

March 21, 2016

The Russian Withdrawal

(Due to the Good Friday market holiday, our next issue will be published April 4, 2016.)

On March 14th, Russian President Vladimir Putin surprised the world with an announcement of the withdrawal of Russian troops from Syria. The move was unexpected and has raised questions as to whether Russia will really pull its forces out of Syria, and if so, why? In this report, we will examine Russia's initial decision to place forces in Syria and discuss if Putin really means to remove his troops from the country. We will examine what might have prompted the decision to announce the withdrawal and, as always, discuss the market implications of the decision.

Why did Putin go to Syria?

We believe Putin had three objectives for his initial intervention in Syria.

To protect Bashar Assad's regime: The Assads have been long-time allies of the Soviet Union/Russia. On one level, the intervention was simply Putin coming to the aid of a client state. However, as with all nations, there were other factors that played into the decision as well. Russia has military assets in Syria, including a small naval base in Tartus. If there was a regime change in Syria, that base may have been lost. In addition, if Syria devolved into a jumble of jihadist proto-states, Russia could have faced terrorist threats in its southern regions from a failed Syrian state.

To prove Russia is a formidable nation: A major part of Putin's appeal is his nationalism. He plays upon the wounded pride of the Russian people, who remember the days when the Soviet Union was a real superpower. By showing that Russia could conduct military operations in the Middle East, it would force the U.S. and the West to accommodate Russia's goals in this region and elsewhere. In other words, the operation in Syria was designed to bolster Putin's domestic and international status.

To improve his bargaining position with Europe and OPEC: Russia has two vulnerabilities. First, it lacks natural defenses and thus needs to expand its influence in its near-abroad to create buffer regions. Second, its economy is heavily dependent on natural resource exports, especially oil. To address the first vulnerability, Russia has tried to increase its influence in the former Warsaw Pact nations through energy sales and geopolitical threats designed to make NATO appear weak.

The key nation in this process is Ukraine. If Ukraine is in the Western orbit, Russia is critically vulnerable; in fact, it might be indefensible. Thus, Russia is unlikely to tolerate a Western-leaning government in Kiev. As Ukraine moved closer to the West, Putin invaded the Crimea and effectively took control over parts of eastern Ukraine. In response, the U.S. and Western Europe implemented sanctions that have hurt the Russian economy.

The Saudi-led drop in oil prices has also crippled the Russian economy. Thus, Putin's goals include (a) getting sanctions eased or eliminated, and (b) boosting the

price of oil. By participating in operations against Islamic State (IS), Putin hoped to gain goodwill with the West and exchange that for sanctions relief. With OPEC, it is quite possible that Russia's position allows it to control the flow of the conflict in Syria. Russia could conceivably use that position to bargain with Saudi Arabia for production cuts (see below).

The Operation

In September 2015, Russia began a buildup of forces in Syria, moving warplanes into theater. Over the ensuing weeks, Russia placed around 80 aircraft and some 4,000 troops in Syria. Most of them were airmen, although some *Spetsnaz* (Special Forces units) units were reported in the country, likely doing spotting for bombers. Two airbases were expanded and secured.

During autumn and winter, Russian forces conducted a sustained bombing campaign, mostly directed against a non-IS insurgency. These groups are the most direct threat to the Assad regime. The campaign worked. Syrian government forces, who were losing ground before Russia intervened, have rebounded, gaining ground around Damascus and Aleppo. Overall, since Russia entered the fray, the Syrian government has gained 4k square miles of territory. The Alawite regions have been secured and buffers have been created. Although there have been some Russian airstrikes against IS, these appear to be mostly cosmetic.

Why Stop Now?

Sometimes, one of the most difficult problems of war is determining when it ends. Nations tend to find it easy to enter a conflict. In its initial phases, public support is usually high. If a conflict is existential, the goals are easy—survival is at stake. However, when outside powers intervene in

clashes that are not primary threats, determining the exact goals can be tricky.¹ “Mission creep” often follows. A good example is the 2003 Iraq War, which started out as a quest to find and eliminate Saddam Hussein's weapons of mass destruction. It ended up resulting in a regime change, forcing the U.S. to manage a Sunni-Shiite sectarian conflict. The American experience in Vietnam and the Soviet one in Afghanistan are also good examples of conflicts that seemed to be unending, in part because the goals changed. Putin clearly wants to avoid this problem. After all, he doesn't want to see his intervention in Syria shift from a popular move to a never-ending disaster.

We suspect that Russia would have liked to restore the territorial integrity of Syria. However, Putin has likely concluded that Assad does not have the military to accomplish that goal and so a much larger Russian commitment would have been required to recreate the original borders. Thus, Russia's goals were recalibrated to secure the Alawite regions and no more.

