

Allianz Research | 17 June 2026

# Southern Europe won the last decade. The next one is less obvious

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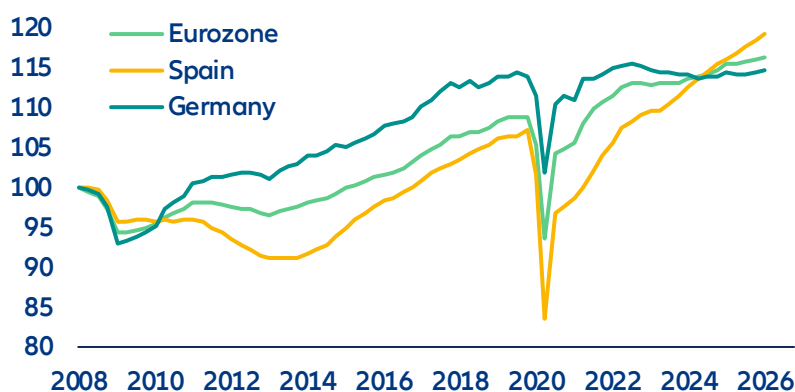
## In Summary

- **Southern Europe has delivered an impressive turnaround this past decade, broader and more durable than many expected.** Spain, Portugal and Greece are running ~11% above pre-pandemic output, while Germany has stagnated for four consecutive years. Sovereign spreads that peaked above 250bps during the debt crisis have compressed to around 70. Southern banking systems, once the epicenter of Eurozone fragmentation risk, have largely completed their NPL clean-up (it is German and French banks that are now carrying rising asset quality pressures). This is not a cyclical blip but reflects an earned shift through labor market reforms, fiscal consolidation and the NGEU investment impulse – the largest coordinated public investment program the Eurozone has ever deployed. Spain's renewable buildout – now supplying more than half of its electricity – has added a further dimension: an industrial energy cost advantage that did not exist before 2021 and that has no equivalent in the North. The reversal is real but increasingly reflected in market pricing.
- **The growth model has delivered output convergence, but productivity – the engine of durable income catch-up – remains the unfinished business.** Employment-led recovery has run its course as the primary driver; Greece remains below its 2008 per capita income level. Sustaining the narrative through the next phase requires a more difficult set of structural changes: judicial efficiency, capital market deepening, R&D intensity and a completed Banking Union. The NGEU disbursements ending in 2026 sharpen that test: what phases out is not just a fiscal impulse but a reform discipline mechanism, and where implementation has been compliance-driven rather than institutionally embedded, the risk of slippage rises. The fiscal impulse is fading, with no clear replacement, and private cross-border capital flows remain too limited and episodic to fill that gap organically – the handover from public investment anchor to market finance is assumed but not yet visible in the data. These are not reasons to dismiss the story – they are the conditions that would extend it.
- **The political calendar and spread geometry call for selectivity.** France, Italy, Spain and Greece all face national elections in 2027, creating fiscal pressure points at the precise moment external conditionality fades and the ECB continues quantitative tightening. At around 70bps, BTP and Bonos spreads leave limited room for positive surprises and some room for temporary widening if credibility wavers. This is not a crisis configuration – sovereign balance sheets are in materially better shape than in 2011 and the ECB's Transmission Protection Instrument (TPI) provides a credible backstop – but it is a configuration in which episodic volatility is more likely than further compression. The region's reform record since 2012 is real and the underlying story has not exhausted itself. What comes next is more differentiated: returns will accrue to investors who discriminate by country, sector and reform trajectory rather than treating Southern Europe as a monolithic allocation.

## The convergence scorecard: the wreckage of the 2010s and the post-pandemic catch-up

**The Eurozone's defining fault line of the 2010s – the North–South divide – has materially narrowed over the past five years.** The 2008 financial crisis and the subsequent Eurozone sovereign debt crisis produced a split of historic proportions. Between 2008 and 2013, Spanish GDP fell by roughly -9%, unemployment peaked at 28% and youth unemployment exceeded 55%. Greece suffered the most severe peacetime output contraction in a developed economy in the post-war era. Italy and Portugal followed trajectories nearly as damaging, albeit with somewhat better access to external support. In the years that followed, Mediterranean economies experienced only a sluggish recovery, while the core bloc (Germany, France, the Netherlands and Belgium) continued to expand, led by Germany's export competitiveness and manufacturing rebound, powered by surging global demand for automobiles and machinery in emerging markets.

