

November 5, 2018

Reflections on the Khashoggi Incident: Part I

Jamal Khashoggi, a well-connected Saudi journalist, entered the Saudi consulate in Istanbul on October 2nd and has not been seen since. His apparent death (at the time of this writing, no body has been produced) has caused an international incident.

The assumed death of Khashoggi highlights a number of issues for the Middle East that we will explore in this two-part series. This homicide did not occur in a vacuum and the context of this event could have broader ramifications for the region. We will not recount the events leading to his death nor dwell on the details of the apparent murder, which have been widely reported in the world media. However, our decision to not discuss the details of the event does not mean we overlook it on a human level. What happened to Khashoggi was terrible, but the focus of this report is to give context to this ugly event.

In Part I of this report, we will begin with the particular problem of kingly succession in the Kingdom of Saudi Arabia (KSA). We will pay particular attention to the generational change in power that Crown Prince Mohammad bin Salman (MbS) represents. We will note the history of earlier successions and examine the potential for instability if King Salman dies and MbS remains crown prince. Part II will deal with the regional power rivalry between Turkey and the KSA, along with Turkish President Erdogan's actions in the wake of

this homicide. We will analyze U.S. policy goals in the region followed by our expectations for the resolution of this incident. As always, we will conclude with market ramifications.

Saudi Succession

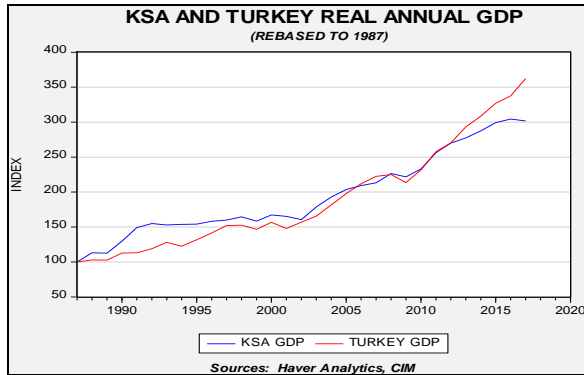
The KSA was founded by Ibn Saud, a charismatic sheik who created the modern kingdom. Through military campaigns and intermarriage, Ibn Saud gradually unified the territory on the Arabian Peninsula to create the modern Saudi state. During this process, he had at least 22 wives and 45 sons, 36 who survived to adulthood. He ruled Saudi Arabia from its founding in 1932 until 1953.

Due to the large number of sons, Ibn Saud created a succession plan that would shift from brother to brother rather than the more traditional process known as primogeniture, in which the reign is passed from the eldest brother to his eldest son. This new succession plan did manage to maintain peace among the founder's sons but it also held the potential for an eventual crisis as the generation of the sons of Ibn Saud aged out.

The problem with this method is seen by noting the age of each succeeding king. Ibn Saud, the founder and first king, was 57 when he took power. His oldest son, Saud, succeeded him at age 51. Saud was replaced by Faisal at age 57. Khalid came after Faisal at age 62. Fahd succeeded him at age 61. After Fahd, the age of succeeding kings rose markedly. Abdullah was 81 when he took the throne, and the current king, Salman, was 79 when he took office. The age progression alone makes it clear that the

plan of promoting the first generation of brothers is nearing its end.

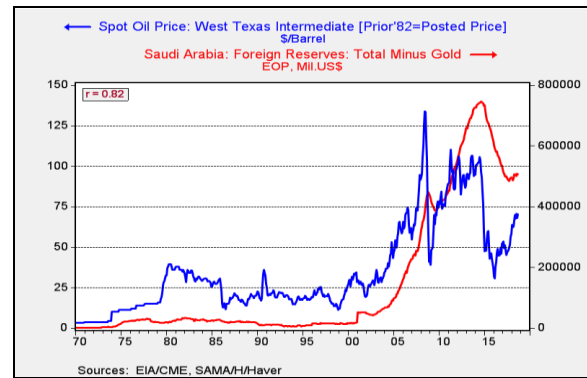
The age drift for kings has led to two significant problems. First, economic growth has become increasingly sluggish as the elderly kings failed to reform and diversify.



This chart shows the annual real GDP of the KSA; for contrast, we also show the other major Sunni power in the region, Turkey. We have rebased the data to 1987 for comparison purposes. In the early years, the Saudi economy outperformed Turkey, although by 2005, as Turkish President Erdogan solidified power, Turkey's economy began to catch up with the KSA. Since 2012, the Turkish economy has expanded rapidly and is now 20% larger than the KSA's economy. Turkey, as we will discuss below, is a regional rival for the KSA and Turkey's growing economic clout is a reminder of the KSA's need for reform.

