

December 11, 2017

Moving Fast and Breaking Things: Mohammad bin Salman, Part III

In [Part I](#) of this report, we began with a brief background of Mohammad bin Salman (MbS) and discussed the surprise arrests of many leading figures in Saudi society, including several members of the royal family, that occurred the weekend of November 4. In [Part II](#), we examined the forced resignation of Saad Hariri, the missile attack on Riyadh and the crackdown on the clerics, which all took place the same weekend as the events discussed in Part I. This week, we will analyze how these events fit into the broader geopolitics, discuss the drift in American foreign policy and conclude with market ramifications.

The Broader Geopolitics

It is important to view the actions being taken by MbS within a specific context that partially explains some of his behavior. After WWII, the U.S. took on the superpower role; for most of the period, it shared that role with the Soviet Union.

President Truman, using the theoretical construct from George Kennan's "long telegram,"¹ made containing communism the key element of American foreign policy. The American public generally accepted this position and supported it. However, there were four other elements of foreign policy that were not acknowledged and were, in fact, hidden within the rubric of containing communism. These involved "freezing"

¹https://www.trumanlibrary.org/whistlestop/study_collections/coldwar/documents/pdf/6-6.pdf

potential conflict areas and providing the reserve currency.

The first conflict zone was **Europe**. Europe had been the breeding ground for two world wars. The problem with Europe was mostly caused by its physical geography that precluded unification. It has southern mountain ranges that cut off the Iberian Peninsula and Italy. The Baltic Sea separates the Nordic states from the continent. The British Isles are large enough to support a large population and industry, but far enough away to allow Britain to interfere with the continent without fully joining it.²

Nevertheless, the biggest problem was Germany. Until 1870, the area now known as Germany was either part of the loose federation called the Holy Roman Empire or simply a group of small states and principalities that essentially acted as a buffer between France and what is now Eastern Europe. When the Prussians united Germany in 1870, it created a large state in the middle of the continent with much of it sitting on the Great Northern European Plain. Its few natural barriers meant that when Germany industrialized, it was destined to become an economic powerhouse. At the same time, the lack of natural boundaries meant it was always in danger of being invaded from both the east (Russia) and west (France).

² It should be noted that the last successful land invasion of Britain was in 1066 and the recent Brexit decision should not be a surprise given the history of British relations with the continent.



(Source: www.thefreebiespot.com)

As this map shows, northern Germany has no natural barriers; essentially, an army could march almost unimpeded from the Pyrenees Mountains to the Ural Mountains.

After WWII, Germany was divided into four zones managed by the four allied powers—the U.S.S.R., U.S., U.K. and France. When the Soviets would not allow elections in their zone, the other three formed West Germany and the Soviet zone became East Germany. The U.S., through NATO, essentially took over the defense of Europe. Germany no longer had to fear invasion as long as the U.S. was willing to provide security. Postwar Germany could focus on economic recovery and development, which it successfully managed. Under NATO, the European militaries atrophied and are now generally unable to conduct high intensity military operations on a sustained basis.³ At the same time, the lack of military power in Europe essentially guarantees that European powers won't start another major ground war.

The second area of concern was the **Far East**. Japan and China had fought occasional wars since the 13th century; thus, conflict between the two nations was not

³ This became clear during the bombing campaign against Libya in 2011. See: <https://newrepublic.com/article/87377/libya-nato-military-power-europe-us>

unusual. However, during the late 1800s, the issue began to escalate. Japan emerged as a major world power in the late 19th century. The Meiji Restoration led Japan to adopt Western practices and the modernized economy allowed for the creation of a strong military. Japan defeated both China and Russia in a series of wars, starting in 1895. However, even with these victories, Japan struggled with a significant vulnerability—it had few natural resources on the island and was always at risk to a blockade. To expand its resource base, it invaded China in 1931. Over time, the U.S., fearful of Japan's rising power, began implementing a series of economic sanctions in the late 1930s. After Japan formally allied with the Axis powers in 1940, Japan took control of French Indochina after France's defeat in WWII. This led the Roosevelt administration to implement a scrap metal embargo and close the Panama Canal to Japanese shipping in the same year. Further Japanese encroachment into Indochina led the U.S. to implement an oil embargo and freeze Japanese assets in the U.S. in the summer of 1941. In December, Japan bombed Pearl Harbor, formally bringing the U.S. into WWII.

In the aftermath of WWII, the U.S. demilitarized Japan and guaranteed its security, as it had in Europe. This policy not only protected Japan, it assured ready access to raw materials and made it clear to the island nation's neighbors that they would not need to fear future incursions from Japan. This policy supported Japan's recovery and laid the groundwork for regional growth that has accelerated over time.

