



A PEEK AT THE WEEK THAT WAS - August 31, 2013

*Patient Capital... Positioned for Profit*

***" The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists."***

Ernest Hemingway, The Next War

This past week has sadly been all about WAR! It has impacted Mr. Market and Ms. Bond and over at Bill Bullion's Gold Bar, the mood has been up and down as the international banter goes back and forth.

So this week, we will spend a little time peeking at war. Not a pleasant thing, to be sure, but as seemingly inevitable to humanity as the sun rising in the east and setting in the west. And as we take a peek, we'll look specifically at modern warfare...that involving the cyberworld...as it has an unfortunate tendency to impact many more of us than the standard, nasty stuff.

And in the interests of pure summer fun, we will continue our peek at the friendly Fed. This week, we'll take a look at who owns that mysterious creature created over 100 years ago on Jekyll Island. And we'll learn why control is far more important than ownership.

We'll steer clear of both the shiny stuff and the sheeny stuff this week, not because we want to but just because we won't have room. But trust us anyway when we say, they are both still very interesting.

Finally, we'll take a look at our chart(s) of the week, which show the correlation between a rising market and increasing margin debt on the one hand...and the recent surge in the put/call ratio on the other. These are conflicting signals but in the current environment, they may make a lot of sense.



PROPERTY OF \_\_\_\_\_?

## WHAT IS THE FEDERAL RESERVE AND WHO OWNS IT? AND DOES IT MATTER ANYWAY?

Last week, we talked about how the smart bankers secretly boarded a private railway car in Hoboken, NJ. to trek down to Jekyll Island on Georgia's Atlantic Trust. The purpose of the trip...to create a Frankenstein like creature which we managed, quite cleverly, to portray as Greta Garbo.

It was a brilliant maneuver which continues to this day...even if Greta is looking a bit worse for wear.

So, in hindsight, just what was it that we created anyway?

This is the commonly accepted version.

According to [Investopedia](#), our creature looks like this...and as usual, all the bolding and snide comments in red are ours:

*The Federal Reserve was created by the U.S. Congress in 1913. Before that, the U.S. lacked any formal organization for studying and implementing monetary policy [no...it just relied on a counterparty-free gold system...silly sausages]. Consequently markets were often unstable and the public had very little faith in the banking system [actually the bankers, but let's blame "the system"]. The Fed is an independent entity [oh....absolutely], but is subject to oversight from Congress [bollocks...they have no clue...ask Bob Rubin back during the Mexican peso crisis!]. Basically, this means that decisions do not have to be ratified by the President or anyone else in the government, but Congress periodically reviews the Fed's activities [OK...we're confused...the Fed is "independent" but it's still subject to "oversight" but yet its decisions don't have to be ratified by any elected official...well...that's clear enough isn't it?].*

*The Fed is headed by a government agency in Washington known as the Board of Governors of the Federal Reserve [sounds official and independent enough]. The Board of Governors consists of seven presidential appointees, each of whom serves 14 year terms. All members must be confirmed by the Senate and can be reappointed [OK...no cronyism there]. The board is led by a chairman and a vice chairman, each appointed by the President and approved by the Senate for four-year terms. The current chair is Ben Bernanke [aka "savior of the world"], who took over for Alan Greenspan on February 1, 2006. Greenspan had been chairman since 1987 [yes...and no one understands a word he said during that time].*

*There are 12 regional Federal Reserve Banks located in major cities around the country that operate under the supervision of the Board of Governors. Reserve Banks act as the operating arm of the central bank and do most of the work of the Fed. The banks generate their own income from four main sources:*

- Services provided to banks [like what exactly?]
- Interest earned on government securities acquired while carrying out the work of the Federal Reserve [which is exactly what?]
- Income from foreign currency held [does that include gold...sorry...but the Germans were asking?]
- Interest on loans to depository institutions [.25%...what a deal...for them]

*The income gathered from these activities is used to finance day to day operations, including information gathering and economic research. Any excess income is funneled back into the U.S. Treasury. [I guess an audit is out of the question?]*

OK, snide comments apart...it all sounds pretty official right? Remember from last week, when we told you we were brilliant. Created by Congress. Has a board of governors. Not a single bank but a "system". And, of course, it's not called "Federal" for nothing.

