



Panic*

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"When you absolutely don't know what to do any more, it is time to panic."

John van der Wiel; Dutch Chess Grandmaster

Even if the last few years' crises have led to a certain habituation effect, 2011 rates as a thoroughly historic year. While pressure on the stock markets might still be described as moderate in comparison to the experiences of 2008, the record levels of risk premiums in the banking sector and many states in particular have led to doubts about the financial system in general. In this connection, the crisis apostle's position has experienced constant popularity, and in a contest between dismal prospects, even an immediate relapse into anarchy cannot be ruled out. These tendencies culminated in panicky developments in November 2011, particularly in the credit market. Although, as befits our position, we have difficulties with excessively positive outlooks, we cannot help but see this scenario as a clear opportunity. With the current dominance of those who see gold as the only answer to the ongoing situation, risky asset classes seem, at least in some cases, to be very attractively valued. If we rule out the anarchy scenario, there are, above all, two market segments which will make a profit in 2012: financials and government bonds from the countries which got a ticking off from the market in 2011.

The central issue – apart from the banking sector's problems – is still the performance of Europe's peripheral regions. The European Community's at times very unsuccessful attempts to solve some of its member states' debt problems have led to their fundamental performance being pushed into the background. At the heart of the criticism lies the theory that politics can fight the symptoms of the crisis, but not its causes. The ECB's acquisition of government bonds, the ban announced on "naked" short sovereign CDS and the avoidance of necessary liability mechanisms, for example through Eurobonds, are the salient examples of this. To this effect, the Brussels summit of 8/9 December's resolutions can be understood as a necessary (but by no means sufficient) first step in the right direction irrespective of all its political risks. That is to say, the direction of prescribed fiscal discipline, which does not

promise a quick recovery but very much the opportunity for healing over the long term.

In so doing, thoroughly peculiar resolutions have been made. The introduction of automatic sanctions for breaking budgetary rules, the establishment of an economic government, the accelerated introduction of the ESM and the implementation of national austerity packages which have been decided at European level can be seen as individual steps towards a European fiscal union. Meanwhile, private creditors voluntarily participating in the cost of states going bankrupt seems a less happy idea (Greece should remain the exception here), while the ECB's purely supporting role (should this be meant in the truest sense of the word) can be positively welcomed. None of these measures is a cure-all – but they are European politics' first credible reaction to the current situation and achieve one thing (despite all the concerns about their implementation). The EU has put itself in a position of taking action and given up its position of passivity. It has at least bought itself some time, and in view of the panic reactions which manifested themselves in the markets, this is extremely valuable.

Below, we will attempt to work out which problems can be solved at all at the current time (something which seems necessary in view of the universal crisis situation), which measures are necessary for this and what impact these measures will have on the markets

Which crisis would Sir like, then?

The three amigos

The whole of 2011 was dominated by news of crises, with the Greek crisis followed seamlessly by the European debt crisis, then the euro crisis, the global financial system crisis and even a universal democracy crisis. You probably cannot accuse us of being overly optimistic at this point, although in such situations it makes a great deal of sense to remember the fundamental facts so as to avoid any sort of descent into panic. 2011 was simply the point at which several developments which had already been building for years or even decades culminated. These developments are definitively inter-related, but nevertheless represent separate problem areas. The identification of these problem areas is immensely important because solutions can only be successful if the real cause of the problems is recognised. The current situation can be divided into three problem areas.



1. The government debt crisis actually refers to some Western industrialised nations' debt situation. It is not just the usual suspects from Europe at the heart of this problem but the USA and Japan too. So this is not a geographically restricted problem even if it is not a global phenomenon because not every country is affected.
2. The current banking crisis results from the fact that a large number of global financial institutions (again, not a purely European problem) have bloated balance sheets and lack business models. That is fine so long as no external or internal shocks occur. The sub-prime crisis and the government debt crisis that occurred straight after it were the trigger which showed up the banking sector's problems.
3. The euro crisis is not a currency crisis. A currency crisis means a situation in which the devaluation of a country's own currency starts a financial crisis there. That is not the case in Europe. The euro crisis is instead a crisis of the fundamental mechanisms of the European Monetary Union, which have proven too rigid to be able to react to internal or external imbalances. This in turn is a purely European problem and reflects the potential risks of monetary unions, which have been described on paper for decades.