Figure 1: GDP 2008=100



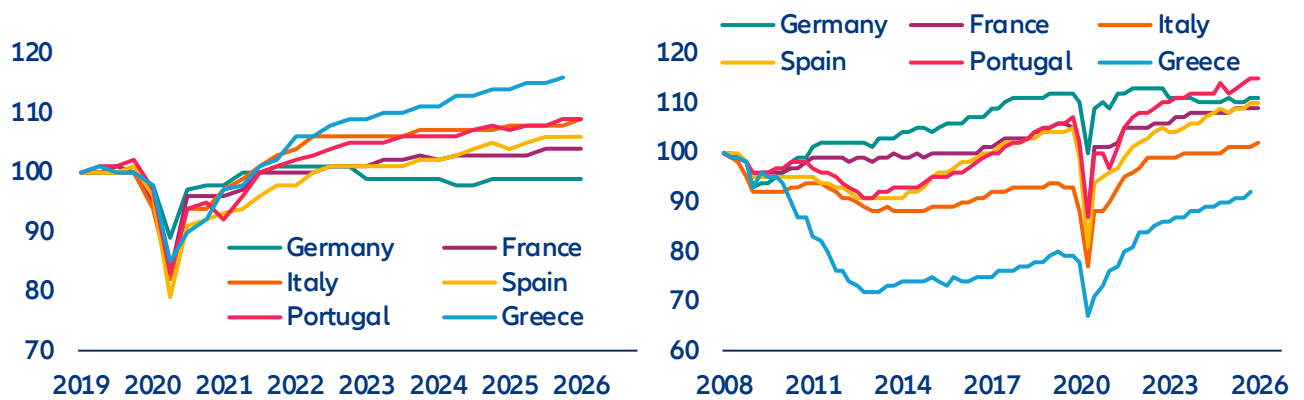
Sources: LSEG Datastream, Allianz Research

**The post-2021 recovery marked a clear shift in the geography of Eurozone growth, with Southern economies moving from chronic underperformance to cyclical leadership.** This shift reflects three reinforcing mechanisms. First, reforms implemented in the aftermath of the sovereign debt crisis – often under EU and IMF conditionality – improved competitiveness, labor market flexibility and external adjustment, laying the foundations for stronger employment and export performance. Second, the recovery has been strongly sector-biased, with contact-intensive services – particularly tourism – benefiting disproportionately. In Southern economies, tourism typically contributes between 10% (in Italy) and 20% of GDP (in Greece and Portugal) once indirect and induced effects are included. Third, the deployment of Next Generation EU (NGEU) funds supported public investment and credit conditions, amplifying domestic demand and accelerating structural upgrading, including through infrastructure and digitalization.

**At the same time, Germany's growth model, built on cheap energy inputs and external demand, has been structurally disrupted.** The loss of Russian gas, combined with weaker demand from China, has exposed vulnerabilities linked to underinvestment and slower technological adaptation, contributing to prolonged stagnation between 2022 and 2025. The resulting convergence combines catch-up and compression – a critical distinction. The narrowing of income gaps reflects not only structural improvement in the periphery, but also a rebalancing of relative growth across the Eurozone.

**However, this convergence remains incomplete when assessed through a structural lens.** While output growth has converged, convergence in GDP per capita – the more relevant measure of welfare – has been significantly more limited. Despite strong post-pandemic performance, longer-run comparisons point to persistent scarring effects from the sovereign debt crisis. Greece remained below 2008 per capita income levels in 2025, Spain has broadly closed the gap, while Portugal has exceeded it, reflecting sustained reform implementation and a strong tourism-led rebound.

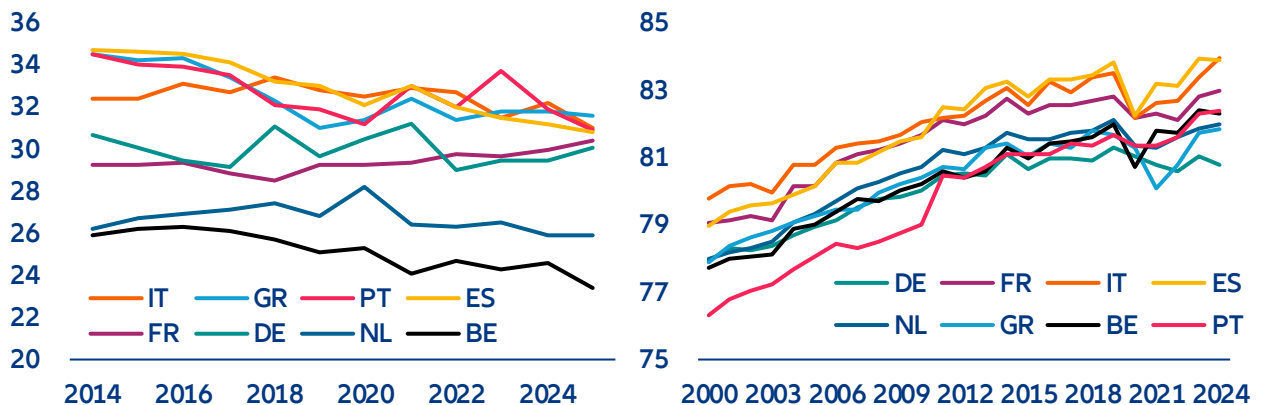
Figure 2: GDP per capita, 2019=100 and 2008=100



Sources: LSEG Datastream, Allianz Research

**This divergence reflects the nature of the current growth model.** Since 2021, growth has been predominantly employment-driven rather than productivity-driven. This has delivered rapid gains in output, but only partial convergence in income levels. The human dimension of the crisis decade remains visible. Southern Europe leads the EU in life expectancy yet carries persistently higher income inequality than its northern peers (Gini coefficients of 32–34 versus 25–30 in core economies), with recent gains that have not reached the bottom of the distribution. The current phase therefore risks resembling “convergence by slowdown” in the core as much as genuine structural catch-up in the periphery.