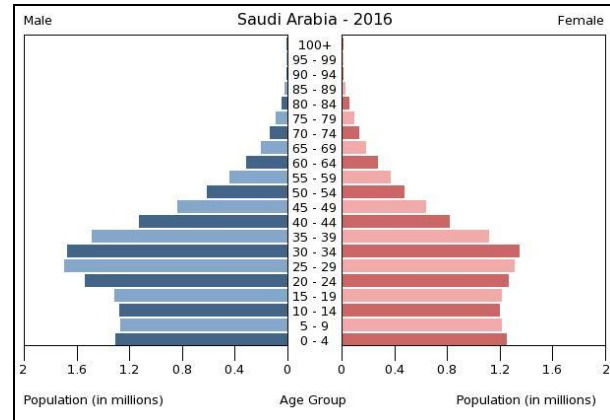
Second, the KSA remains dangerously dependent on oil prices. The next chart shows the relationship between the KSA's foreign reserves and oil prices. The two series are highly correlated at +82%. The Saudis tend to project power through aid and foreign investment and maintain domestic tranquility as a rentier state, offering cradle-to-grave support for Saudi subjects. The ability to fund this largess is essentially due

to foreign reserves, which, as shown below, come from oil prices.



The need for economic reform is obvious. A single-dimensional economy dependent on a key commodity is vulnerable to price declines and, in the case of oil, policy adjustments on climate change could be devastating.

In addition, the population is very young.



(Source: The Central Intelligence Agency. - The World Factbook, Public Domain, <https://commons.wikimedia.org/w/index.php?curid=61454133>)

This young population has been chafing under the religious restrictions that the older generation of rulers accepted as part of the coalition of the House of Saud and the Wahhabi clerics.

In June 2017, King Salman removed then-Crown Prince Nayef, an older 2nd generation

prince, in favor of the king's son, MbS. The new crown prince painted himself as a reformer, implementing restrictions on the clerical police, changing regulations on women driving cars and offering an aggressive economic reform plan. The king has given MbS wide powers, effectively removing any contender to the throne from any power center in the kingdom.

Although the plans for social and economic reform have been lauded by the West, the crown prince has exhibited reckless behavior as well. His war in Yemen continues to be a drain on resources with no end in sight. A year ago, he turned the Riyadh Ritz Carlton into a makeshift prison for princes and powerful private Saudi citizens who were accused of corruption.¹ The prime minister of Lebanon was held against his will and forced to make statements against Iran and Hezbollah. There was a crackdown on conservative clerics.² He also implemented a blockade of Qatar, a member of the Gulf Cooperation Council. In August, the KSA recalled its ambassador to Canada and expelled the Canadian ambassador to Saudi Arabia over Canadian criticism of human rights abuses in the KSA.³ The KSA, never overly tolerant of internal criticism, has become even less accepting under the effective government of MbS.⁴

¹<https://www.nytimes.com/2017/11/04/world/middleeast/saudi-arabia-waleed-bin-talal.html>

² See WGRs, Moving Fast and Breaking Things: Mohammad bin Salman, [Part I](#) (11/20/17) and [Part II](#) (12/4/17).

³ <https://www.wsj.com/articles/saudi-arabia-recalls-ambassador-to-canada-1533512832>

⁴https://www.washingtonpost.com/world/middle_east/khashoggi-death-throws-new-light-on-saudi-princes-crackdown-on-dissent/2018/10/22/8b9b72da-d56c-11e8-8384-bcc5492fef49_story.html?utm_term=.f9fda2db5493&wpisrc=nl_daily202&wpm=1

In light of these actions, the ill-fated apparent murder of Jamal Khashoggi fits a pattern. After years of stable, perhaps even ossified, leadership, the Saudi state is now in the hands of a rash and impetuous leader. There is some history for this pattern. The succession from Ibn Saud was tumultuous.

The first King Saud, the eldest son of the founder, ended his rule in abdication, effectively deposed by his brothers. The first successor to Ibn Saud was erratic and a spendthrift; he attempted to assassinate Egyptian President Gamal Nasser and engaged in a proxy war against Egypt during the Yemen civil war in the early 1960s. The clergy and Saud's powerful brothers (Princes Khalid, Fahd and Abdallah, all three future kings) conspired to force Saud's ouster. In 1964, Saud was deposed in favor of his brother, Faisal, Ibn Saud's third son and the prime minister during the Saud administration. Although Faisal was considered a good king, he was assassinated by a half-nephew. The kingdom's leadership really wasn't stabilized until King Fahd, who was king from 1982 to 2005.

One potential outcome is that the generational shift to the grandsons of Ibn Saud may be as tumultuous as the succession to the sons of the first king. There are hundreds of king-eligible princes and their fear is that a King MbS would favor his own children and forever shut out the other grandsons of Ibn Saud. MbS's reckless behavior may, in part, reflect his legitimate worry that his elevation to power has created enemies among his fellow royals. At the same time, this reckless behavior increases the chances of instability. In other words, the shift to the next generation of the royal family may carry much more risk than generally realized.

Part II

Next week, we will conclude this report with a discussion of the regional power rivalry between Turkey and the KSA, along with Turkish President Erdogan’s actions in the wake of this homicide. We will analyze U.S. policy goals in the region, followed by

our expectations for the resolution of this incident and concluding with market ramifications.

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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.

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