Empty promises

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Take a quick look at the chart below. From the equity market's perspective, Brexit was nothing more than a blip. In fact, Brexit was a good buying opportunity. If you bought the day after the vote you would be up by more than 8% on the S&P 500, and by close to 6% on the TSX. If you bought the FTSE on the day after the vote, you would be ahead by north of 7% in C$ terms.

Clearly the realization that Brexit does not mean an immediate exit and that a very long and boring negotiation cycle with the EU is ahead, played a role in the market's recovery. But as important was the changing expectations regarding how central banks respond to the crisis.

The Bank of England was first to promise to inject liquidity into the market, while raising expectations for a rate cut. The Bank didn't end up easing yesterday but with Governor Carney basically promising to ease in August, the market is reassured. In Japan, Prime Minister Abe met with Bernanke this week. Very little information was released about that meeting, but it's safe to assume that the word "helicopter" was mentioned once or twice. Japan will probably not go with full-scale helicopter money, but it's now tweeting about another monetary easing move, supplemented by a ¥10 trillion fiscal stimulus (financed in part by construction bonds). That will come as close as you get to pleasing Bernanke.

Before the vote, the market attached no less than a 50% probability of a Fed rate hike in December; that probability fell to 10% during the Brexit hysteria, and it's now standing at around 40%. The ECB has hinted that expanding its bond-buying program is a real possibility. At the same time, China, hidden behind the Brexit fog, was able to sneak another 1.5% currency devaluation on top of a similar drop since April. Six months ago the market reacted very violently to a devaluation of the same magnitude. Ironically, the only central bank that is not offering anything (beyond questionable optimism) is the Bank of Canada, with its hands tied by "elevated and rising" financial vulnerabilities.

We have seen this movie before. Markets get nervous, central banks come to the rescue, and markets recover. This cycle that originated during the sub-prime crisis is still with us, but now it's spinning much faster. But can central banks deliver?

Quick…which central banks had it more difficult—those that had to deal with the 2008 crisis (Bernanke, Trichet…etc) or today's central banks? I guess the common answer would of course be those that had to deal with the sub-prime crisis. But is it really so? Back then the timing and the direction was clear and the toolbox was full. Today the Fed is not sure when it should move, while the ability of the Bank of Japan or the ECB to really change anything is close to nil. And that's where the risk lies. Up to this point (and including the Brexit episode) markets have shown uncanny faith in the ability of central banks to save the day. How will investors react when they finally find out that their safety blanket is full of holes?