Figure 3: Gini coefficient and life expectancy



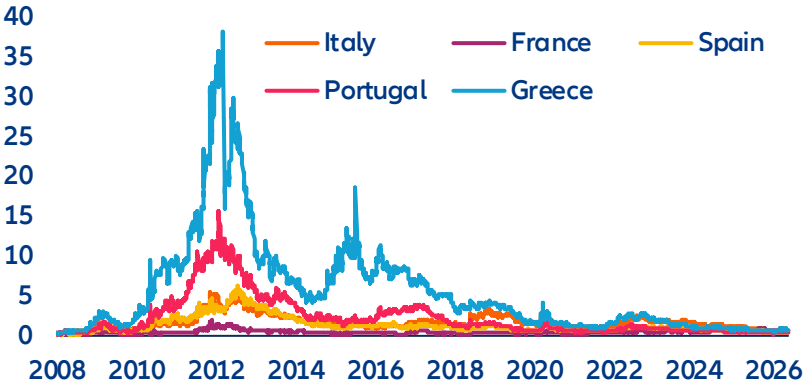
Sources: LSEG Datastream, Allianz Research

### The capital market scorecard

**Financial markets have broadly confirmed the convergence narrative.** Italian 10-year spreads compressed from a peak of 250bps in 2022 to an average around 70bps in early 2026; Greek government bond spreads consistently trade tighter than Italy. EGB spreads are nowadays broadly back to the levels of 2008. NGEU has also been a key driver of this compression, with its combined impact on growth, fiscal balances and policy credibility accounting for a significant share of the observed convergence<sup>1</sup>. Equity markets echo this: Italian, Spanish and Greek indices have all outpaced the Stoxx Europe 600 since 2022, with gains driven by value rotation and banking rehabilitation rather than a fundamental re-rating. Measured from the sovereign crisis period (2008=100), Southern European markets experienced a prolonged phase of underperformance followed by a gradual recovery.

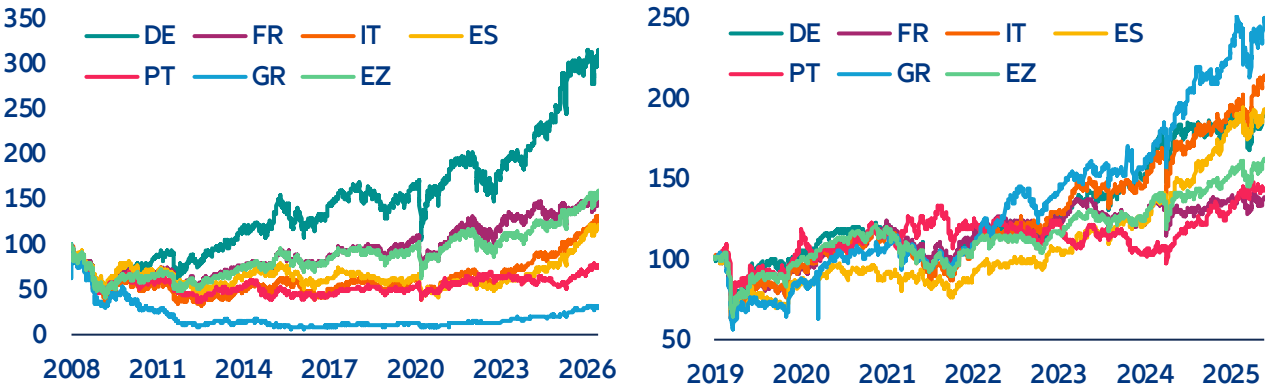
<sup>1</sup> [What to watch | November 14, 2025 | Allianz](#)

Figure 4: 10y government bond spreads over Bund



Sources: LSEG Datastream, Allianz Research

Figure 5: Equity index (2008=100, 31/12/2019=100)

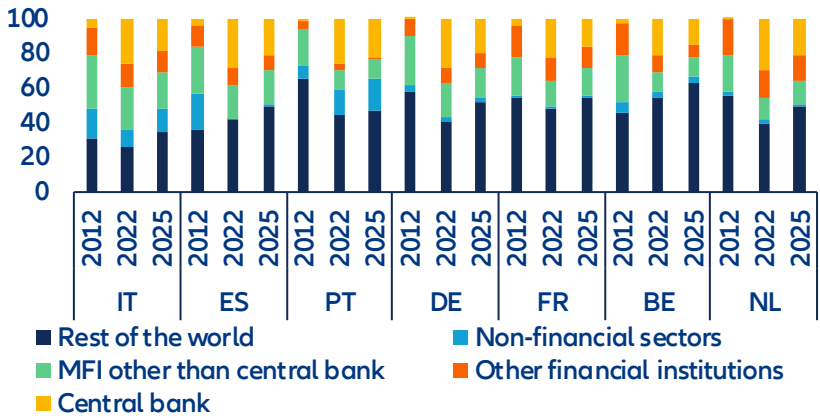


Sources: LSEG Datastream, Allianz Research

**A substantial share of this re-rating reflects a catch-up from deeply discounted levels rather than a transition to premium valuation.** The initial phase of financial convergence – the compression of crisis-era risk premia – has largely played out. Whether it becomes durable will depend on the transition to real convergence through productivity gains. Future performance will depend less on multiple expansion and more on the underlying drivers of earnings growth.

