

March 24, 2014

Will Putin Stop with the Crimea?

Now that the Crimean referendum has passed in favor of annexation, what will Putin do next? In other words, will he stop with the Crimea?

In this report, we will look at the post-Cold War situation from Putin's perspective. From this viewpoint, we will examine Putin's likely next steps and how this will affect the U.S. and the rest of the developed world. As always, we will conclude with market ramifications.

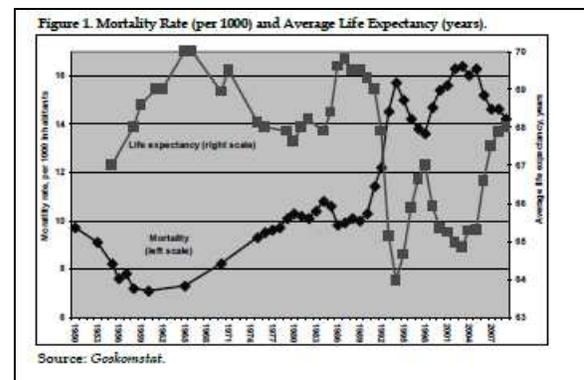
The End of the Cold War and Putin

The general narrative from the U.S. and the West was that the Cold War was a victory for democracy and capitalism. The actual end of the Soviet Union was less dramatic. According to Jack Matlock,¹ the Cold War's end began in 1987, when U.S. Secretary of State George Shultz and Soviet Foreign Minister Eduard Shevardnadze met and it became clear that communist ideology had essentially come to an end. It took another couple of years before we had the dramatic images of the fall of the Berlin Wall and four years until the Soviet Union dissolved. According to Matlock, President George H.W. Bush opposed the rapid dissolution of the U.S.S.R., but Boris Yeltsin pressed various regions, including Ukraine and Belarus, to form their own governments. Yeltsin, the elected Russian president, wanted to solidify his power by ending any pretext of the Soviet Union.

¹ March 14, 2014, *Washington Post*.

From Matlock's perspective (he was Ambassador to the U.S.S.R. from 1987-91), the Cold War was more of a negotiated settlement than a win for the West. As the years passed, the narrative in the U.S. and Europe was not that of a negotiated settlement. Instead, the West treated the end of the Cold War as an unequivocal victory.

There is an old saying that "history is written by the victors." Given the dramatic rollback of the Warsaw Pact and the struggles Russia endured in the 1990s, which included a debt default and the greatest recorded decline in life expectancy during peacetime,² it was no wonder that the West viewed its victory as near total.

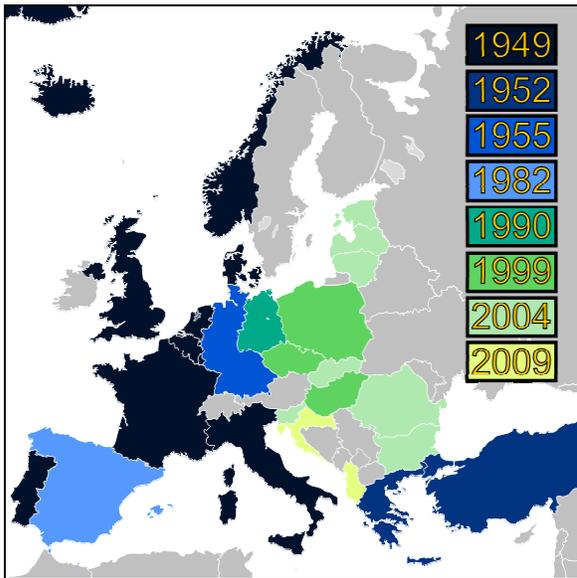


After the George H.W. Bush administration ended its term in office, subsequent administrations tended to discount Russian interests. The Kosovo War deeply troubled Russia—Serbia was a traditional Slavic ally which Russia had supported. By bypassing the U.N. (and Russia's veto on the Security Council), Russians believed this attack violated international law.

² Popov, Vladimir. "Russia's Mortality Crisis," PONARS Eurasia Policy Memo No. 127.

The Iraq war led to similar complaints. President Bush’s “coalition of the willing” was, in Russia’s eyes, another example of American unilateralism. The ousting of Libyan leader Moammar Gaddafi had the same tone.

But these events paled in comparison to the expansion of NATO into the former Eastern Bloc states.