**So the Federal Reserve is part of the federal government, right?  
Presumably then, it's accountable to taxpayers isn't it?**

Well, not so fast amigos. Not quite...in fact far from it.

**So, who owns the Federal Reserve?  
Somebody must...right?  
Everything has an owner after all?**

Well, according to the Fed itself, it is all a bit confusing.

Of course, it is. After all, we are the masters of obfuscation...you don't think Alan Greenspan learned that all by himself do you?

From our own FRB website...in response to our own question (just to show you how up and up we are)... "[Who Owns the Federal Reserve?](#)".

The Federal Reserve System fulfills its public mission as an **independent entity within government**. [an oxymoron if ever we've heard one] It is **not "owned" by anyone** [we can't believe that you actually still believe that one] and is not a private, profit-making institution.

As the nation's central bank, the Federal Reserve derives its authority from the Congress of the United States. It is considered an independent central bank because **its monetary policy decisions do not have to be approved by the President or anyone else in the executive or legislative branches of government**, [well, would you trust any of those geniuses to actually handle money?] it **does not receive funding appropriated by the Congress**, [of course not, why bother when we can print our own money...and yours too?] and the **terms of the members of the Board of Governors span multiple presidential and congressional terms** [so we can outlast them, of course]

However, the Federal Reserve is subject to oversight by the Congress, which often reviews the Federal Reserve's activities and can alter its responsibilities by statute. Therefore, the Federal Reserve **can be more accurately described as "independent within the government" rather than "independent of government."** [Huh???

*Remember, we are the masters of misspeak]*  
The 12 regional Federal Reserve Banks, which were established by the Congress as the operating arms of the nation's central banking system, are **organized similarly to private corporations--possibly leading to some confusion about "ownership."** [wherever would you get that idea?] For example, the Reserve Banks issue shares of stock to member banks. However, owning Reserve Bank stock is quite different from owning stock in a private company. The Reserve Banks are not operated for profit, and ownership of a certain amount of stock is, by law, a condition of membership in the System. The stock may not be sold, traded, or pledged as security for a loan; **dividends are, by law, 6 percent per year**. [we bet a lot of you prudent savers would like a nice legally protected 6% wouldn't you? Sorry, not happening]

Once again... the emphasis and snide comments are ours

Here's the problem folks...there is a perception that somehow the Fed is a public institution, providing a public service for the greater good of all.

Check out this link which we received back as a "best answer" in response to our Google query below...click [here](#) if you don't believe us.

#### **Peek to Google: What services does the Fed provide to commercial banks?**

##### **Best Answer - Chosen by Voters**

A central bank, reserve bank, or monetary authority is a public institution that usually issues the currency, regulates the money supply, and controls the interest rates in a country [we like the sound of all three of those]. Central banks often also oversee the commercial banking system within its country's borders. A central bank is distinguished from a normal commercial bank because **it has a monopoly on creating the currency of that nation**, [what a great racket...how can we get in on that? You can't buste...or it's the big house for you] which is usually [are you kidding] that nation's legal tender.

The primary function of a central bank is to provide the nation's money supply, but more active duties include controlling interest rates, and **acting as a lender of last resort to the banking sector during times of financial crisis** [of course....after all, that's really why our creature was created] It may also have supervisory powers, to ensure that banks and other financial institutions do not behave recklessly or fraudulently [Actually, that was the Glass Steagall Act and it worked too well...so we had to get rid of it in 99. And now that our risk of loss is "socialized" we can really up our derivatives bets...oops, we mean...our fully hedged and sure to succeed off balance sheet transactions totaling trillions of nominal dollars].