**One important structural caveat:** the ECB's gradual withdrawal as price-setter via QT means marginal sovereign funding increasingly depends on hedge funds and active managers with shorter horizons, making spreads more reactive to fiscal signals than during the QE era. For Italy this matters most – retail absorption capacity is approaching its limits, and marginal funding depends increasingly on investors with firmer fiscal conditions and shorter time horizons. The fact that spreads have compressed despite this shift is a testament to the improvement in underlying fundamentals elsewhere in the South; for Italy, it is a risk that remains latent.

Figure 6: Government debt holdings by investor type



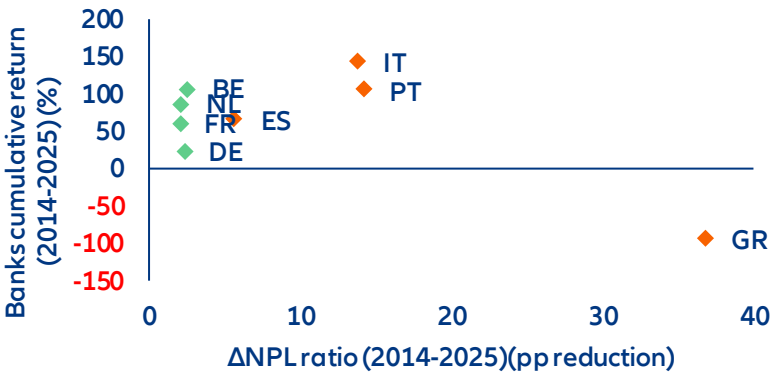
Sources: LSEG Datastream, Allianz Research

**Banking sector: the structural inversion markets have not fully priced in**

**Banking sector repair is arguably the most underappreciated development in European finance over the past decade.** A decade ago, Southern banks were the epicenter of Eurozone fragmentation risk: non-performing loan (NPL) ratios stood at 17% in Italy, 18% in Portugal and close to 50% in Greece. The subsequent clean-up – driven by ECB supervisory pressure under the Single Supervisory Mechanism, stricter provisioning and active NPL disposals – was slow and painful, but is now largely complete. By Q3 2025, all four Southern banking systems continue to reduce NPL volumes: Spain currently stands at 2.4%, Italy -2.7%, Portugal 2.6% and Greece 2.8%.

**What makes this development particularly relevant is the direction of travel elsewhere.** Germany and France are now experiencing rising NPL volumes, driven by commercial real estate and corporate sector stress. A decade after the sovereign debt crisis, it is core European banks – not Southern ones – that are carrying the asset quality problem. This inversion is structural, not cyclical, and is not yet fully reflected in prevailing narratives about fragmentation risk in the Eurozone.

Figure 7: NPL ratio change (%) vs Banking Equity Index Cumulative Return (2014 Q3-2025Q4)



Sources: LSEG Datastream, Allianz Research

**Improved asset quality also has direct macro-financial implications.** The sharp reduction in NPL stocks freed up capital, reduced provisioning needs and strengthened profitability, increasing banks’ capacity to extend credit to the private sector. In that sense, banking sector repair is not just a legacy issue but a precondition for the broader economic convergence, as it restored the transmission of monetary policy and supported investment and growth.

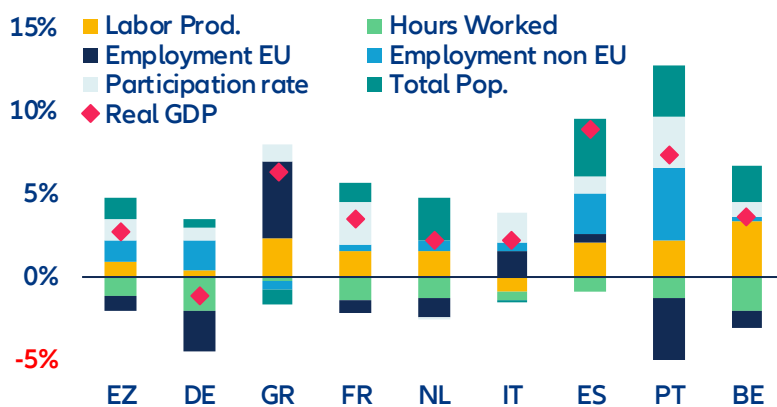
## What did the South do right?

### Labor market dynamics: the core driver of Southern resilience

**Labor market performance is central to explaining the strength and persistence of Southern Europe's recovery.** Since 2021, employment has not lagged output but has acted as the primary engine of expansion. Labor input – through both rising participation and higher employment rates – has accounted for the bulk of GDP growth, pointing to a distinctly labor-intensive recovery phase.

