Weekly Geopolitical Report

By Bill O'Grady

October 5, 2015

Putin and Syria

Last month, Russia moved a significant amount of military hardware into areas of Syria controlled by the Assad regime. The action caught the Obama administration by surprise and raises questions about what Russian President Putin is trying to accomplish.

In this report, we will examine Russia's short-term geostrategic goals and the tactics Putin is using to achieve these aims. As always, we will conclude with potential market ramifications.

Russia's Goals

Russia has four short-term goals.[1] These are as follows:

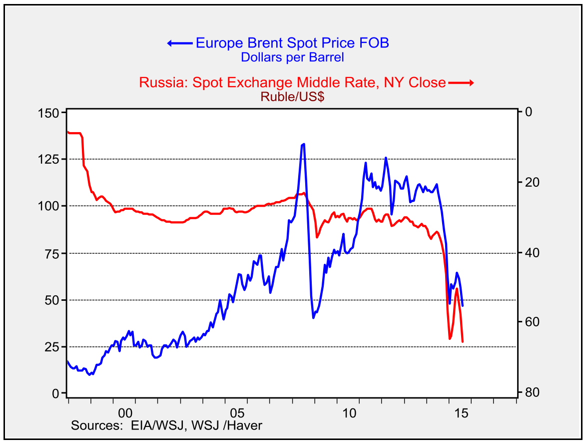
Sanctions Relief: U.S. and European sanctions have become a serious drag on the Russian economy. In March 2014, the U.S. and Europe began implementing sanctions against Russia after Putin ordered the annexation of the Crimea and had Russian operatives infiltrate the eastern regions of Ukraine. Over the following months, sanctions were tightened as both the U.S. and Europe took additional actions to interfere with financial flows and investment into Russia.

During the past year, Russia has been forced to delay drilling activity in the Arctic. A major project was initially undertaken with Exxon (XOM, 72.97), but the firm pulled out of the venture after sanctions were imposed. The Russian partners have admitted that drilling will be delayed until 2020, which means that the likelihood of any oil production from this region won't occur until mid-decade at the earliest. Russia will need that new supply to remain relevant in the global oil markets and sanctions have undermined that effort.

In addition, the Liquefied Natural Gas (LNG) processing facility at Yamal has lost its ability to source U.S. dollar (USD) based loans. The project has participants from three countries, Russia, France and China. Given the fact that China doesn't participate in sanctions, most of the project's funding has come from China. However, the recent financial problems in China have limited financing for this project. In addition, sanctions make Russia more dependent on China, a country with which the former has had difficult relations over the past century.

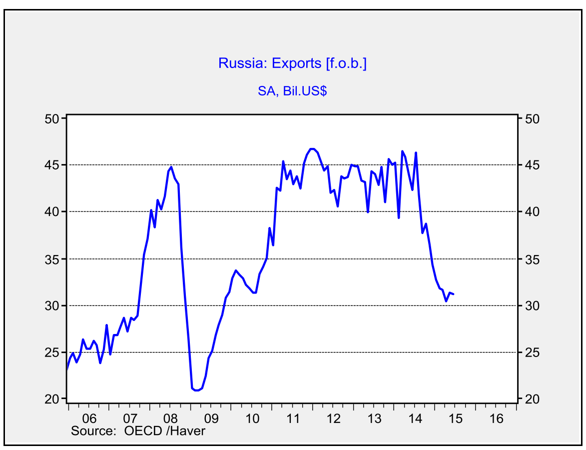
Sanctions, coupled with the decline in oil prices, have put significant pressure on the Russian economy. The following charts show these problems.

[1] Russia's long-term goal has been consistent across all previous governments—to expand its buffer zones as far as it can manage. Because the country lacks natural barriers to invasion, throughout its history, it has protected itself by expanding as far west and south as it can. This strategy had two major successes: against Napoleon and Hitler. However, this strategy is expensive to maintain and, eventually, governments lose control of these buffer zones and are forced to regroup. This leads to periods during which the Russian borders collapse toward the core areas of the country. Over time, the process begins again.



This chart shows the Russian ruble (RUB) on an inverted scale along with the price of Brent crude oil. Note that as oil prices declined, the RUB fell sharply; however, it was already weakening by the time oil prices plunged.