Functions of a central bank may include:

- \* implementing monetary policy [sure...the dollar's lost over 95% of its value since 1913 but you can't really blame us for that, can you?]
- \* determining Interest rates [aka punishing prudent savers if necessary to help our banking buddies]
- \* controlling the nation's entire money supply [two trillion locked up in bank reserves that was printed to support a failing economy...that's some management]
- \* managing the country's foreign exchange and gold reserves and the Government's stock register [well...we kind've have the gold reserves covered...sort of...really...OK...just trust us]
- \* regulating and supervising the banking industry [actually the FDIC does the dirty work...usually on Friday evenings]
- \* setting the official interest rate – used to manage both inflation and the country's

exchange rate – and ensuring that this rate takes effect via a variety of policy mechanisms [at least until the bond vigilantes come after us...which they seem to be doing right now...ouch]

Most developed nations today have an "independent" central bank [wait a minute...you just said it was "public"...make up your mind], that is one which operates under rules designed to prevent political interference [like complicated questions or Heaven forbid, an audit]. Examples include the European Central Bank (ECB) and the Federal Reserve System [remember, we can't call it a bank] in the United States.

Confused? Befuddled? Of course, you are!

You see when it comes down to it, who owns the Fed is ours to know and yours to find out.

**But who really cares? Ownership is not important. Control is!**

We control the currency. The only dollar notes allowed by law are ours. We call them "Federal Reserve Notes". Any alternatives are deemed counterfeit and if you try it, you will end up in a correctional facility. We'll make darn sure of that. Sometimes the politicians try to rein us in, like Ronny Paul and his silly audit idea, but they can't.

We have lots of important international friends and confidants. We know where all the gold is (at least...oops, Freudian slip...we meant, at least, we think we do...well...OK...we're looking). Just trust us. After all, we're a public institution...well...not really...but let's move on. We don't want to confuse you more than we have already.

**Much more importantly (and this is why we really exist), if any of our banking chums, like Citibank, get into a spot of bother, we just print some digital dollars, buy some treasury bonds and bail them out...all part of the original master plan.**

**Best part, of course, is that the US tax payer is responsible for all that debt. It's crazy, we know. But we keep getting away with it.**

In fact, we frequently pinch ourselves because we can't believe how well it's worked out and how long we've managed to keep the scheme going. It's our 100th birthday this year. Well done chaps!

By the way, don't cross us, or annoy us or get too big for your boots, or we'll pull the rug out from under you. Just ask that guy who used to run Lehman.

Well...here's to more happy days ahead and another 100 years of "progress"!

Next week, we'll take a look at how well we've done with our double...actually, triple...mandate. But who's counting?



**" There are few die well that die in a battle."**

William Shakespeare - Henry V: Act IV, scene 1

Hemingway was right. Inflation and war are the playthings of politicians.

Bartender Ben has had some difficulty in manufacturing large scale inflation, despite his best efforts. Of course, we shall eventually endure his beloved inflation, in spades...and it will not be pleasant. But for right now, in the USA,...a nation of deteriorating demographics and continuing deleveraging of debt..."official" inflation is elusive, so we may have to settle for war.

War is a wonderful thing for a politician. It is harmless (to them). It is distracting. It can hide a multitude of sins. It can unite a divided populace behind a "popular" cause. What better way to deflect blame than to find a foreigner more evil than oneself? That is always easy. And that's why our "leaders" inevitably err in that direction.

We use the word "err" deliberately because in our humble opinion, war is typically a creation of

convenience. Sure, there are occasional "just" wars but even then, behind them all you find the convenient brand of evil on the one side and an indignant brand of righteousness on the other. Trace every war in the history of mankind and you will find a convenient guiding hand behind it. For example, it is convenient to now condemn a certain dictator for his alleged use of chemical weapons. However, just a decade or so ago, it was convenient to ignore, if not condone, another dictator's actual use of more deadly chemical weapons against a mutual enemy. If you don't believe us, click [here](#).

The one commonality of wars is that they are invariably bad for the participants...willing and unwilling. And that's why we do not like them. They are not productive. They do not create wealth. They destroy lives and generations of promise. As a world, we somehow survive them, but we are not the better for them.

