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Unhinged

"**New Starbucks Opens In Rest Room Of Existing Starbucks**"

- One of the finest ever headlines from 'The Onion'.

"Eventually, Starbucks rest rooms everywhere will sell coffee," [Starbucks CEO Howard] Schultz said. "In the meantime, we plan to open an additional location in this Starbucks' ladies' room within months, and are already drafting plans for a fourth restaurant along the corridor leading from the main seating area to the rest rooms. At some point a 'Starbucks Express' window will eventually open in the walk-in closet of the men's room Starbucks."

- From the same story.

When this excellent satire on Starbucks' expansionism first surfaced in June 1998, the markets were enjoying the fruits of a technology boom. (If you failed to participate in that comparatively short-lived opportunity to make reckless profits, you may, if you prefer, call it a bubble.) Back then, US policy rates stood at a now extraordinary-looking 8.5%. If we see their like again, any time soon, they will be rapidly en route to something closer to 1,000%. This time round, as Starbucks CEO Howard Schultz attacks speculators for pushing up the price of coffee – assuming this is a component of any product at Starbucks – US policy rates (more specifically, the target rate for fed funds) stand at 0 – 0.25%. Schultz was aiming at the wrong target. If he wanted to identify the real culprit, for dizzying volatility in commodity prices and much else besides, he should have lambasted the developed world's central banks.

Speaking in London as part of a book tour last week, Mr Schultz had a pop at speculators for pushing up coffee prices to a 34-year high. Bank of England deputy Governor Charlie Bean and executive director of markets, Paul Fisher, for some reason felt compelled to rush to an unwarranted defence of 'speculators' and to suggest that prices tend to be underpinned by "fundamentals". Chief among those fundamentals is that when central banks keep interest rates and therefore the price of money at zero, it tends to have a knock-on effect on the prices of all financial assets. Speculators are a convenient scapegoat whenever asset prices reach levels that inconvenience businesspeople or politicians. But if you don't like the message that asset prices and the market are signalling, then don't allow central bankers to set and then manipulate the price of money in the first place. This represents the latest existential dilemma facing the long-suffering Governor of the Bank of England (pictured below).

Bank of England Governor, Mervyn King

DangerMouse's hampster sidekick, Penfold
(c) Cosgrove / Hall Productions

King's tenure in the role has been nothing if not a long period of policy failure; the Bank of England's own web site suggests, with a straight face, that "The Bank sets interest rates to keep inflation low to preserve the value of your money" and also "contributes to protecting and enhancing the stability of the financial system". The stability of the UK banking system is legendary. As for monetary policy as a bulwark against inflation: the UK retail price index stands at 5.3%, year on year. The Bank of England base rate stands at 0.5%. The value of UK bank depositors' capital is currently being preserved at a rate of minus 4.8% per annum, give or take. It is awkward for King that he said in 2004 that "Maintaining monetary stability and maintaining financial stability.. are the essence of central banking," given that in the same year he also said in a speech, "I offer my congratulations to the Chancellor, Gordon Brown, for his.. successful pursuit of economic stability – not even Gladstone achieved such stability." Unkind observers might suggest that such insight confirms Mervyn King as a somewhat inessential central banker – in a field populated by personalities that are not exactly indispensable .

Heading the UK's central bank in 2011 is admittedly a role only a committed sadomasochist would solicit. For the last four quarters, the Bank has downgraded its 2011 growth forecasts. It has now downgraded its 2012 forecast as well. Even on newly diminished forecasts, "the risks are skewed to the downside". Absent stubborn inflationary problems, any central bank in this position would be cutting rates, not raising them. But the Bank is, even amongst its developed market peers, almost uniquely exposed to two colossal problems, given the outsized role of property and financial services within its economy. On the one hand, it has been forced to sacrifice broader national interests order to keep the banks' life support system and its associated stimulus operational. On the other, it has to be mindful of the grotesque state of our national finances (where responsibility is shared between reckless banks and the feckless socialists of the previous administration). Who on earth would want to try and pilot the UK economy and its still unreconstructed banking system between Scylla and Charybdis ?

Even as Starbucks' Schultz bemoaned the supposed role of speculators (who are widely if strangely presumed to extract profits uniformly from each market in which they operate), some of the froth was being blown off commodities markets, notably those for oil and silver. But in a sense, any asset denominated in those US dollars being printed so shamelessly into creation by a Federal Reserve that seems to have completely lost its senses will be prone to similar price volatility, and in both directions. Having let the inflationary genie out of the bottle, the Fed has gone on to smash the bottle, so it will have the devil's own job of getting it back in. Markets may now be conditioned, in a deeply Pavlovian sense, to expect the Fed to intervene whenever prices head demonstrably south, certainly in equities. Bond prices (and the rest) were already distorted courtesy of quantitative easing. Far from having global imbalances reconciled during the post-crisis machinations of the monetary authorities, imbalances between the developed and developing worlds have been exacerbated. As Felix Zulauf points out in his latest commentary, the emerging world has already started to tighten monetary policy, albeit not decisively yet. But the developed economies are now reaping the inflationary whirlwind sewn by their mid-crisis monetary stimulus, and inflation is clearly threatening to swamp inflation targets that have now been essentially abandoned. "The dilemma will be whether they will act according to the unsatisfactory economic recovery and stay loose, or to the rising inflation rate and tighten." Europe has taken baby steps to tighten policy, even in the face of an existential crisis for the Euro and the Euro zone periphery. Japan has no choice in light of its recent tragedy. "But what about the US, which remains key as a market trendsetter ?"

Stock markets, and notably those of the US, have taken an awful lot of news on the chin this year, and so far shrugged all of it off. Middle Eastern regime change ? Japanese tsunami ? The well discussed and anticipated end of Quantitative Easing in the US, scheduled for the end of June ? A rise in resource prices which has started to impact on developed economies and triggered inflationary pressure in those still developing ? In his latest piece for GMO, Jeremy Grantham writes that

"A third round of quantitative easing would very probably keep the speculative game going. But without a QE3, there seem to be too many unexpected (indeed unexpectable) special factors weighing against risk-taking in these overpriced times.. Risk now should be more reflective of an investment world that has stocks selling at 40% above fair value (about 920 on the S&P 500) and fixed income, manipulated by the Fed, also badly overpriced."

Perhaps for the first time, and flying in the face of market tradition and convention, Grantham advocates not floating along with the Fed, but fighting it. The reason that markets are starting to feel unhinged, and that our times are so overpriced, is precisely because of the Fed and its peer central banks. It should perhaps be added that if the Fed ever possessed any form of moral or ethical authority, its recent actions show that it has lost all claim to them now. On a not unrelated note, Steve Forbes suggested that the US could return to the gold standard within five years.

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