

August 8, 2016

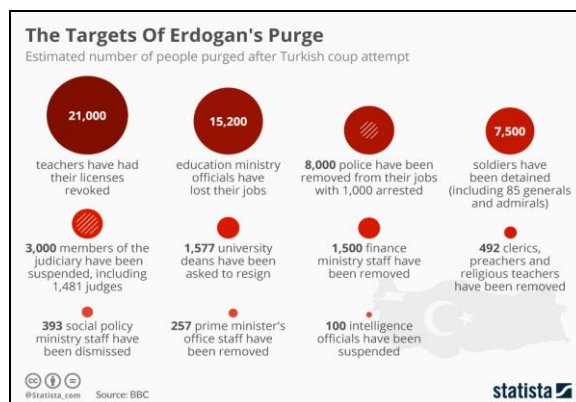
The Turkish Coup, Part III

Last week, we recounted the events of Turkey's recent coup and some of our thoughts about why the coup failed and who was behind it. This week we will discuss the unfolding purge, including the role of Fethullah Gulen, and discuss the impact on regional geopolitics. In this week's report, we will examine the market effects of the coup and its aftermath.

The Purge

At first blush, this coup seemed to be the work of Kemalists in the military. For example, the coup plotters forced a Turkish state media broadcaster to read a prepared statement which accused the government of "eroding democratic and secular rule of law," as they declared martial law. This is fairly standard coup behavior. However, nearly from the start, President Erdogan accused Gulen of fomenting the coup. We will examine this issue below.

The scope of those affected by the purge is rather large.



Although a bit more than 15k of military and police have been removed from their posts (and in many cases, under arrest), the education sector has been hit hard, with nearly 28k being removed from their jobs, including 21k teachers who have had their licenses revoked and nearly 1,600 university deans who have been forced to resign. The purge continues to widen and it appears that the Gulenists are the primary target. For example, Gulenists are deeply imbedded in education which explains why Erdogan has targeted academia.

In addition to the purge, Erdogan has implemented a state of emergency that will allow him to rule by decree. We would not be surprised to see this decree extended. Erdogan is not going to let this crisis pass without extracting the most value he can for it. We suspect Erdogan intends to reshape Turkey's government to resolve which Islamic group is going to dominate the country's future.

Did Gulen Lead the Coup?

At first glance, a Gulenist coup is out of character, while a Kemalist-inspired takeover would fit the historical pattern. As we noted in Part I, periodic coups and persistent threats of military intervention were a predominant feature of Turkey's history from its founding after WWI until the late 1990s. However, the two purges noted in Part I have mostly ended the military's influence on the political process.

The next battle for the domination of Turkey's political establishment appears to be between two Islamic-leaning leaders, Erdogan and Gulen. Therefore, even though the statement released to the media by the

coup conspirators had all the elements of a secular coup, Erdogan’s claims that Gulen was behind it, or at least inspired it, cannot be easily dismissed.

The Case against Gulen

The Turkish press has reported that one of the soldiers who took the military’s Chief of Staff, Gen. Hulusi Akar, into custody told the general that he should contact Gulen.¹ Although there is some concern over the reliability of the claims, as it was likely these coup participants were tortured, the statement has not been denied by the plotters. Of course, Gulen himself has denied any participation in the coup.

There are a couple of characteristics that suggest the Gulen movement would have the capacity to plot a coup. First, the Gulenists have been steadily infiltrating Turkish society for at least 25 years. Gulen described his plan for dominating Turkey in a famous sermon delivered in 1999:

You must move in the arteries of the system without anyone noticing your existence until you reach all the power centers...until the conditions are ripe, they [the followers] must continue like this. If they do something prematurely, the world will crush our heads, and Muslims will suffer everywhere, like in the tragedies in Algeria, like in 1982 [in] Syria...like in the yearly disasters and tragedies in Egypt. The time is not yet right. You must wait for the time when you are complete and conditions are ripe, until we can shoulder the entire world and carry it...You must wait until such time as you have gotten

¹ <http://www.hurriyetdailynews.com/coup-soldier-told-turkeys-top-general-to-talk-to-gulen-erdogan.aspx?pageID=238&nID=101996&NewsCatID=341>

all the state power, until you have brought to your side all the power of the constitutional institutions in Turkey...Until that time, any step taken would be too early—like breaking an egg without waiting the full forty days for it to hatch. It would be like killing the chick inside. The work to be done is [in] confronting the world. Now, I have expressed my feelings and thoughts to you all—in confidence...trusting your loyalty and secrecy. I know that when you leave here—[just] as you discard your empty juice boxes, you must discard the thoughts and the feelings that I expressed here.²

Gulenists have been steadily, but quietly, increasing their presence in the major institutions of power in Turkey, including the police, military, government administration, business and academia. Consequently, it would appear that they are well positioned to act as a “fifth column” within Turkey.