But wars come in many forms. The ones we understand are the ones that are made of newsreels and cinema. They are always violent. They are sometimes heroic. They inevitably result in inconceivable physical pain and suffering. They are an enduring indictment of man and make the word "civilization" more an oxymoron than a noun.

But as humankind evolves, so do conflicts. As real time live feed video increases, we are hopeful that violence will decrease. There is nothing nice about real pain and suffering. As humans, we generally just can't take it. And so, the more obvious it becomes, the more onerous it will to bear. We can only hope.

But that does not mean that conflict will be confined. It will just be more subtle, less ostentatious. Less flashy. Yet potentially more fearful.

The modern world of warfare will be an assault on average. It has the capability to catapult our perfect modern lives into a state of perdition. These are not wars of physical carnage yet they will inevitably have a significant impact on our lives and our finances. Best we be aware of them.

This week we'll take a look at the advent and expansion of cyber warfare in particular and examine how it may impact us and why. But before we move on....Heeeeere's Johnny!



***" Hark! the shrill trumpet sounds, to horse, away  
My soul's in arms, and eager for the fray."***

William Shakespeare - Richard III: Act V, scene 3

The latest new war we've been hearing about, of course, is that tragic abuse of humanity called **Syria**.

Barackus Caesar seems determined to get involved, with or without his NATO mates and in spite of Putin's protestations. And let's not forget that Syria's largest trading partner is China.

But who cares...Caesar needs a convenient distraction. The market is slipping, there's that pesky debt ceiling issue coming up, his Obamacare plan is showing signs of shakiness and even his fellow Democrats are having doubts about his omnipotence.

The republic is running out of bread, so let's put on a circus.

Secretary of State (Sanctioned Stupidity), John Kerry, has been blowing the bugle. As a former victim of war, Jumping Johnny should have more sense...but he doesn't. He is caught up in self-sanctioned righteousness...and this is a dangerous state indeed.

So...is there any doubt that we shall prevail in Syria, should we proceed? None, whatsoever, of course. The US has a massive military advantage. Perhaps things could go wrong. An errant missile hitting a Russian destroyer would not be good. Nor would anything that provoked the Israelis to hostility. But barring such little mishaps, all should be

just peachy.

Nevertheless, the Syrians are not without some recourse of their own. It's a ragtag mob of probably pretty young cyber freaks called the SEA...the Syrian Electronic Army.

From [Wikipedia](#):

*The Syrian Electronic Army (SEA), also known as the Syrian Electronic Soldiers, is a collection of pro-government computer hackers aligned with Syrian President Bashar al-Assad. Using denial of service attacks, defacement, and other methods, it mainly targets political opposition groups and western websites, including news organizations and human rights groups.*

From [NBC](#)....a couple of days ago:

### **Syrian Electronic Army seen as 'nuisance,' not a serious cyberthreat**

From [ABC](#)....a couple of hours ago:

### **Syrian Electronic Army a Credible Threat**

So, who is right? And does it matter anyway? Surely this hodge podge gaggle of geeks could not harm us...could they? Well...they have allegedly delivered some minor mayhem to the **NY Times**, and **Twitter** recently and seem to have been pretty busy lately in multiple countries. You can read more on their nefarious activities [here](#).



But our beat is finance and investments, so our concern is what they...with or without help from their Iranian mates...might do to the markets. They've shown that they have the potential to inflict some degree of pain.

Allegedly, the SEA was the twit behind one little tweet we wrote about way back on April 27.

As we said back then...when commenting upon the market....

Looking at the markets...the Dow traded within a 137 point range, the S&P 22 or so and the Nasdaq, a measly 55. Pretty ordinary, range bound trading stuff really!

Wall St: *Nothing to see here folks...move along!*

Main St: *Hey...hold up a minute buddy...what's that I see? Looks suspicious.*

Wall St: *Oh that...it's nothing to be alarmed about...just some twits having a lark. Everything's under control! Just keep buying and you'll be fine.*

Unfortunately, we suspect that everything is not under control and that if we just keep buying, everything and everyone will NOT be fine.