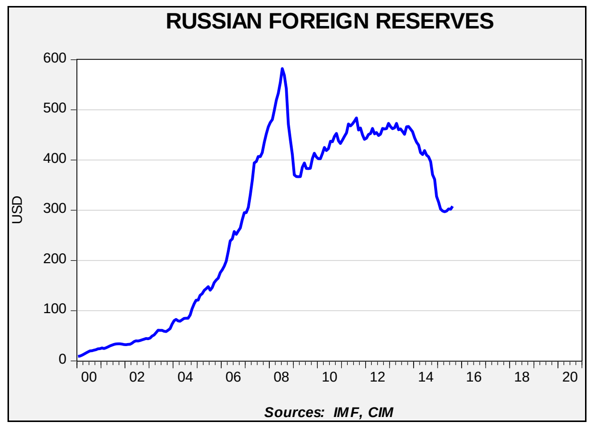
Despite the weaker currency, Russian exports have plunged.



Falling oil prices and restrictions on financing have made it harder for Russia to export goods.

Industrial production has fallen sharply as the economy contracts due to sanctions and weak commodity prices.

Finally, Russia's foreign reserves have also contracted.

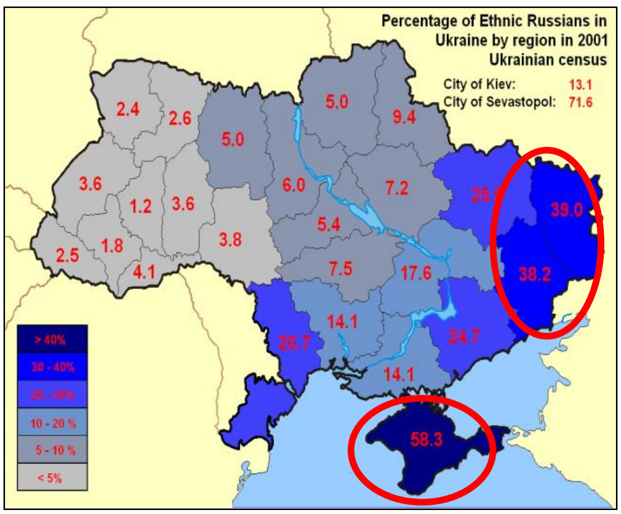


Russia's reserves have stabilized only because the central bank stopped defending the RUB. Although Russia has built a rather impressive level of reserves since Putin took office in 2000, much of that was due to higher oil prices.

To support the economy, lifting sanctions is critical. Russia needs access to Western financial markets and technology, and sanctions are restricting its ability to acquire these resources.

Control Ukraine: In order to protect the core of Russia, Ukraine must either be absorbed into Russia or at least aligned with Russian interests. The Orange Revolution weakened Russia's influence in Ukraine and the ouster of former Ukrainian President Yanukovych was a serious blow to Russian interests. In order to prevent Ukraine from joining NATO and putting the Russian state at risk, Putin annexed the Crimea and has fostered separatist movements in the regions of Luhansk and Donetsk.

However, these actions have backfired on Putin. Given the regions Russia now effectively controls, the bulk of Russian sympathizers in Ukraine are in regions outside the control of Kiev.



(Source: Wikipedia Commons)

The red circles identify the three regions where Russia has sponsored separatist movements. Note that these areas have high levels of ethnic Russians. Although Putin has tried, through the Minsk agreements, to force the Luhansk and Donetsk regions into national votes, Ukrainian President Poroshenko has wisely refused to support any polls in the occupied regions. ***As the numbers show, Ukrainian policy will tend to lean West due to the low level of Russian support in the rest of the country.*** So, supporting separatist movements and occupying the Crimea has reduced Russian influence in Ukraine and led to sanctions. Tactically, Putin was able to successfully gain control of part of Ukraine and can use this leverage to keep the country unstable. However, strategically, the move looks like a loser.

Expand Influence: The Soviet Union shared a superpower duopoly with the U.S. until the communist state dissolved in 1991. Putin has been trying to return Russia to geopolitical relevance since he took office in 2000. The decision to move military equipment into Syria is part of Russia's desire to widen its global influence.