Obviously, these three problem areas are closely linked, which in a globalised world of integrated capital markets should come as no surprise. Geographically or sectorally limited crises will always take on a global character via (largely) global goods markets and against a backdrop of (largely) free capital flows, as the sub-prime crisis has impressively demonstrated. But the causes for these three problem areas can be sharply delineated from each other.

Cause and effect

Many economists hold global imbalances (particularly current account ones) responsible for the fact that there are countries poor and countries rich in capital. If you stop to think that every flow of goods is matched by a flow of capital and furthermore that the balance of payments must, by definition, always balance, then this should not come as a shock. But this phenomenon has existed for as long as there has been foreign trade.

Rather, there are mechanisms in the global capital markets which counteract such imbalances, e.g. exchange rate movements or interest rate divergences.

Now, you can argue that the European Monetary Union put these very mechanisms out of action, aptly depicting one of the basic problems of monetary unions.

But that does not explain the USA's or Japan's high level of debt. A country's debt can, of course, also be explained by demographic change; however you will find that this parameter alone cannot explain the almost exponential rise in some countries' debt in the past few years. Ultimately, all countries with too much debt can combat this by taking their own economic measures. Flows of goods and demographic changes need to be addressed on an economic policy level then but need not inevitably result in spiralling debt. As banal as it may sound, high levels of government debt mostly have a very simple cause – a completely inefficient distribution policy. As we have already discussed this problem many times and want to avoid any repetition, only one thing remains to be said. If private financial assets are sufficient to dramatically reduce government debt, it follows that some private households must have profited at the community's cost in the past. This can be proven to be the case in some euro zone countries. But even in the USA, private financial assets significantly exceed government debt. Global imbalances can lead to one country being rich and another poor. But that is much harder to remedy than the problem of a poor country with rich citizens.

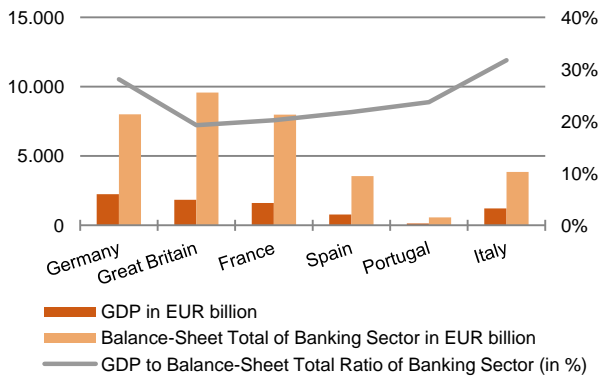
Without being able to offer a detailed examination of the global financial system in this newsletter, the banking system's current problems can be set out very simply. In economics, the pro-cyclical behaviour of the banking system has always been a central factor when studying banking crises. Banks tend towards excessive lending in times of low default and moderate interest rates. This is just what happened in the last 15 to 20 years.

The development of new financial instruments, the emergence of new refinancing sources (such as sub-prime CDO) and, in turn, the integration of the capital markets were all conducive to this.

A large number of effects thus resulted from a decoupling of the financial system from the real economy, which could be seen in bloated bank balance sheets and overly low core capital ratios. In times of economic prosperity, this behaviour by the banks leads to temporarily very high returns on equity, but these make banks extremely vulnerable to external shocks (such as the loss of risk-free investments). Too many banks lack a business model which is profitable across the entire economic cycle. As people are not allowing Schumpeter to prevail in view of the much talked about systemic importance, the market's self-healing mechanisms are not kicking in. Winding up banks ultimately leads to immense costs for states themselves and, in turn, worsens the problem of government debt.