Because on Tuesday, April 23rd around 10.00 a.m. this happened:



And then this happened:





Our fear is that, with US intervention looming or actual, those SEA scallywags may try to impact the market in a more severe manner than a humble tweet or ten. What better way to strike the capitalist pigs than through their precious markets. So...will we see more of these?

From [CNBC](#), Thursday, 22 Aug 2013 | 7:55 PM ET.

**Nasdaq: 'Connectivity issue' led to three-hour shutdown'**

Nasdaq said it halted trading for three hours Thursday after a "connectivity issue between an exchange participant" and a system that disseminates all stock prices for the industry.

From [ComputerWeekly.com](#), Friday 23 August 2013:

**Nasdaq shutdown raises security fears**

A software glitch that caused the tech-heavy Nasdaq stock exchange to shutdown has raised fears over stock market stability and cyber attacks and renewed calls for greater market regulation.

Here's the problem folks and it's real!

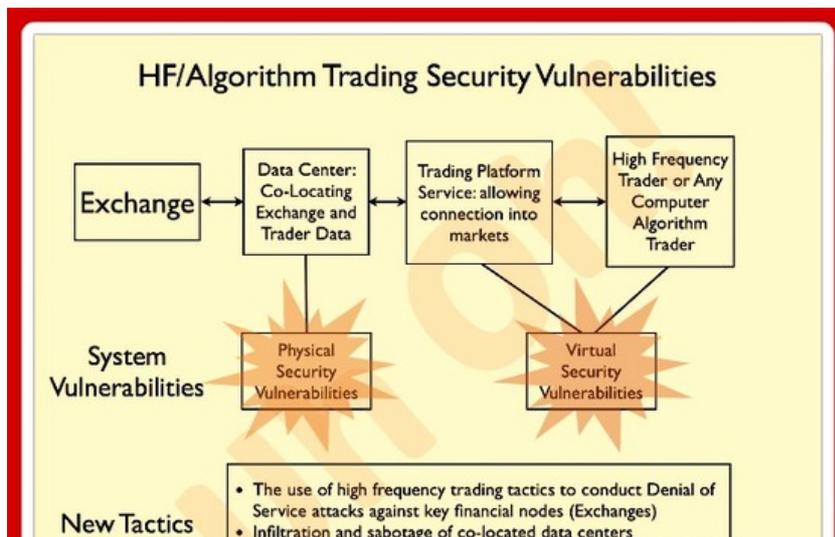
When you combine the complexity of multiple electronic exchanges worldwide with an ever increasing web of high frequency trading systems, you potentially have the makings of a malevolent hacker's dream. Some reports suggest that you can practically drive a trojan tank through some of their security systems. As the diagram below shows, this is a complicated picture. Simply put, the more complexity, the more vulnerability. You can read the accompanying article which is the source of this diagram, [here](#).

Neither the SEC or the wise men and women running these markets will tell you of the potential risks, of course. Why panic Mr. Market when he's having such a great time at Club S&P (formerly 1700).

Checking the wires before we finish up and hit the send button, it appears that Barry has, at least for now, opted for distraction over destruction.

As commander in chief, he will seek the sanction of the good senators and representatives of we, the people. This should make for interesting political theater over the next week or so...all the while providing the SEA geeks with more than enough time to formulate a plan. We will continue to mull over their potential for mayhem in future weeks as the drum beating inevitably increases.

In the interim, we would strongly suggest that, when it comes to your investments, you know exactly what you own and why you own it...not to mention keeping a watchful eye. September is upon us, after all!



- Speed Intelligence - HFT practice of using orders to test speed of networks to detect vulnerability

### CHART(S) OF THE WEEK - WHO NEEDS A WAR WHEN YOU HAVE THESE TO WORRY ABOUT?

This week we have a couple of conflicting charts which, when read together, may make some sense...and cause some concern.

The first tracks the rise in margin debt (the red ink) against the rise in the drinking fever at Club S&P. Yes...we know it's busy but we hope that you can see that as more margin debt is taken on, the higher the S&P goes. This has happened before. Firstly, during those heady days at the end of the last century and then again in the golden Goldilocks days from late 2005 till around mid 2007.

