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Nagorno-Karabakh

In early April, fighting erupted in the region around Nagorno-Karabakh, a disputed area within Azerbaijan but controlled by Armenia. Reporters described the fighting as the worst since the 1994 ceasefire. This region is considered one of the world's "frozen conflicts," experiencing periodic unrest.

In this report, we will discuss the history and geopolitics of the Caucasus region. We will examine how the three nations in the area—Georgia, Azerbaijan and Armenia—have evolved, and how the three larger surrounding powers—Iran, Russia and Turkey—affect the region. Next, we will discuss why this conflict could become a concern for the world, especially the U.S. As always, we will conclude with market ramifications.

The Caucasus

The Caucasus region is situated between the Black and Caspian Seas, with Russia to the north, and Turkey and Iran along the south. As the map to the right shows, some recognizable conflict zones are evident. For example, Chechnya is where Russia conducted two major military operations to prevent the province from breaking away from the Russian Federation. The neighboring Dagestan is a hotbed of tensions as well. The regions in Georgia that Russia invaded in August 2008, South Ossetia and Abkhazia, are also in this area. Nagorno-Karabakh sits between Azerbaijan and Armenia.



(Source: Wikipedia commons)¹

The Caucasus region has been at the crossroads of empires for centuries. Both the Ottoman and Persian empires held territory in the area. The Russian empire extended its reach into the region after a series of wars that ran from the late 1700s into 1828. In the Treaty of Turkmenchay, Persia ceded most of the modern Caucasus region to Russia.

Tsarist Russia controlled the region into the Russian Revolution in 1917, but the area was always unsettled. For example, Armenia is one of the oldest Christian polities, while Azerbaijan is mostly Shiite Muslim.² During the Russian Revolution, various groups in the Caucasus rose up to create new states. However, the Bolsheviks

¹ http://upload.wikimedia.org/wikipedia/commons/thumb/f/fe/Caucasus-political_en.svg/2000px-Caucasus-political_en.svg.png

² Azeris represent the largest ethnic majority in Iran, constituting about 20% of Iran's population, although some sources dispute this level.

put down these conflicts and instituted order. Joseph Stalin was in charge of minority affairs in the Caucasus and his goal was to create Soviet states that would be easier to manage (a ploy used by European colonists in the Middle East). Accordingly, even though Nagorno-Karabakh was mostly populated with Armenians, he gave the region to Azerbaijan. Stalin did allow Nagorno-Karabakh to become an autonomous region, but the Armenians were not happy with this decision. However, since all of the Caucasus was part of the Soviet Union, tensions remained controlled.

With the steady unwinding of the Soviet Union in the late 1980s, various regions began to break away. Armenians in Nagorno-Karabakh petitioned Moscow to leave Azerbaijan and unify with Armenia, but the Soviet Union denied the request. In November 1989, Azerbaijan ended the autonomy that Stalin had granted to Nagorno-Karabakh; the government in Nagorno-Karabakh refused to disband and proclaimed unification with Armenia. Finally, in 1991, after Armenians in Nagorno-Karabakh approved the creation of a new state, the two newly formed nations, Armenia and Azerbaijan, went to war over Nagorno-Karabakh. The conflict attracted mercenaries from the region as Afghan and Chechen mujahedeen fought with the Azerbaijan, while Russians and Ukrainians fought with Armenia. By 1994, Armenia essentially controlled Nagorno-Karabakh and the districts around it and a ceasefire was negotiated. The extent of Armenia's control is shown on the above map. Needless to say, Armenia is generally satisfied with the status quo, while Azerbaijan is less pleased.



(Source: SRAS)

Since the ceasefire has been in place, there have been numerous incidents, much like what was seen earlier this month, where forces from each side engage in skirmishes. There is always a legitimate concern that one of these events could escalate into a much bigger conflict. So far, that hasn't happened, but it could occur sometime in the future.