Second, Gulenists have shown a degree of ruthlessness that belies their moderate Islamic stance. It has been well documented that much of the damning evidence against the military purges, especially the “Sledgehammer” case, were manufactured by Gulenist elements in the police and media.³ The military purge events show that the Gulenists are willing to engage in unsavory practices to achieve their aims.

Although the AKP and Gulen’s followers worked together to remove the military from political influence in the last decade, the two

² <http://www.meforum.org/2045/fethullah-gulens-grand-ambition>

³ http://rodrik.typepad.com/dani_rodriks_weblog/2016/07/is-fethullah-g%C3%BClen-behind-turkeys-coup.html

groups have been increasingly at loggerheads. For example, Gulen opposed Erdogan's decision to directly send shipments to the Palestinians. In May 2010, Turkey dispatched a flotilla of six civilian ships to Israel. The vessels were carrying humanitarian aid and construction materials, with the aim of breaking Israel's blockade of the Gaza Strip. On May 31, 2010, Israeli forces boarded the ships with the goal of forcing the vessels to land in Israel for inspection. A conflict broke out between the Turkish activists and the Israeli commandos, leaving 10 activists dead. Erdogan was livid about Israel's behavior; Gulen was critical of Erdogan's confrontation with Israel, suggesting that such belligerent behavior "would not lead to fruitful matters."⁴ Gulen has also been critical of Erdogan's crackdown on opposition parties, especially the Kurds.⁵

According to Dani Rodrik, in late 2013, the AKP and the Gulenists union of convenience fell apart as Erdogan took steps to reduce the influence of Gulen's followers through minor purges in education, the police and the media. Much of the media crackdown appears to be designed to undermine Gulenist influences. According to this source, the one area of the Turkish power structure that has mostly avoided the president's purges has been the military.⁶ However, there were signs that Erdogan was turning his sights on Gulenists in the armed forces. According to unconfirmed reports, a large number of Gulenist officers were being targeted for discharge at meetings scheduled for early August. There has been some

⁴<http://www.wsj.com/articles/SB10001424052748704025304575284721280274694> (subscription required)

⁵ <http://www.wsj.com/articles/turkish-president-says-u-s-exile-fethullah-gulen-responsible-for-coup-1468693543> (subscription required)

⁶ Op cit.

speculation that fears of a broader purge of Gulenists at these meetings was a factor triggering the coup.

At the same time, it should be noted that these claims against Gulen are mostly circumstantial. Obviously, if the reports that coup plotters told the military's Chief of Staff to call Gulen are true, it would indicate he was behind the coup attempt. However, the reliability of these comments was undermined by reports of torture. We strongly suspect that Gulenists probably played a leading role in the coup but Gulen himself either (a) has hidden any direct evidence that he was involved, or (b) was not involved in the coup and the Gulenists who were involved acted independently or at least without direct instructions from Gulen. We suspect the second scenario is probably more likely.

That won't stop Erdogan from using this failed coup to aggressively eradicate Gulen's influence. He would really like to force the U.S. to extradite Gulen. As we will discuss below, Erdogan has some leverage in this area.

The Effect on Regional Geopolitics

Turkey sits at the crossroads of Europe and Asia. It has been an important nation for centuries. During the Cold War, it was a key bulwark against Soviet expansion. During the Iraq wars, it played a critical role, albeit in a different fashion. It was a base for air operations during the First Gulf War and during the "no-fly zone" period after the war. However, Turkey denied its airspace to President Bush in the Second Gulf War, complicating that campaign. Turkey's goals are as follows:

National Unity: Erdogan is transitioning Turkey from a secular to an Islamic state. It appears that he will tolerate secular parties

but wants the AKP to be the primary religious party. He has been very intolerant of the Kurds lately, although he has, at times, tried to woo them if he felt he needed their support. In the aftermath of the coup attempt, we expect Turkey to focus inward. Erdogan will attempt to neutralize the Gulenists and stifle any movements that could threaten AKP dominance. He will use the current state of emergency to accomplish this goal.

