

March 29, 2019

The butterfly effect spells trouble for Europe



Chaos theory incorporates 'the butterfly effect' whereby a seemingly insignificant event such as the flutter of a butterfly's wings, can initiate a series of chain reactions, ultimately leading to something as drastic as a hurricane. It refers to the idea that small differences in one place, can lead to widely diverging, non-linear outcomes elsewhere. When it comes to the global economy, it seems that the slightest jolt around in the world, ends up causing some kind of collateral damage in Europe. This is something we briefly commented on in our [2019 outlook](#).

To illustrate this concept, we can use the ongoing trade tensions as an example. Though it is not a direct actor in the US-China trade dispute, Europe's economy is taking a direct hit from the pervasive uncertainty in the global economy which is dampening export demand. After growth in global goods imports reached its lowest level since the Great Recession in January, it is factories in the export-oriented eurozone, that are absorbing much of the impact.

The butterfly effect in motion is preventing Europe from recovering from what was initially perceived as a temporary slowdown due to domestic factors such as new emissions regulations

which caused bottlenecks in car manufacturing, as well as low water levels in key rivers such as the Rhine.

Last Friday, this idea was accentuated by a new batch of PMI data, which served to crystalize fears about an economic slowdown. The composite PMI for the eurozone declined from 51.9 to 51.3 in March, with the manufacturing component declining to 47.6 - the lowest level since 2013. A subcomponent of this measure, factory new orders fell to 44.5 – a level unseen since 2012. A key detractor was Germany, supposedly the region's economic powerhouse, which escaped recession only by a smidgeon in the second half of 2018. It has seen very minimal improvement in 2019 and the country's council of economic experts have lowered their growth forecast for 2019 to 0.8% from 1.5%.

In response to the PMI data, investors fearing a recession, fled to the safety of Government bonds, causing the yield on the 10-year Bund to fall below zero for the first time since 2016 and the US yield curve to invert.

The European Central Bank has attempted to quell fears. On Wednesday, the President, Mario Draghi, said that convergence towards the target for inflation of below but close to 2% "has been delayed rather than derailed" citing the strength of the labour market. However, he acknowledged that "substantial accommodation" in the eurozone was still needed, adding that the ECB is not short of instruments.

But the true problem is not one that can be remedied by another dose of monetary medicine. In the shorter-term, we might still see economic data find a floor, but over the longer term, to bolster itself against external shocks, Europe needs to rejuvenate its antiquated economy, with all of its old structural demons. The continent boasts plenty of world-class companies but not many of them were set up in the past twenty-five years. In days gone by, Volkswagen was a strong match for Ford, for example. But how many of the FAANGs hail from Europe? Europe is missing its chance to participate in and drive the new digital economy. For this reason, amongst others (Brexit, banking scandals and so on...) we find it difficult to get excited the economic prospects of the bloc and are reluctant on the European equity market.

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeliness of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent, - subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of-date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch | L-2953 Luxembourg | RCS Luxembourg B-6307 | Tel. +352 4590 6699 | www.bil.com.