Too many banks per country



Source: LBBW Credit Research

In addition to the problems of government debt being too high and the banking system too fragile, a third trouble spot can be found in the deficient mechanisms within the European Monetary Union. This is not a problem of the euro per se. Instead, it becomes clear that the Maastricht Treaty ex post turns out to be the lowest common denominator politically achievable at that time. The mechanisms set out in the treaty are unsuitable for combating economic divergence and are further weakened by the fact that member states have shown little willingness to stick to the relevant criteria (e.g. a deficit of 3% and a debt ratio of 60%). It is thus within the nature of those monetary unions which do not satisfy the criteria of an optimum single currency area, that divergences will appear in the economic cycle. In view of the limited opportunities for member states to react through economic policy (no monetary policy of their own and no ability to devalue their own currency), such divergences can become permanent. At the level of the state, individual national problems can accordingly only be addressed through fiscal policy, as a result of which, room for manoeuvre is severely limited. The players were well aware of these developments while creating the monetary union. But the political will for a united Europe was much stronger than the doubts about whether a monetary union between economies with completely different structures would be able to function. Even though the individual member states' fiscal freedoms have now been cut back, the move to a transfer union is unavoidable. This is just what is happening in Europe right now, even if politicians are avoiding this term at all costs. If the political will for transfers is there, monetary unions can be maintained even of member states with different levels of competitiveness. This is the case in the USA and also in Germany (inter-state fiscal adjustment). Moreover, just this principle has been used within the EU since it came into existence, for instance with the aid of structural funds for assisting structurally weaker regions. You just have to be clear about the fact

that national competences are being given away and transfers will not just be of a temporary nature.

The mega bailout or the search for the Holy Grail

Crisis interactions

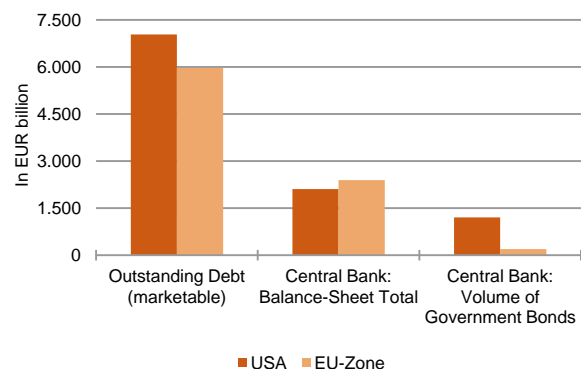
All of these problem areas are of course linked. Bank and sovereign crises are closely connected due to the former's systemic importance. And the monetary union's rules have a direct influence on governments' budgetary flexibility and of course also on the European banking system. This means that there is no one solution in the sense of a single brilliant measure solving three very complex problem areas in a single blow. Each problem area requires its own complex solution mechanisms, but these need to be co-ordinated, so as not to result in effects which counteract each other.

This is the precise opposite of the much discussed demands of recent months. The English-speaking world in particular prefers simple, comprehensible measures, which above all promise to have a positive impact on the market. In other words, combating the symptoms and simply papering over structural problems through additionally generated growth. The call for more active intervention by the ECB and the creation of Eurobonds are the two most prominent examples of this. But can these really remedy the aforementioned problem areas?

1. Buy me I: The demand for a more active role for the ECB

A lot of commentators want the ECB to have a much more active role in combating the euro crisis. In their view, the ECB should take on a similar role to the Fed and intervene much more strongly in the market. This very American-influenced understanding of a central bank's role is also apparent in the following diagram.

Battle of the ideologies – the Fed vs. the ECB



Source: the ECB, the Fed and Bloomberg (October/November 2011)



The Fed has done much more buying up of government bonds than the ECB. This can be observed not only in absolute terms, but also relative to their total assets and to the outstanding nominal sum of government bonds. Of course, this intervention in the government bond market has also become much more important here. There are two primary arguments which you should consider.

