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# 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.

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