Protect Russia from U.S. Policy: Putin sees U.S. foreign policy as reckless. President Bush's decision to oust Saddam Hussein left a significant power vacuum in the Middle East. President Obama's support of the "Arab Spring" has led to instability in Egypt and the ouster of authoritarian governments in both Libya and Syria. In fact, the West actively supported the ouster of Muammar Gaddafi through a U.N. resolution and the U.S. has persistently called for Syrian President Assad to resign. In the aftermath of these actions, Libya is a country in name only and the territorial integrity of Syria is lost. In Iraq, the decision to oust Saddam Hussein led to a civil war that has made Iraq difficult to govern. President Obama's decision to prematurely exit Iraq has fostered the dissolution of the country and led to the rise of Islamic State (IS). Due to the power vacuum created in Iraq and Syria, IS has established a strong foothold and has the potential to spread its radical jihadist creed throughout the region. In fact, it would not be a stretch to see IS operatives finding their way to Chechnya and becoming a direct threat to Russia. Although the U.S. sees Assad as a tyrant that kills his own citizens, from Putin's perspective, removing him without a plan may lead to even worse conditions. Unfortunately, Putin has ample evidence to suggest that the U.S. does not have a real plan other than to rely on the faith that democracy will create a new government in Syria. That hope clearly hasn't worked too well in the Middle East.

Tactics and Strategy
President Putin can probably be best characterized as a good tactician but a poor strategist. Russia has supported a number of "statelets" besides the three in Ukraine, which are South Ossetia and Abkhazia in Georgia and Transdniestria in Moldova. In addition, Russia provides some peacekeeping in Nagorno-Karabakh. These statelets give Russia influence in its "near abroad" and help it expand its control at a relatively low cost. It appears that the recent military buildup in Syria is designed to create an Alawite statelet that will allow Russia to keep its naval base at Tartus and give it a platform to build its influence in the Middle East. Thus, Putin will try to protect Assad or his successors to maintain influence in the region.

However, the decision to support Assad militarily is risky. First, it has angered the Gulf Sunni powers, who have already gone on record indicating they cannot support efforts to keep Assad in power. Second, the jihadist insurgency, which includes IS but also a series of other jihadist groups in the region, is dangerous and will likely attack Russian positions in Syria.

Putin believes he is filling the power vacuum left by the Obama administration's refusal to maintain America's traditional role in the region. Unfortunately, Russia does not have the military or financial capacity to wage a serious campaign against IS or the other insurgent groups in the region. The Obama administration's unofficial response has been to tell Russia to "go for it."

Ultimately, it appears that the primary goal of Putin's military buildup is to make Russia a key player in stabilizing the region and use this effort to convince Europeans to ease economic sanctions. Thus, we would expect (and to some extent, have already seen) a reduction in hostilities in Ukraine between the breakaway regions and Kiev. If Putin can form a new coalition to fight IS and keep Assad in power or broker his exit to another leader amenable to all parties, he could probably press for an easing of sanctions.

That goal, though worthwhile, is probably unrealistic. The fact that the Sunni powers already oppose him means that they will lift their support for jihadist insurgents fighting Assad; in fact, it wouldn't be out of the question to see some support for IS. In addition, Turkey may undermine Russia's efforts if Russia supports Kurdish ambitions for autonomy.

So, tactically, Putin has maneuvered brilliantly to undermine President Obama's and America's image in the region and the world. Strategically, he has probably put himself into a difficult position that may force him to expand Russia's role in the region, which will likely be expensive and still may not achieve his goals.

Ramifications
Whenever tensions increase in the Middle East, the immediate worry is that oil prices will be affected. In fact, oil prices probably will be the key market affected by Russia's actions. The problem is determining the directional impact of Russia's actions on oil prices. On the one hand, the Sunni states, which are infuriated by Russia's support of Assad, might try to expand oil production to drive down prices and further cripple Russia's economy. On the other hand, anytime there is military conflict in the

region, there is a certain degree of risk that something will go wrong and oil supply will be disrupted.

For the most part, we doubt the Gulf States have the stomach for a larger drop in oil prices. To balance its fiscal spending, Saudi Arabia needs oil prices of $105 per barrel. Low prices are forcing the kingdom to tap its foreign reserves. Although Saudi Arabia has ample reserves, it will likely try to retain them as long as possible. In addition, according to the Department of Energy, OPEC only has 1.5 mbpd of excess capacity, so the ability to add more barrels to the market is limited.

Thus, Russia's decision to intervene militarily is probably bullish for oil prices. Unfortunately, its impact is binary; until something happens to reduce supplies, oil prices will likely remain soft, but if something happens to affect oil flows, history suggests prices could spike significantly higher. For concerned investors, an appropriate strategy that comes from Russia's involvement is to reduce underweights in energy.

Bill O'Grady
October 5, 2015