Firstly, the Fed's interventions have so far been only tolerably successful. Without knowing what would have happened if the Fed had never bought up an enormous amount of CMBS positions on the primary market in the first place so as to curb the direct consequences of the sub-prime crisis on the American real estate market, making the Fed the largest holder of US government bonds – even ahead of China and Japan, the fact remains that the USA is facing its biggest economic challenge since the Second World War. The American-influenced idea that, in times of crisis, a central bank should first and foremost seek to ease the situation in the financial markets in order to generate economic growth has thus far failed on a grand scale. On the one hand, the monetary transmission mechanism has to be called into question if the liquidity made available primarily seeps into the financial system. The Fed's extremely expansive monetary policy since the end of the 1990s can instead be seen as the cause of the American real estate crisis and the fragile banking system. On the other hand, monetary policy measures are not an effective weapon for combating structural problems. But structural problems are exactly what the American economy is facing.

Digression: Is money creation a public good?

The advocates of the ECB having a more active role in combating crises frequently use an argument which at first glance appears reasonable. The provision of liquidity by the central bank or the real economy's money supply is often described as a public good. This should be provided by the state, as demand cannot be satisfied when the private sector provides liquidity. This argument, which if anything follows the Anglo-Saxon understanding of the economy, does not hold up to closer scrutiny. A pure public good is characterised by two things – the inability to exclude people and no rivalry in consumption. The inability to exclude people describes the circumstance in which no one can be excluded from consuming the good. The non-rivalry in consumption, on the other hand, just means that one person's use of the good does not exclude another person's. This is the case, for example, with the public goods of peace or street lighting. The market mechanism is not particularly efficient in the provision of public goods because too few users are prepared to pay for the good because it is available anyway. You get freeloading. Liquidity, on the other hand, obviously does

not meet the definition of a public good. There is plenty of rivalry between its consumers (so long as a value greater than zero is attributed to this money supply, something which continues to be the case with the euro despite the crisis), and other users are excluded through the consumption of liquidity. The money supply accordingly needs to be understood as a private good and should be provided as such. Any use of liquidity also needs to be paid for at market prices; only then will a collectively efficient result be achieved (with regards to the amount of liquidity provided). If a central bank interferes with this mechanism, this will inevitably lead to an oversupply of liquidity, ultimately resulting in the liquidity being misallocated. The basic principle of the market mechanism is also based on non-competitive market participants being forced out of the market. In this case, the banks will be precisely the ones which are unable to refinance themselves in the market for liquidity, for example due to unprofitable business models. The logic of this argument leads to just one conclusion – either you let Schumpeter prevail in the banking sector too or you have to accept the disadvantages of a constant oversupply of liquidity. The crises of recent years are the logical consequence of the second alternative.

One very decisive argument for why the ECB's government bonds need to be valued completely differently from those of the Fed is based, quite simply, on the mechanisms of a monetary union. When the Fed makes unsterilised purchases of US government bonds, it does not increase its credit risk by so doing. Ultimately, the US Treasury backs the Fed as a final resort. It does this irrespective of whatever monetary policy measures the Fed implements. If the American state were to go bankrupt, the number of US government bonds it was holding would be of no relevance to the Fed. In Europe it is completely different. When the ECB buys up bonds from the peripheral countries it creates a credit risk on its balance sheet. This risk is not covered by the peripheral countries, but rather, most notably, by the stable countries. A Greek default would thus force the ECB to recognise a balance sheet loss, which would ultimately have to be borne by the remaining countries.

It follows that the call for the ECB to expand its purchases of government bonds must be resolutely rejected, since firstly the Fed is not a suitable comparison and secondly certainly no role model. The typical American style of combating crises by providing unlimited liquidity has fatal consequences, the magnitude of which over the last few years has been astounding.