Become the Dominant Sunni Power:

Although Saudi Arabia fancies itself as the dominant Sunni power in the region, the kingdom's lack of power projection capabilities tends to weaken the Saudi case for regional dominance. In effect, Erdogan's foreign policy looks similar to the Ottoman foreign policy. He will eventually want Turkey to project power in the region and that means he has to curb Iranian, European, American and Russian influence. In addition, Turkey will need to prevent the creation of a Kurdish state.

We expect Erdogan to reduce the influence of the aforementioned powers by making the following adjustments:

Demand Gulen's extradition as a condition of supporting the fight against IS.

Turkey doesn't view IS as a major problem. It is a Sunni power that is undermining Shiite influence in the region, occupying Assad's territory and fighting the Kurds. The U.S. does not share Erdogan's goals. America's primary goal is to eradicate IS; admittedly, there doesn't appear to be any real idea of what follows if IS goes away. Turkey has been reluctant to support U.S. efforts against IS because it fears that the Kurds will fill the subsequent power vacuum. We would not be surprised to see Turkey revoke its permission allowing the U.S. to use the Incirlik air base for

operations against IS unless Gulen is extradited.⁷ For the U.S., the key decision is whether Gulen can act as a restraint on Erdogan or if Gulen's influence has weakened to the point that the cost of undermining relations with Turkey is too high. The odds that the U.S. extradites Gulen, or at least encourages him to seek asylum elsewhere, are increasing.

Turkey will heal relations with Russia to reduce U.S. leverage over Turkey's foreign policy.

Turkey isn't happy with Russia's support of Assad; Erdogan wants to see the Syrian leader ousted. Turkey's downing of a Russian warplane that had strayed into Turkish airspace chilled relations. On the other hand, Turkey relies on Russia for 55% of its imported natural gas and needs Russia's help in stabilizing the Caucasus. Recently, Erdogan apologized for shooting down the Russian aircraft and relations appear to be improving. We suspect some of the reason behind Erdogan's change of heart is that he needs leverage against the U.S. to prevent America from dominating Turkey's foreign policy. At the same time, we would not expect Turkey to become too cozy with Putin and will likely try to play the U.S. against Russia.

Turkey wants to thwart Iran's ambitions.

Like Saudi Arabia, Turkey wants to contain Iran. As noted above, IS acts as a barrier to Iran's ability to project power in the region. Although we don't expect Turkey to overtly support IS, it will be a reluctant opponent. We would expect Erdogan to negotiate with

⁷ This is especially likely because much of the rebels' air operations originated from this air base. The fact that the rebels used this base and work alongside American airmen is partly behind accusations from Turkish sources that the U.S. had to have supported the coup.

Iran for natural gas supplies to weaken Russia's influence on Turkey.

Europe will accede to Turkish demands.

Erdogan has hinted that he may bring back the death penalty, which would prevent Turkey from entering the EU. However, the EU desperately needs Turkey to control the flow of refugees into Europe. If Europe becomes overly vocal about the anti-democratic practices in Turkey, the refugee crisis in Europe could return. Given the current spate of terrorist attacks in Europe, a surge in refugees would seriously undermine the establishment parties in Europe. Although most European leaders will be uncomfortable with Erdogan's tactics, we would not expect serious opposition as the cost of opposing them could be very high.

Ramifications

Probably the most important impact from the events in Turkey is that it reminds investors of the inherent risks in emerging markets. Violent changes in governments are quite rare in developed markets. Although emerging markets as a whole were not dramatically affected by Turkey, we do expect that Turkish markets will be volatile as the state of emergency unfolds and the purges widen.

So far, Turkey's oil pipelines have remained open. We would expect them to remain so; however, the robustness of the Turkish military is now in question and it may take years for it to rebuild. Thus, if IS decides to target oil flows, disruptions would be possible and Turkey's security services may struggle to prevent them. A series of disruptions could be bullish for crude oil prices.

Although we expect EU leaders to turn a blind eye toward Erdogan's growing authoritarianism, if Europe decides in favor of the value principle over expediency then European financial assets could come under pressure if the current refugee crisis escalates. This is not our base case, but the possibility does exist.

Overall, the biggest issue is that a nation that stands at the crossroads of the East and West is going through serious adjustments. Although we expect Erdogan to prevail, the risk of instability is high. If Turkey becomes unstable, the potential will rise for negative conditions to develop in oil markets and in Europe.

Bill O'Grady
August 8, 2016

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.