**This dynamic reflects both cyclical demand and structural adjustment.** Participation has increased across demographic groups, while migration has played a critical stabilizing role. Foreign workers accounted for more than half of labor force growth in recent years, easing labor shortages at a time when supply constraints were binding, particularly during the 2022 energy and supply shock. At the same time, earlier labor market reforms – especially in Southern Europe – have improved hiring dynamics, reduced rigidities and increased resilience to shocks.

Figure 8: Supply-side GDP decomposition, 2022-2025 cumulative growth

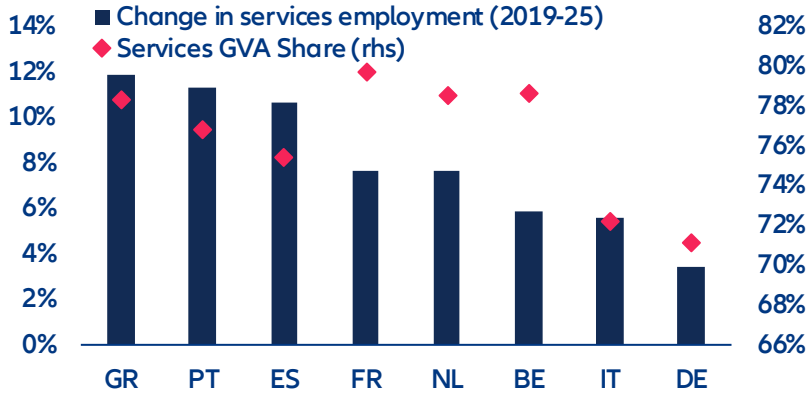


Sources: LSEG Datastream, Allianz Research

**Spain provides the clearest example of a structural break.** The 2021 labor market reform directly targeted the long-standing duality between temporary and permanent contracts. The impact is visible in the contractual structure: temporary employment declined by more than 10pps between Q4 2021 and Q4 2025, while hiring shifted decisively towards open-ended contracts. The share of fixed-term contracts – previously close to 90% of new hires – fell to below 60%, and youth temporary employment declined sharply, converging towards the EU average.

**On the demand side, the sectoral composition of the recovery has amplified these effects.** Strong services demand – particularly tourism – translated into high employment elasticity, allowing output growth to feed rapidly into job creation. Compared to the pre-crisis period, employment has responded more quickly and more proportionately to economic activity. Importantly, employment gains have been predominantly private-sector driven, pointing to robust underlying demand dynamics rather than administrative expansion.

Figure 9: Employment in services vs services GVA/ total GVA



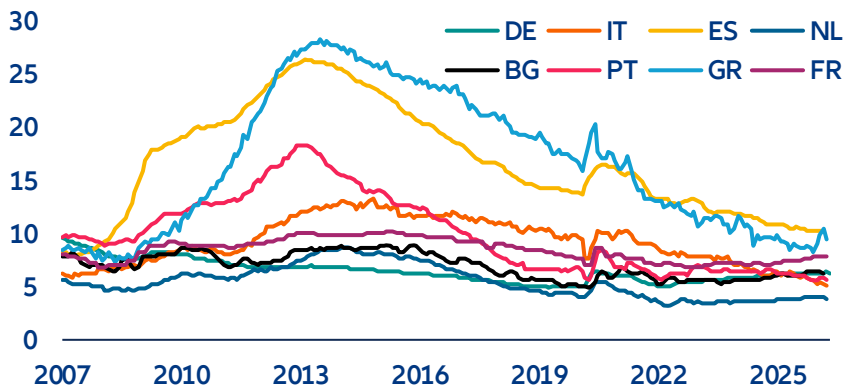
Sources: LSEG Datastream, Allianz Research

**These shifts are not merely statistical.** Greater contract stability alters firm incentives, making investment in training and skills more profitable, improving match quality and supporting a gradual shift towards higher-quality employment. At the same time, increased labor availability – particularly in high-demand sectors such as construction, hospitality and ICT – has allowed employment to expand without triggering proportional increases in unemployment or strong second-round inflation effects. Migration composition also matters: Non-EU workers are disproportionately represented in shortage sectors and often exhibit high participation rates.

**At the aggregate Eurozone level, compositional changes have contributed to the decline in unemployment.** A larger share of older and more educated workers – groups with structurally lower unemployment rates – has mechanically compressed aggregate unemployment, while migration has expanded labor supply without raising joblessness.

**These gains come with clear trade-offs.** The recovery has been driven predominantly by the extensive margin, while average hours worked remain below pre-pandemic levels. This reflects both cyclical and structural factors, including the expansion of part-time employment, the shift towards services with structurally lower working hours and precautionary labor hoarding amid persistent shortages. As a result, labor input has increased mainly through employment gains rather than higher utilization per worker, dampening productivity growth and weakening the pass-through from output growth to aggregate income. Strong employment performance therefore partly masks an incomplete normalization of labor utilization. The implication is that output convergence has translated only partially into income convergence, as employment gains have not been matched by commensurate productivity growth. The key medium-term question is whether improvements in labor market structures – contract stability, participation and labor supply – will translate into a sustained reacceleration of productivity.