Over the past decade, buoyed by high oil prices, Azerbaijan has been boosting its defense spending. It currently spends about \$3.0 bn per year on its military, which represents about 5% of its GDP. In 2003, Azerbaijan spent about \$177 mm on defense. The buildup of Azerbaijan's military is significant and puts Armenia at a disadvantage. Even with this expansion, however, it is highly doubtful that Azerbaijan's military could successfully dislodge Armenia from Nagorno-Karabakh or its surrounding regions because the area is mountainous and the Armenian military is entrenched in its positions. To change the status quo, these two Caucasus nations need outside intervention. Consequently, Armenia and Azerbaijan are constantly trying to gain the favor of outside powers to provide support for their goals.

The Outside Powers

The three important regional powers are Russia, Turkey and Iran. Because of its superpower status, the U.S. is also peripherally involved. Here is a summary of their positions:

Russia: The long-standing geopolitical imperative for Russia is to expand its influence into its “near abroad” to force potential invaders to move long distances before reaching the Russian core around Moscow. After the Soviet Union fell, the protective regions around Russia became independent. Since Vladimir Putin took office in 2000, he has steadily tried to expand Russia’s influence in the surrounding regions.

One strategy Putin has employed has been to create statelets that undermine the sovereignty of governments in Russia’s near abroad. For example, when Georgia was signaling its intent to join NATO, Russia invaded South Ossetia and Abkhazia, effectively proving to Georgia that the West would not come to its aid. Controlling these smaller areas is also less expensive than total control. The invasion of the Crimea and the control of the eastern Ukrainian provinces of Donetsk and Luhansk were designed to prevent Kiev from becoming a Western ally. Russian influence in Transdnistria, a region in eastern Moldova, is designed to do the same thing. Unlike the Soviet or Tsarist models, where the Russian government took direct control of its near abroad, the dearth of financial resources has led the Putin government to use a less costly method of protecting its core.

The management of relations between Azerbaijan and Armenia, with regards to Nagorno-Karabakh, is also part of Russia’s power projection. Russia is strongly allied with Armenia. It provides arms (at

reportedly discounted prices) for the Armenian military, has 5,000 troops stationed in the country and has a military base at Gyumri. Armenia joined Putin’s Eurasian Economic Union when other former satellites were trying to join the EU. At the same time, Russia also sells military equipment (at full price) to Azerbaijan.

Russia wants all sides in the Nagorno-Karabakh dispute to depend on Moscow to maintain order. The Kremlin tends to step in quickly when conflicts develop. Although Russia has close relations with Armenia, it is not averse to supporting Azerbaijan’s positions if it can leverage those for gains elsewhere. For example, when Russia wants to undermine Turkey’s power in the region, it becomes friendly with Azerbaijan in a bid to weaken Turkey’s ability to project power. *Essentially, Russia will support the status quo until a better deal comes along.*

Turkey: The Turkish government sides with Azerbaijan in its conflict over Nagorno-Karabakh. Although the latter is Shiite, it tends to view Azerbaijan as co-religionist. In addition, Turkey has a troubled history with Armenia.³ Although Turkey did recognize the new nation of Armenia when it declared independence in 1991, the two countries have yet to establish formal diplomatic relations. During the early 1990s war that ensued over Nagorno-Karabakh, Turkey closed its border with Armenia and that status has never changed. The closed border hurts Armenia’s economy and forces the country to defend that frontier.

³ Most historians accept that the Ottoman Empire conducted a campaign of genocide against Armenians during 1915-18. Turkey contends that Armenians were an enemy force determined to overthrow the Ottoman regime and thus Turkey was eliminating a threat.

As relations between Turkey and Russia have deteriorated over the latter's support of the Assad regime in Syria, Turkey remains resistant to normalizing relations with Armenia. In fact, we suspect Turkey would be open to undermining Armenia as a way to harm a Russian ally. Thus, Turkey has generally been supportive of Azerbaijan's actions around Nagorno-Karabakh.

