and yield in 2025. Especially the Euro high-yield market remains small size compared to investment grade, accounting for approximately 10% of the market, but it is still double the size it was in 2008. This is noteworthy given that large investors moved towards private debt, implying that the share of strategic high-yield investors in the liquid market might be even lower than in the past. With demand for riskier credit likely to fade, credit fundamentals such as the interest-coverage ratio (EBITDA divided by interest expense) are a key indicator of a company's ability to service its debt in the near term under current conditions. For investment-grade corporates, the financial buffers established post-pandemic have diminished, bringing the metric closer to long-term norms, which appears acceptable given the present low-growth environment. In the high-yield sector, companies with higher leverage are also below average, but at a notably lower level. The narrow historical range highlights the limited financial flexibility of these companies. Any further decline in income (exceeding 10%) or worsening of financing conditions could rapidly push these weaker companies to strained levels, incompatible with the current low spreads. Although we do not anticipate such stress, this situation underscores the importance of incorporating current fundamentals in pricing and spreads, not only in Euro but also USD high yield.

Figure 15: Interest-coverage-ratio (Euro high yield)



Source: Bloomberg, Allianz Research (Financial Data as reported per Q2/2025)

**Late-cycle credit markets will bring more differentiation into 2026 and wider spreads, especially for lower ratings. We reiterate our caution despite high-yield spreads having reached our fair value for end-2025.** Our outlook for low nominal global economic growth generally supports credit markets. But this context also requires differentiation between sectors and companies. Given risks are skewed towards lower growth and higher inflation/rates, companies with high leverage and those undergoing restructuring are likely to face the greatest pressure. US financial deregulation intentions could keep financing costs low and demand for credit high for a bit longer, and fiscal pressure could further extend this. But as seen recently, investors are on their own when it comes to defaults. We continue to maintain a cautious stance high-yield bonds as these companies may have benefited most from investor optimism on credit and a lack of differentiation. While the market dynamics may not immediately lead to a correction, we anticipate a normalization that suggests a gradual convergence to the historical median, as fundamentals indicate. We expect private debt can add risk buffers via additional pick-up as well as close risk oversight of experienced managers. With our forecast of normalization in credit pricing approaching, this should serve well for more differentiated approaches where higher quality and active selection are expected to outperform.

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

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