Figure 10: Unemployment rate (%)



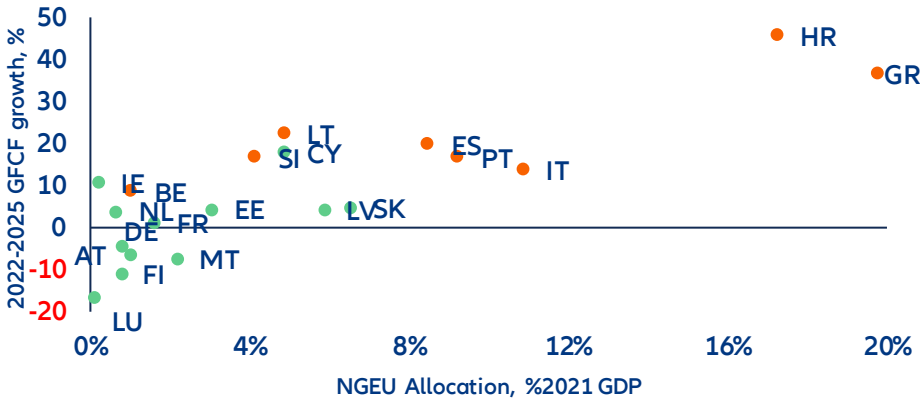
Sources: LSEG Datastream, Allianz Research

**NGEU: front-loaded investment impulse with reform conditionality**

**The scale of the NGEU allocation to Southern Europe is easily underestimated.** Greece received funds equivalent to nearly 20% of GDP, Italy close to 11%, Portugal 9.3% and Spain 8.5% – allocations that dwarfed those of core economies, with Germany receiving less than 1% of GDP and France just 1.6%. For economies where national fiscal space remained severely constrained, this represented a public investment impulse with no post-war precedent outside of crisis interventions.

**The macroeconomic transmission operated through three distinct channels.** First, the direct investment effect: Disbursements concentrated from 2022 onwards drove a visible recovery in public investment as a share of GDP across the South, reversing a decade of austerity-driven compression. Second, the fiscal accounting effect: Grants do not count as borrowing – they flow through the expenditure side without adding to national debt. For high-debt economies running primary surpluses, this was analytically significant: it allowed investment to expand while headline debt ratios continued to fall, contributing directly to the snowball dynamic and to the spread compression that followed. Third, the conditionality effect: By linking disbursements to predefined milestones, the NGEU transformed reform commitments into binding obligations, lowering the political cost of reform by externalizing part of the decision process. Spain's labor market reform, Portugal's digitalization agenda and Greece's administrative overhaul were all advanced under this framework.

Figure 11: NGEU allocation vs GFCF cumulative growth



Sources: Eurostat, Allianz Research. Orange dots represent country which have requested loans on top of grants.

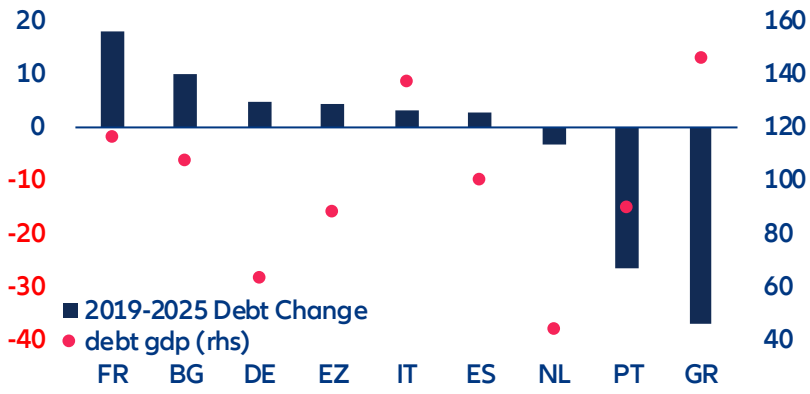
**NGEU did not operate in isolation from fiscal consolidation – it amplified it.** By flowing through the expenditure side without adding to national debt, grants improved headline balances and contributed directly to the debt dynamics that followed. The two pillars are complementary: NGEU created the fiscal room; Southern governments, for the most part, used it well.

**Fiscal consolidation: the pillar that is cracking**

**Following the sovereign debt crisis, Southern economies implemented prolonged and politically costly consolidation strategies – cutting deficits, rebuilding primary balances and restoring institutional credibility at significant social cost.** After the pandemic, they made the most of a favorable window: strong nominal growth and still-low effective interest rates combined to generate a powerful snowball effect, pushing debt ratios down materially. Portugal cut its debt ratio by over 40pps to below 90% of GDP since 2020. Spain delivered primary surpluses from 2022 onwards. Greece regained investment-grade status by 2025. Monetary policy set the lower bound for spreads across the board, but fiscal consolidation determined the extent of the re-rating.

**Italy's picture is more nuanced.** The return to a primary surplus in 2024 was a genuine improvement and should not be dismissed. However, the surplus has not been large enough to stabilize the debt ratio against a backdrop of weakening growth and past generous policy (Superbonus tax credit) – debt has continued to drift upward, leaving the fiscal position rather vulnerable. Italy's spread compression reflects ECB backstop credibility and a period of relative political stability as much as fundamentals, and it is the case that most warrants watching as financing conditions normalize and the ECB's role as marginal buyer fades.