This is even more the case if you ask what effect a more active role for the ECB would have on the aforementioned problem areas. ECB purchases of government bonds do not have any positive impact on member states' debt situation. The hope of reducing the risk premiums for Spain and Italy (let alone Greece) through



purchases on the secondary market has, to date, come to nothing. A central bank will not solve a government debt problem without becoming part of the problem itself. The answer to whether these purchases will solve the banking sector's fundamental problem is also a clear no. Of course the central banks' concerted action in reducing costs in the refinancing of the dollar has recently made an important contribution to taking the pressure off European banks in particular. But even these actions can only represent supporting measures to the necessary contraction of bank balance sheets. If the ECB buys the European debtor states' bank bonds, it will only be shifting the problem – not solving it. And in the end, purchases of government bonds are not an efficient means of eradicating the European Monetary Union's defective mechanisms at all. Even from this perspective, further purchases of government bonds by the ECB have to be seen as the wrong way to combat the current situation.

2. Buy me II: The introduction of Eurobonds

When evaluating Eurobonds, you have to differentiate according to type. Eurobonds can be issued with joint and several liability or the liability of the individual member states can follow the Nice framework. They can serve as the sole means of refinancing or be issued up to a certain debt level (Maastricht criteria as the limit). But there is one thing they cannot guarantee – the avoidance of moral hazard within the EMU. This is what most critics use as their central argument against Eurobonds. And there is not much you can counter that with. Moral hazard can only be avoided if Eurobonds are issued according to strict fiscal rules. But then, if strict fiscal rules were applied, Eurobonds would be completely unnecessary. This is precisely the case in a fiscal union. Eurobonds do not reduce member states' aggregated level of debt either (they should do the opposite instead); they only change the distribution of liability. Ultimately, they can thus be seen as the pure instrument of a transfer union – although there are then much more efficient and sensible redistribution mechanisms available. But what effects would Eurobonds, in contrast, have on the banking sector's problems? Obviously none which would involve a reduction of risks in the sector. If issuing Eurobonds were linked to the aim of these turning up on bank balance sheets again, you would not be solving the problem of the link between the banking sector and the state but strengthening it. If banks lend money to states, they do so only because they are making the implicit assumption that they are not taking on any additional risk of default. This is based on the logic that if the state goes bust, then so will its banks, irrespective of how many of the country's bonds they have on their balance sheet. The demand on the banking system must, however, instead be that it look for a different

business model, other than buying the next higher entity's bonds with cheap central bank money. This definitely does not contribute to any sort of economic value enhancement. Primarily at the level of economics, the discussion about central bank purchases of government bonds or the introduction of Eurobonds meanwhile often ignores the practical solutions. On the website <http://www.oekonomenstimme.org/english/>, extremely prominent economists make theoretically comprehensible suggestions for insulating the banking crisis from the sovereign crisis. On more precise analysis of most of the ideas, however, you soon notice that a central transmission mechanism of economic policy measures is possibly being incorrectly assessed – namely the capital market. The capital market is not just an intermediary for the efficient provision and distribution of risks, it is in part dominated – in an economic sense – by investors acting irrationally and not following the principle of *homo economicus* (see our credit newsletter of August 2011). As the capital market is attributed a fundamental importance in all suggested solutions, these mechanisms cannot be ignored. The immense rise in risk premiums for EFSF bonds in recent weeks should give advocates of Eurobonds food for thought, as should the CDS spreads for Germany, which were trading at record levels in November.

Although Eurobonds and ECB government bond purchases have completely different mechanisms of action, they have one thing in common – both are completely unsuitable for remedying the causes of the current crisis. They can reduce its symptoms temporarily but no more than that.

You pays your money, you takes your choice

If the measures stated in the discussion so far should prove useless for inducing a quick solution to the three crisis points, it does not take clairvoyance to come to the conclusion that there is no such thing. The enormous government debt of some countries and the bloating of bank balance sheets far above a level acceptable in real economic terms came about over many years. The European Monetary Union's mechanisms were agreed more than 20 years ago and have been causing economic misallocations ever since. It seems too optimistic to believe that these problem areas which have been building over decades can be solved within a short period of time. The only logical conclusion is that there is no simple way out of the current situation, but rather that combating the causes of these crises will take a long time. Specifically, this has the following impact.

