Brexit is a problem central banks will struggle to fix

Mohamed El-Erian

Not enough tools in the box to deal with the repercussions of UK leaving EU

The initial market reaction to Brexit was dramatic.

With institutional uncertainties being added to a global economy beset by fragile growth and artificial finance, the result was a combination of foreign exchange volatility, flight to haven government bonds and a sell-off in stocks led by European banks.

What comes next for the average investor need not necessarily get a lot uglier provided markets can avoid that dreaded combination of government disruptions and financial accidents.

In the immediate aftermath of the referendum, markets were heavily influenced by a set of technical influences. The most important comes from the tug of war between cash on the sidelines and margin calls that force selling on the part of levered long accounts that had become way too comfortable with the notion that the status quo would prevail. Thereafter, corporate, economic and political factors will be in the driving seat.

Brexit weakens the outlook for corporate profits due to lower growth in the UK and Europe, and a notably higher risk of recession. Facing questions about future institutional linkages, some companies will hold back on investments, particularly those whose value proposition is based on the free flow of goods and services between Britain and the continent. Others, such as banks, will shed staff. And with questions also raised about the status of immigrant workers, consumer confidence will be dented.

Political fluidity will be more intense. From the resignation of Prime Minister David Cameron to the challenges facing a divided Conservative party that is in government, this will not be a smooth time for British politics — and especially when the country needs to negotiate its future relationships with angry European partners who appear in no mood to wait, at least for now. The resulting uncertainties will be amplified by risks to the integrity of the UK, especially on account of a Scottish independence drive.

Fluid politics will also be evident across the English Channel as anti-establishment movements feel emboldened by Brexit success, raising concerns about a domino effect in the EU. But their path will be far from smooth as, simultaneously, buyer's remorse spreads on account of economic and financial dislocations.

It certainly is a combination of factors that points to a more volatile outlook for risk assets in the period ahead. But in no way is it similar to the shock that hit the global economy in the aftermath of the September 2008 collapse of Lehman Brothers.

Critically, the payments and settlement system is not in play and, as such, there is unlikely to be a "sudden stop" on the horizon for the global economy.

It is also an environment with rich pickings for investors with ample cash and the appetite to withstand high mark-to-market volatility. Over time, opportunities across the capital structure will include securities issued by companies and countries with strong balance sheets, positive cash flow, and solid management.

Particularly attractive possibilities will reside in securities that will initially overshoot on the way down, either because they lack sufficient dedicated investor sponsorship (eg, emerging markets) or are so widely held that they end up serving as an ATM for investors who suddenly wish to raise more precautionary cash (certain technology names).

While this is an interesting baseline for investors, the most vexing investment question that Brexit raises is elsewhere. And the best way to think about it is in terms of a mound of sand that can, almost counter-intuitively, be brought down by the addition of just a small handful of incremental grains.

For quite a while now, investors have been comforted by the notion that central banks are willing and able to sustainably shield them from the detrimental effects of unusual economic and political developments.

But central banks now carry an enormous policy burden that has seen them venture ever deeper into an experimental policy terrain that includes negative nominal interest rates. In the process, they have lost policy flexibility and also put their effectiveness and credibility at risk.

Few, if any, of the tools that central banks now have at their disposal can effectively deal with the complications that Brexit entails. As such, markets now face an even bigger "fat tail" of potential policy mistakes and/or market accidents.

The writer is chief economic adviser at Allianz, chair of President Obama's Global Development Council and author of "The Only Game in Town"