Figure 12: Change in debt-to-GDP ratio



Sources: Eurostat, Allianz Research

**Energy transition: from structural vulnerability to competitive advantage**

The 2022 energy crisis triggered a structural shift in the distribution of energy exposure across the Eurozone – one that cuts against the traditional North–South framing. Southern economies – particularly Spain and Portugal – accelerated investment in renewable capacity, materially reducing their dependence on imported gas. Spain now sources more than 50% of its electricity from renewables, lowering its exposure to gas price volatility. On electricity, where the renewable build-out has been fastest, Southern Europe has moved from structurally higher-cost to lower-cost relative to the German industrial benchmark.

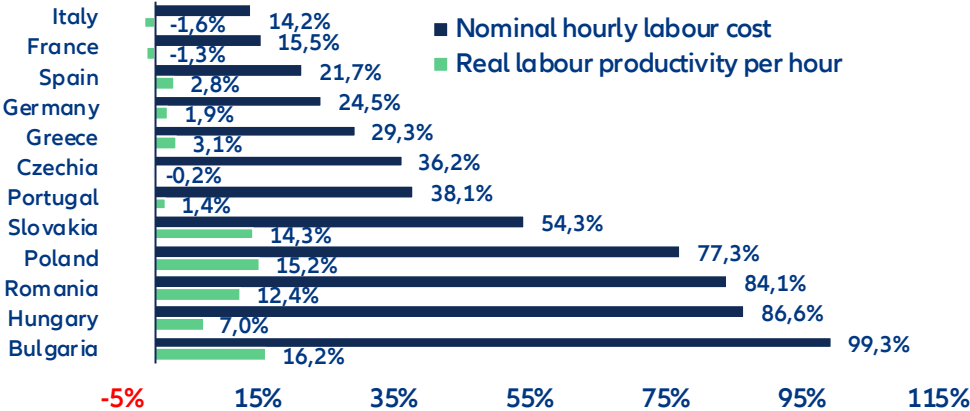
The implications extend beyond near-term growth. Energy has become a binding constraint for capital allocation in energy-intensive sectors, including digital infrastructure and AI. As a result, energy-intensive industries – chemicals, steel, aluminum and cement – are increasingly locating in energy-advantaged jurisdictions. Southern Europe, with its expanding renewable base and Atlantic LNG access, is becoming more competitive in attracting this reallocation.

However, the adjustment remains incomplete. Three residual exposures deserve explicit quantification. First, oil dependency: Southern economies remain net importers of crude, with transport fuels accounting for roughly 35–40% of final energy consumption. Second, EV adoption is uneven – the EV share of new car sales reached ~23% in Germany versus ~14% in Spain and ~8% in Italy in 2024 – leaving Southern transport sectors structurally more exposed to oil price volatility for at least the next decade. Third, energy poverty remains a distributional vulnerability: Approximately 13% of EU households in Southern member states report an inability to adequately heat their homes (Eurostat 2024), limiting the political durability of energy transition policies.

**External tailwinds: the CEE rotation**

Beyond the South gaining on the North, a broader reordering of comparative advantage is unfolding across the European economy. Some of the factors that previously powered Central and Eastern Europe’s convergence are increasingly becoming sources of pressure, exactly as they are turning into relative advantages for Southern Europe. Since end-2019, nominal hourly labor costs rose by +99% in Bulgaria and +87% in Hungary, against productivity gains of just +16% and +7% respectively, while productivity in Czechia remained broadly flat despite strong wage growth (Figure x). The drivers are structural rather than cyclical. Labor markets in CEE have tightened to record levels, with unemployment at 3.1% in Poland and 2.8% in Czechia, while working-age populations have shrunk sharply since 2015 (Bulgaria –13.5%, Poland –11.3%, Romania –8.8%). The low-wage manufacturing model that anchored the region’s integration into European supply chains is therefore becoming structurally harder to sustain as labor scarcity and rising costs erode part of the competitiveness advantage that originally underpinned it. At the same time, Southern Europe is benefiting from almost the opposite configuration: more moderate labor-cost pressures, stronger labor-market normalization and a more services-oriented growth structure supported by tourism and renewable investment.

Figure 13: Nominal labor cost and real productivity, cumulative % change since 2019