In addition, Russia has offered support to Syrian Kurdish forces who have created a zone of control along the Turkish border. This development has irked Turkish President Erdogan, who faces a growing Kurdish insurgency. Russia and Turkey have been at odds recently, especially after Turkey downed a Russian warplane that had briefly entered its airspace on November 24, 2015. Consequently, Russia is inclined to support the Kurds to make life more difficult for Erdogan.

¹ The Powell Doctrine, named after Gen. Colin Powell, tries to address this issue. See: https://en.wikipedia.org/wiki/Powell_Doctrine

It also appears that Putin probably wants to encourage Assad to step down. Last December, Putin sent Igor Sergun,² the director of military intelligence (GRU), to Damascus to inform Syrian President Assad that it was time for him to step aside. Assad refused the directive and remains in power. However, by sending Sergun, Putin has tipped his hand and indicated that he is not wedded to supporting Assad. Why would Putin press Assad to resign? We suspect Putin would like to trade Assad's "retirement" for sanctions relief. Assad's stubbornness is probably a factor in Putin's decision to withdraw. Without Russian support, it is highly unlikely that loyalist forces will continue their recent successes. Although Russia has denied reports that the withdrawal announcement was a surprise to Assad, we have our doubts this is the case. Simply put, Putin is giving Bashar Assad a lesson in geopolitics.

Once it became clear that Syria wasn't going to be reconstituted, Putin likely concluded that there was little point in maintaining the same level of operations. Putin concluded that he had achieved enough to allow for a reduction in his military commitment.

In addition to disciplining Assad, Russia also avoids mission creep by withdrawing. Media reports indicate that there were great celebrations in Russia as the first warplanes returned from Syria. By withdrawing before Russia suffered serious losses, the operation can be characterized as a success. This will bolster Putin's standing in front of parliamentary elections later this year and help dull the pain that comes from a weak economy.

² Sergun passed away on Jan. 3 under suspicious circumstances.

Two Potential Outcomes to Monitor

There are two other factors that could be behind Putin's decision to withdraw from Syria.

Did the U.S. and Russia strike a deal?

The Obama administration has no obvious path to achieve its goals in the region. Airstrikes alone will not destroy IS. Only ground troops can accomplish that goal and the president has been reluctant to take that step. There is no "Sunni coalition" willing to do the job because destroying IS isn't a high priority for any nation in the region.³ So, the default situation is that IS is contained but not eliminated.

However, it would be harder to contain IS if Assad falls. Thus, it is possible that Obama and Putin decided to stabilize the Alawite enclave to ensure some modicum of stability. Since the president has called for Assad's ouster, it would be virtually impossible for the U.S. to take steps to protect the regime. However, Russia could protect Assad due to its lengthy alliance with Syria and because Putin hadn't made statements suggesting policy goals he didn't intend to execute.

The fact that Putin tried to get Assad to step down argues against this hypothesis. However, removing Assad for a different Alawite leader would improve the likelihood of negotiating a peace deal with the Kurds and the non-IS jihadist groups operating in Syria. Russia's withdrawal from Syria will degrade the loyalists' military capabilities and may encourage others in the regime to oust Assad.

Is the withdrawal part of an OPEC supply reduction deal? Although Saudi Arabia's decision to boost supplies was made mostly to defend market share, the

³ See WGR, 12/7/2015, [The Evolution of IS](#).

collateral damage done to its enemies, Russia and Iran, was likely welcomed by the kingdom. We would not expect Saudi Arabia to change its market share policy until it sees the oil market rebalance (a drop in supply and rise in demand). However, reducing support for Assad will be welcomed by the Saudis and may encourage them to take steps to reduce output and support prices. Saudi Arabia would like to see Assad out of power and Russia's steps to undermine the Syrian regime should build some goodwill for policies to boost oil prices, something the Russian economy could certainly use.

Ramifications

Overall, it appears that Russia's decision to reduce its military exposure in Syria was a multi-faceted decision. With regards to market effects, it may have a modestly positive effect on oil prices. However, the most significant effect may be on Russia's financial markets. The drop in oil prices and Western sanctions have weighed heavily on the Russian economy.⁴ If the withdrawal leads to an easing of sanctions and/or a rise in oil prices, we would expect the ruble to appreciate and Russian financial assets to rise as well.

Bill O'Grady
March 21, 2016

⁴ See WGR, 2/8/2016, [Russia's Struggles](#).

This report was prepared by Bill O'Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, fundamental company-specific approach. The firm's portfolio management philosophy begins by assessing risk, and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.