Iran: The Iranian regime is also sympathetic to Baku (capital of Azerbaijan), but due to wars and sanctions in the Middle East it has had less influence than its historical position would indicate. On the surface, Azerbaijan and Iran should be natural allies. After all, Ayatollah Khamenei is Azeri. However, Iran is a Shiite Islamic theocracy; Azerbaijan is mostly a secular state. Iran would like to use the Caucasus as a gateway to sell Iranian energy to Europe. Russia has little interest in Iran expanding sales into its "backyard," and so Iran will likely become a threat to Russia in this region...which is not too dissimilar to what Persia was two centuries ago. This situation gives Russia another reason to cultivate friendly relations with Azerbaijan.

United States: Since the Truman administration, the U.S. has actively been engaged in containing the Soviet Union and its successor states. During the Cold War, U.S. policy was successful. This policy has generally remained in place, although it is also clear that American administrations have not been able to establish "red lines." It's not completely clear how aggressive the U.S. will be in supporting nations in Russia's near abroad; in other words, no one is sure when the U.S. will go to war in support of border nations. For example, the Bush administration allowed Russia to invade Georgia. The Obama administration did not react militarily against Russia's invasion of the Crimea. Although it isn't

clear where the red lines lie, we suspect that NATO nations would be defended at all costs.

For nations outside of NATO, it appears the U.S. will only offer limited support. The U.S. has been friendly with Azerbaijan due to its oil production and pipelines; however, it has criticized its human rights record. The U.S. has also been critical of Armenia for its close relations with Russia; at the same time, there is a constituency of Armenian-Americans that has a voice in American foreign policy. The U.S. would likely prefer a diplomatic solution to Nagorno-Karabakh, but it would probably not intervene if a hot war broke out.

The Current Situation

We suspect that there are three reasons why Azerbaijan apparently launched attacks against Armenian positions in Nagorno-Karabakh. First, Baku has probably concluded that Russian bandwidth is limited. Its involvement in Ukraine and Syria has reduced its interest in Armenia and Nagorno-Karabakh, which allows Azerbaijan to try to improve its bargaining position in future negotiations. Second, Azerbaijan has boosted its defense spending and may be trying to use its improved relative position to intimidate Armenia. Third, the drop in oil prices has hurt the Azerbaijani economy. It is likely that Baku is using this attack to distract Azerbaijanis from the weak economy.

Neither Azerbaijan nor Armenia can resolve Nagorno-Karabakh militarily. Both have an interest in swaying the opinions and behaviors of regional power brokers. In a sense, these flare-ups are for show. However, there is always a small possibility that conditions could escalate in an unexpected manner. For example, if one of the parties used weapons of mass

destruction, it might prompt a wider international response. Since 1994, there has been a low-grade war going on in Nagorno-Karabakh. We suspect the recent event is due to Azerbaijan feeling it may have an opportune moment to improve its negotiating position.

Ramifications

Overall, we expect the regional powers to contain tensions over Nagorno-Karabakh. Although Turkey would like to weaken Armenia, it has its hands full with the Syrian situation, IS and the Kurdish uprising. Russia wants to appear as a responsible power broker to extract favors from Europe over sanctions linked to Ukraine. Iran does not want a hot war on its northern border.

In general, we don't expect this situation to worsen. However, investors should be aware of the background to this frozen conflict to understand the issues fostering it and what could occur if the regional power

brokers make mistakes in managing the situation.

If a conflict were to spread, we see two major risks. First, oil flows from Azerbaijan could be adversely affected. It is not out of the question that northern oil flows from Iraq could also be threatened. Second, there could be a jihadist uprising. The northern Caucasus region, which is under the control of Russia, has been a source of jihadist insurgents. Chechen fighters have been reported to be active in IS. If they were to shift toward Nagorno-Karabakh, it could be a major problem for Russia, Turkey and Iran. We don't expect this to occur because Azerbaijan is nominally Shiite and IS is radical Sunni, but a jihadist problem across the Caucasus could result if the local states were to fail.

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