Of course, both times, Mr. Market fell off the bar room table and lapsed into a severe case of depression. Will it happen again...who knows...but you know what history and poetry have in common...they often rhyme.

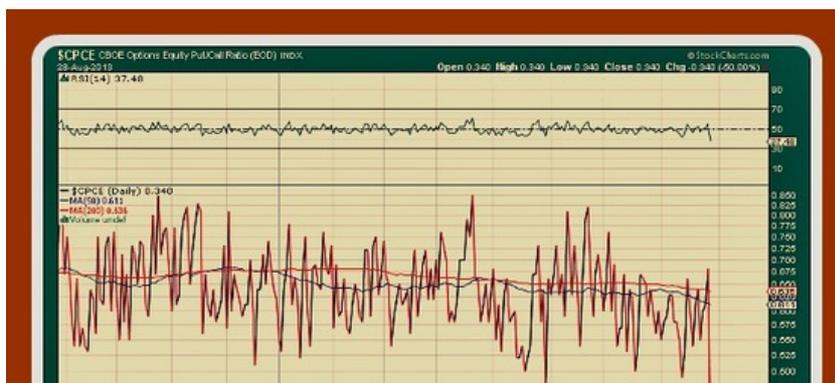
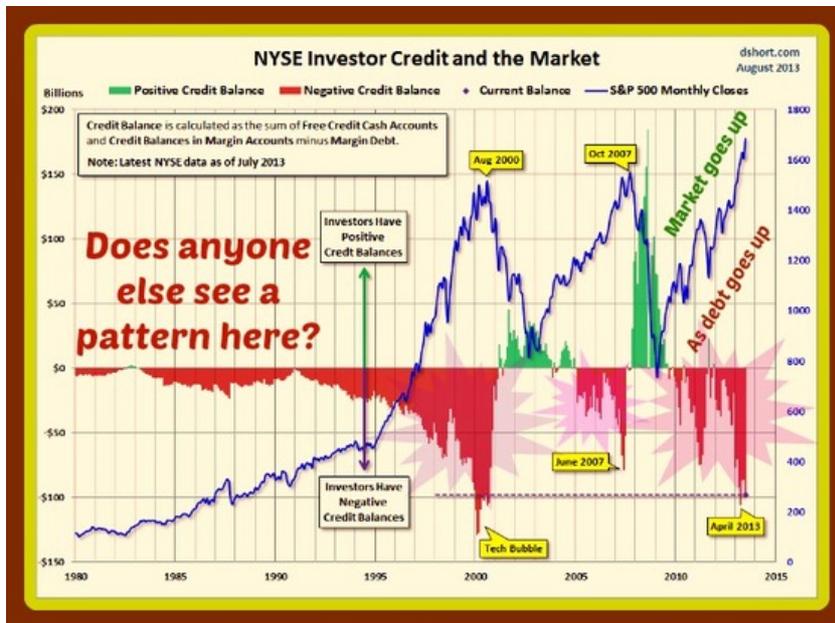
The second chart is simply scary and may be aberrational in nature but it is still worth our attention.

While the first chart shows an ever increasing use of margin (a.k.a. borrowing or leverage) to purchase stocks, the second shows the ratio of put options to call options.

Simply put (no pun intended), puts represent fear of the market going down. Calls represent optimism that the market will go up. The fact that there are so many more puts than calls tells us that the sentiment of Club S&P's party goers has possibly changed. Maybe it's the war talk or maybe it's leveraged buyers hedging their bets or maybe it's the old market mantra to sell Rosh Hashanah, buy Yom Kippur...or a combination of all three? Who knows?

But as we've seen in chart one, the red can convert to green very quickly. And that conversion is often forced, as margin clerks make callous calls to covering clients. There is nothing quite as fearful as forced selling into a rapidly falling market.

Will we see it this time? As usual...we have no clue. But with the sabres rattling and the drums beating, it makes sense to keep our candles lit and our powder dry.





Til next week...

*"Ignorance is the curse of God. Knowledge is the wing wherewith we fly to Heaven."*

William Shakespeare



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