A quick and sustainable reduction of government debt is completely unrealistic in face of very moderate growth expectations. Extreme savings efforts are already needed for some countries to be able to achieve a



balanced budget at all. These savings efforts will likewise involve long-term low growth, which will ultimately be far below potential. Japan serves well as an example of this. Since the real estate bubble burst at the start of the 1990s, Japan has had extremely high government debt paired with limited growth rates. And even after 20 years, no improvement is in sight anytime soon.

The consolidation of the banking system is a mammoth task, not least in view of the systemic importance of the sector (see www.financialstabilityboard.org). At the same time, we should not expect to be able to achieve the increased capital requirements that Basel III prescribes by creating new capital. Instead, this will primarily be done by reducing risk-weighted assets, which will in turn have a negative impact on growth. The central banks can play a supporting role in this process, which is not to say that all banks will continue on in their current form. It should not come as a surprise if in 10 years, not only the relationship of bank balance sheets to a country's gross domestic product has dropped significantly, but the absolute number of banks has decreased. Only the banks which have a sustainably profitable business case will survive this evolutionary process. A lot of business areas which were seen as typical bank business will in future be taken care of by other intermediaries. A lot of analysts will, for example, see project financing as a job that insurers can do a lot better than banks in view of their liability structure. Although even Deutsche Bank recently reduced its return on equity forecast from 25% to 15%, this still looks out and out ambitious in the environment we describe.

The "quickest" successes can be achieved within the European Union if we do not just take the Brussels resolutions as a flash in the pan. However, this will need permanent rescue mechanisms and transfer systems, creating a constant need for adjustment. But maintaining the system's stability in the longer term will take more than the consistent implementation of the Brussels resolutions. National distribution policies are also of particular importance here. If the EU represents a political aim, the meeting of which justifies redistribution between the member states on all levels, then the same must be true for redistribution within the member states. The same holds true for privatisation measures or the gold reserves of some high-debt countries' central banks.

The solution to these three problem areas will, in the next few years (at least), remain a decisive parameter for the performance in the capital markets. This is about structural adjustments which will have a more than temporary impact on the markets. Most of all, the relative valuations between individual market segments will change dramatically, and this process will make itself felt as early as 2012.

2012 – between panic and paradise

There remain two extreme scenarios for how this situation will ultimately be resolved. Either there will be an anarchistic correction of the market, with defaults at state and bank level (panic scenario) plus a collapse of the monetary union. The consequences for the capital markets and countries' economies would be hard to envisage and it is for just this reason that the political authorities are attempting to prevent this scenario. The other scenario is "sweating it out". The structural imbalances which built up over decades will have to be reduced over the long term. In this scenario, we get Japanese symptoms. Growth rates will remain low over the long term, and the continuation of an expansive monetary policy will keep interest rates low. There will not be any inflationary tendencies, as the liquidity the central bank makes available will seep into the financial markets and will not have any effect on the price of goods in the real economy. The equity markets will suffer and trade far below their peaks (see the Nikkei), but default rates will remain at a relatively low level in a scenario of this sort. This speaks in favour of credits in view of the immense implied likelihood of default which is currently priced into the market!