(Source: NATO)

Note the additions of the Baltic States in 2004, along with Slovenia, Slovakia, Bulgaria and Romania. With Poland joining the treaty organization in 1999, the steady encroachment into Russia’s sphere of influence was well underway. When there was talk of Ukraine joining NATO after the Orange Revolution in early 2005, Putin viewed Western behavior as hostile. Moscow is only 288 miles away from the Ukraine border. The addition of the Baltic States put St. Petersburg only 96 miles from a NATO nation. When the Cold War ended, the nearest NATO nation was 1,000 miles away from St. Petersburg.

There is little doubt the Soviets viewed the Nicaraguan Sandinistas as indigenous

socialists trying to improve the lot of the poor in that nation. The Reagan administration believed otherwise and funded the “contras” to undermine the government in Nicaragua. During the Cold War, the U.S. didn’t necessarily use covert or overt action against every nation that was leaning toward the communist bloc. However, if one of these countries was in the Western Hemisphere, the U.S. generally opposed that development and usually took active measures to undermine those regimes.³ That policy came well before the Cold War; it began with the Monroe Doctrine. Expecting Russia not to oppose the expansion of NATO was simply naïve.

From Putin’s perspective, the Orange Revolution in Ukraine and the Rose Revolution in Georgia were not the expressions of citizens pining for democracy but the handiwork of Western intelligence agencies working to undermine governments aligned with Russia. Although these revolutions were likely indigenous, Russia was bound to be uncomfortable with their development.

It is always important to remember that Russia has historically defended itself by expanding its area of influence. Russia has few natural defenses. Thus, throughout history, Russia has tried to expand its borders to force invading armies to travel far and extend supply lines. In two important cases, Napoleon in 1812 and Germany in 1941, long supply lines and bitterly cold winters weakened the invaders and allowed the Russians to win these wars. Losing control of territory is tantamount to becoming indefinable. The downside of this

³ The incursion into Grenada in 1983 was an example of overt action against a country suspected of leaning toward the communist bloc. The undermining of the Allende regime in Chile in 1973 was an example of covert activity.

policy is that the conquered areas tend to dislike Russian control, raising the costs of securing these regions. History shows that eventually the costs become too great, and Russia collapses on its inner core, only to eventually repeat the expansion cycle again.

Putin’s recent speech to the Duma expressed deep resentment for Russia’s treatment after the Cold War. He believes that the West promised not to expand NATO and broke that promise. He also sees the unjustified wars, the economic collapse in the 1990s and the purposeful decisions to ignore Russia’s interests as clear evidence of either hostile intent or reckless disregard. And, in his long tenure in government, he has apparently vowed to reverse that treatment.

It would seem that time has arrived.

What Will Putin Do?

The financial and commodity markets seem to be expecting that Putin will do nothing further. There is a precedent for this outcome. After the Orange Revolution, Putin generally did not take aggressive steps to reverse the situation. Instead, he waited to see if the new regime would be able to govern Ukraine. In fact, the Yushchenko government was mostly ineffective. However, it is important to remember that Russia did disrupt natural gas flows on two occasions which did weaken the Ukrainian economy. Another example was Russia’s incursion into Georgia in 2008; Putin moved into the regions of South Ossetia and Abkhazia, establishing them as autonomous but has moved no further.

Although Putin could take this step on the assumption that the weak and corrupt Ukrainian government will likely fail, opening the door for increased Russian influence, there are two serious risks with this option. First, by taking the Crimea out

of Ukraine, a large number of Russian-sympathizing voters have been removed from the next election. This loss may be enough to marginalize Russian sympathizers and tilt the elections toward Ukrainian nationalists. Second, there is a risk that the West will aggressively try to support Ukraine’s economy in a bid to pull the state away from Russian influence. To date, we haven’t seen anything from Western leaders to suggest such aggressive actions, but it is an option for the West. Of course, supporting Ukraine economically will likely support Russia as well, so this policy would be difficult to pass in Washington, Paris, London or Berlin.

Based on Putin’s vow to protect Russians wherever they live, there will likely be constant agitation of the Russian-sympathizing Ukrainians concentrated in the eastern and southern regions of Ukraine. At present, Russian troops remain massed on the border with Ukraine. There is a possibility Putin could decide to expand Russian territory further by annexing these regions as well.

However, to make a difference geopolitically, Putin will need to control the region east of the Dnieper River; otherwise, the area held by Russia would be vulnerable to military action as the river represents the only major natural obstacle.



(Source: Wikipedia)

As the map shows, this region east of the Dnieper represents about a third of Ukraine.