Sources: LSEG Datastream, Allianz Research

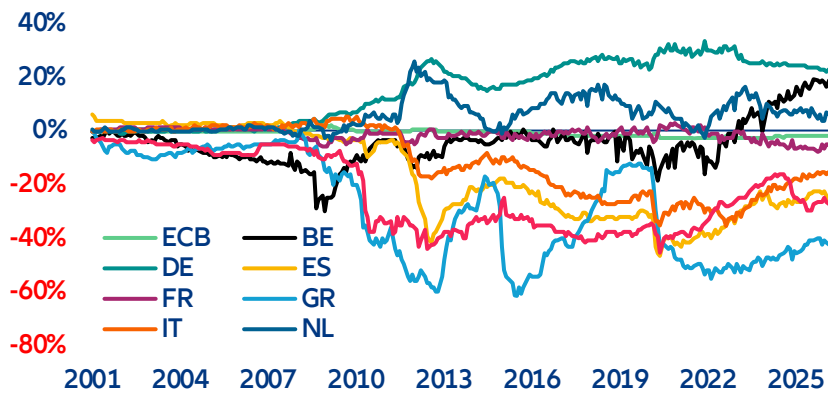
**This divergence is reinforced by the changing geography of industrial competitiveness.** Southern Europe’s renewable build-out, together with Germany’s loss of cheap Russian gas, has materially altered relative energy costs across Europe. In H2 2025, ex-tax electricity prices for medium-sized industrial users stood at EUR10.6 cents/kWh in Spain and EUR10.7 in Portugal, compared with EUR17.1 in Hungary, EUR16.0 in Slovakia, EUR15.6 in Romania and EUR14.6 in Czechia – a divergence of roughly 5–6 cents/kWh that did not exist before 2021. At the same time, CEE economies remain heavily concentrated in sectors tied to the weakening German industrial cycle, particularly autos. Motor vehicles account for 24.7% of manufacturing value added in Slovakia, 21.3% in Czechia, 15.8% in Hungary and 14.6% in Romania, all above Germany’s own 19.5% and several multiples of Spain’s 9.1% or Italy’s 5.9%. The region is therefore simultaneously among the most exposed to high industrial energy costs and the most dependent on a German automotive model facing intensifying Chinese competition and weak external demand. Southern Europe, by contrast, carries neither exposure to the same extent. The result is a broader reordering of comparative advantage across Europe: Germany remains constrained by the structural weaknesses exposed after the energy shock, Southern Europe is increasingly gaining competitiveness in energy, services and investment attraction, while Central and Eastern Europe is confronting the limits of the very model that originally drove its convergence success.

**The post 2026 cliff**

**2026 is the decisive test – political and institutional – as the external anchor fades.** The NGEU is explicitly time-bound, with disbursements scheduled to end in 2026. Italy, Spain, Portugal and Greece together account for almost 60% of the total EU envelope, making the post-2026 transition a system-level test. The key question is whether convergence gains are becoming structurally embedded – in administrative practices, legislation and firm behavior – or remain largely compliance-driven. Where implementation remains compliance-driven, the risk of policy slippage increases sharply once the external anchor weakens.

**This creates a dual risk.** First, the withdrawal of policy support may expose underlying growth dynamics that remain heavily reliant on labor rather than productivity. Second, the loss of a binding reform framework could make policy slippage more likely, particularly in high-debt economies facing renewed fiscal constraints as financing conditions normalize. Convergence is currently policy-supported, not yet fully self-sustaining: Private cross-border capital flows remain limited and episodic. Capital flight has stopped, but it has not clearly reversed – Target2 imbalances have stabilized but have not structurally declined.

Figure 14: TARGET2 balances (% of nominal GDP)



Sources: LSEG Datastream, Allianz Research

**The institutional gap: A completed Banking Union is the critical missing piece for the transition from public to private-led convergence.** Without it, private cross-border flows remain too shallow to replace the NGEU impulse post-2026. Despite a common monetary policy, financial integration remains incomplete: Cross-border bank lending and portfolio allocation within the Eurozone still exhibit strong home bias, with domestic sovereign exposures dominating bank balance sheets. The absence of a European Deposit Insurance Scheme means risk-sharing remains incomplete: ECB backstops continue to substitute for missing institutional integration rather than operating within a fully unified financial system. Initiatives such as the Savings and Investments Union aim to deepen capital markets and reduce home bias, enabling more efficient cross-border allocation of savings, but the scale of private risk-sharing remains limited relative to the size of the Eurozone economy, and the transition from public to private investment as the primary driver of adjustment remains incomplete.

**Political risk.** The political sustainability of reform is not guaranteed. France, Italy, Spain and Greece all face national elections in 2027, putting fiscal discipline and reform commitment to a simultaneous political test across Eurozone economies. Populist movements in Italy and Greece remain a latent risk to reform continuity. Spain's political fragmentation – governing with a minority coalition dependent on regional nationalist parties – adds procedural uncertainty even where the policy direction is broadly reform-positive. Reform gains have not come without a social price: fiscal consolidation in the early phase involved material cuts to healthcare, education and social transfers that compressed living standards for the bottom half of the income distribution, and that political legacy has not fully faded.

**From policy supported convergence to structural test.** The first phase of Southern rebalancing – compressing crisis-era risk premia, rehabilitating banking systems, restoring fiscal credibility – has largely run its course, driven by a combination of domestic policy effort and EU-level architecture. From a macro perspective, the catch-up is real but unfinished: employment-led growth has delivered output convergence without closing the income gap, and the post-2026 withdrawal of the NGEU anchor will test how much of the improvement is structurally embedded. For markets, spreads at decade lows and equity valuations normalized leave little room for further re-rating on recovery alone: Outperformance now requires a differentiated view on which economies can convert institutional gains into productivity-led growth.

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

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(v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures,

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