Milestones in 2012

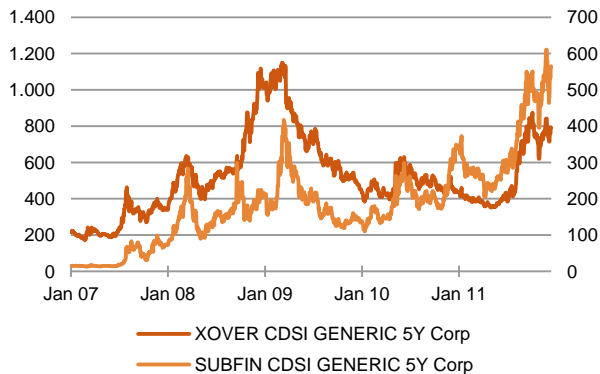
The first milestone will be the possible implementation of the private sector initiative (PSI) at the start of 2012. The most recent announcements about this make the 90% participation deemed necessary seem rather unlikely. Even Greek banks have distanced themselves from participating. But time is short! A nearly EUR 15 billion bond is due on 20 March, and Greece will not be able to repay it without external assistance. Only successful PSI can help to remedy the situation. Should that not succeed and should other protection mechanisms not work (EFSF/ESM), Greece would be insolvent at the end of March. There is a high probability that this would thwart all the rescue efforts of recent months. If we want to reduce the pressure on the PIIS, we need to show that we are able to solve the "relatively manageable" Greek problem. The PSI is thus of central importance for the credit markets' further development in 2012. This will be decisive in whether a panic actually occurs.

Panic versus fundamentals

The following diagram reflects the systematic character of the crisis extremely well. While financial CDS are trading at absolute record levels (well above their 2008/09 levels), the iTraxx Crossover (European HY CDS) is trading well below its then highs.



Financials vs. Crossover



Source: Bloomberg

Trade idea 1: writing bank CDS

As banks continue to have to reduce their RWAs (in order to reach the required core capital ratios), financials will remain under pressure. But even if there are no quick mark-to-market gains, the iTraxx Financials Senior and Subordinated indices' current spread level represents an overcompensation for default risk in anything other than the panic scenario. An "Irish" bank restructuring (subordinated bonds are tendered for 20%) is a manageable risk for systemically important institutions.

Trade idea 2: writing peripheral country CDS

The Brussels resolutions do not envisage private creditors participating in the costs of restructuring a European country in future! The PSI (if it happens) would thus remain restricted solely to Greece. Apart from the fact that, from an economic point of view, holes can be picked in the sense of this decision, there thus remain only two alternatives – the euro zone falls apart or it survives. From a purely technical point of view, the PIIS's CDS (we are excluding Greece) are trading at a level which prices in an enormous risk of default (and thus the probability of the euro zone falling apart). For Portugal this is currently over 60%. Seen from a purely fundamental point of view, Ireland has the best prospects of paying back the EU loans and furthering the reduction of its debt through the growth of its own economy. In light of this, Irish CDS and also Irish government bonds are very attractively valued.

Trade idea 3: European convergence in sovereign CDS

The move towards fiscal union ultimately means no more than the establishment of a persistent transfer mechanism. In this case, the sovereign CDS in Europe have to converge. The peripheral countries' spread premiums will continue to be far above those of Germany, and rightly so. But if Brussels' announcements are to be believed, the current spread difference will narrow.

Those who espouse the panic scenario will continue to recommend gold and dividend-paying shares. We find it difficult to believe that if a complete meltdown of the financial system occurs, the holder of physical gold will have a valuable financial asset on his hands. In addition, there is always the danger of holding gold being prohibited in extreme scenarios (e.g. in the 1930s in the USA). Dividend-paying shares have for years been lauded as attractive. And there are good reasons why they will stay attractive. Ultimately, all of these are answers which arise from classical portfolio theory, the validity of which can easily be called into question. Those who can deal with volatility in the short-term will be rewarded with long-term credit investments, because the implied probability of default will only be realised in a total collapse of the system. And then people will be fairly compensated for it.

**Conclusion: "We are very much in favour of researching panic, but against inciting it."
(Wolfgang Niersbach)**

Forecast:

Current spread levels offer long-term opportunities

	1 – 3 mo.	3 – 6 mo.	12 – 24 mo.
iTraxx Main	o	+/o	+
iTraxx Fin	o	+	++
iTraxx X-Over	o	+/o	+
iTraxx SovX	o	+	++
EUR HG Cash	o	+	++
EUR HY Cash	o	+/o	+
Credit Basis	+	++	++

* The Smiths (1986): I wonder to myself / could life ever be sane again. Were voted *Most Influential Artist Ever* by NME in 2004.



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