It is doubtful the West would stop Putin if his troops took this region. However, there would be other costs. The remaining “rump” of Ukraine would likely become virulently anti-Russian, putting a hostile country on its border. Instead, it is more likely that Russia will continue to support civil unrest in eastern Ukraine, making it difficult for Kiev to govern this region.

In fact, Russia will likely expand this option into Moldova and the Baltics, encouraging civil unrest among the Russian supporters in these nations. Such agitation won't trigger a military response from NATO but will potentially make these countries less “Western” and more neutral. The risk of this policy is that Russian sympathizers are minorities in all these states. Simply put, agitation alone may not be enough to ensure these nations don't continue to support the West.

Instead of threats, Russia could try to expand its influence in the former Eastern Bloc by investment and preferential energy deals. Since the end of the Cold War, Eastern Europe has tried to join the West, mostly as protection against Russian dominance. However, if the nations of the former Eastern Bloc determine that the West is unwilling to protect the region, they may have no other choice than to make accommodations with Russia. Russia could make this process easier by offering “carrots” to these nations.

The last option is a classic Soviet maneuver, which is putting pressure on the West in an unrelated area. The most obvious situation would be with Iran. The U.S. and Europe are in negotiations with Iran to ensure that its nuclear program does not evolve into a

weapons program. Russia could help Iran thwart the sanctions regime and offer nuclear technology to Iran. Already, Russia has offered to build two new commercial nuclear reactors. Russia has persistently promised to sell to Iran (but, to date, failed to deliver) its sophisticated S-300 anti-aircraft defense system, which would make it more difficult for the U.S. and Israel to conduct airstrikes. The U.S. needs Russia to cooperate with the West if negotiations with Iran are going to be fruitful. Russia has significant leverage over the U.S. and the West on this issue.

The key “known unknown”⁴ is the mind of Putin. The general consensus is that he is a calculating decision maker who is carefully weighing his options and making choices. However, it is quite possible he is an angry man who is running a nation that, from his point of view, has been disrespected. And now that Russia is in a position to exact revenge, he may be inclined to take greater risks than currently expected. If the latter is the case, the risk of market disruption or worse is possible. At this point, we tend to lean toward the calculating Putin; however, his recent speech at the Duma may signal a great desire for revenge.

Thus far, the response from the West has been muted, although President Obama has taken steps to interfere with Russia's oil industry in a limited fashion. From Europe, there have been modest sanctions against officials in the Putin regime, and threats to remove Russia from the G-8 appear to be the extent of the “damage.” There are limits to what the West can do to Russia with economic sanctions because Russia is integrated into the global economic system.

⁴ The line is part of a famous quote from former Defense Secretary Donald Rumsfeld that described the problem of making decisions in conditions of uncertainty.

Unlike Iran, which is relatively isolated and almost solely dependent on oil sales, Russia has allowed foreign investment into the country since 1991. It is dependent on energy exports, but does supply about 30% of Europe's natural gas, which is nearly impossible to replace in the short run. Much of Russia's capital flight ends up in Europe, primarily Switzerland and London. Germany and the Netherlands did €113.4 bn in trade with Russia and would likely prefer not to interfere with that activity.

At this point, the U.S. and Europe will probably not move to harsher sanctions. There are more aggressive measures that could be taken. The U.S. and Europe could actively sell the ruble to drive down its value. The U.S. could flood the market with oil by selling out of the SPR. Perhaps the most damaging action would be to engage Russia in a new arms race. Russia's economy could not cope with the increased spending. However, the U.S. appears to be moving toward a smaller, not larger, military. Overall, most of these actions would require cooperation from other countries which will be difficult to acquire. For the most part, we do not expect sanctions to act as a barrier to a determined Putin.

Ramifications

In this report, we did not go into great detail about how recent actions by Russia affect the U.S. That will be the topic of an

upcoming report. However, there is a historical precedent that may suggest a hardliner on foreign policy may be favored in 2016. The Carter-Reagan and Nixon-McGovern elections are two good examples. If Putin begins to believe that a hawkish president may take the White House in 2016, Putin may have an incentive to move quickly before the next president takes office. Thus, Putin may become even more aggressive on fears that the next American leader may be more apt to respond militarily.

Our read on the financial and commodity markets' expectations surrounding Putin seem to indicate that this situation has calmed down. This expectation is probably too complacent. If conditions deteriorate, risk assets, such as equities, especially foreign stocks, carry the most risk. Commodities will probably benefit as would gold and Treasuries.

In the final analysis, the markets and the West are wagering that Putin will remain a calculating leader. Although this may be the most likely outcome, the probability that Putin is angry and wanting revenge may be higher than the markets have currently discounted.

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