The third conflict area was the **Middle East**. The problems in this region were different than in Europe or the Far East. In the Middle East, France and Britain controlled

the region after WWI in response to the collapse of the Ottoman Empire. The colonies they created were not natural states; tribal, ethnic and sectarian groups were haphazardly distributed across national borders. To maintain control, the colonial powers would usually have a minority group dominate the government, making that group dependent on the colonial nation to remain in power. When these nations became independent after WWII, they were difficult to govern and tended to devolve into authoritarian regimes. Although such regimes were antithetical to American values, the U.S. wanted to maintain order in the region. Thus, successive American administrations during the Cold War supported objectionable regimes to prevent Soviet expansion. As the region became the world's preeminent oil producer, the U.S. had further cause to expand its influence to ensure the free flow of this critical resource to the Free World. The U.S. was not able to prevent periodic wars in the Middle East but it did manage to thwart the aspirations of any individual nation in the region from becoming regionally dominant. As part of this policy, the only nation that saw a significant change in its borders during the Cold War was Israel, which gained territory during the Six-Day War and the Yom Kippur War (although it relinquished much of the territory it captured after the latter conflict as part of a peace deal with Egypt).

By insisting on the territorial integrity of the nations in the region, U.S. policy likely prevented broader conflicts. The U.S. offered some support to both sides of the Iran-Iraq War and prevented either from significantly disrupting oil flows. That war ended in mostly an exhausted stalemate in 1988. In 1990, Iraq invaded Kuwait; as part of the stable border policy, the U.S., under U.N. auspices, assembled a large coalition to oust Saddam Hussein's forces from Kuwait.

However, President George H.W. Bush refused to pursue Hussein's troops into Baghdad, in part to honor territorial integrity.

The fourth unspoken element was the reserve currency role. The U.S. pursued this plan at Bretton Woods in 1944 in part to break up the British Commonwealth's pound zone. When the U.S. accepted this role, American GDP was nearly 37% of world GDP. Thus, the U.S. could easily absorb the imports the rest of the world sold into the U.S. to acquire dollars for reserve purposes. However, by the early 1970s, the drain on American gold reserves (as part of Bretton Woods, nations could exchange dollars for gold, maintaining a link to the gold standard) led President Nixon to close the gold window. Foreign nations, needing a reserve currency to conduct trade, adopted a dollar/Treasury standard, allowing the U.S. to run even larger trade deficits in exchange for U.S. government debt.

The Drift of U.S. Foreign Policy

The end of the Cold War was a major victory for the U.S. and the West. At the time, it was felt that there was no competing narrative or ideology for democracy and capitalism. The political establishment in the U.S. wanted to maintain American hegemony; however, there was a sense among most Americans that winning the Cold War relieved the U.S. from its superpower obligations. The inability to create a clear vision of American foreign policy in the wake of the fall of the Soviet Union has plagued U.S. policymakers.

The Middle East has borne much of the brunt of this policy drift. After 9/11, the U.S. invaded Afghanistan and Iraq. The removal of Saddam Hussein from power unfortunately created a power vacuum in Iraq. The British had installed the minority

Sunnis in power but to maintain order Hussein had to operate a brutal, repressive regime. When President George W. Bush overthrew the Iraqi government his administration attempted to create a democracy. However, the long-repressed Shiites won the subsequent elections and, as time has passed, they have oppressed the Sunnis.

Removing the Iraqi government led to a civil conflict that remains unresolved. Compounding the devolution was President Obama's support of the Arab Spring, which led to the collapse of Syria as well. The lack of stable governments led to the rise of Islamic State (IS), a proto-state that, for a time, held significant territory in what was once the border regions of Syria and Iraq. The U.S. and others have steadily attacked IS; at present, it appears this group is nearly vanquished. What replaces it is still uncertain.

President Obama's primary goal in the Middle East was to reduce American involvement. He wanted to "pivot" to the fast-growing Asian region and needed the resources that were tied up in the Middle East to be freed up in order to shift away from that region. His support of the Arab Spring complicated matters further, supporting unrest and eventually contributing to the implosion of Syria and Libya. Obama did realize that if the Asian pivot was going to occur, a regional hegemon to maintain stability was necessary. He opted for Iran, a defensible but politically risky choice.⁴ President

⁴ A cogent defense of allying with Iran in the Middle East was made by Robert Baer, a former CIA operative who was portrayed by George Clooney in the film *Syriana*.

Baer, R. (2008). *The Devil We Know: Dealing with the New Iranian Superpower*. New York, NY: Crown Publishers, a division of Random House, Inc.

Obama's administration negotiated a nuclear agreement with Iran. Assuming compliance, it would prevent Iran from developing a nuclear weapon for about a decade. Five other nations in Europe agreed to the terms of the deal. In return, Iran would have some economic sanctions lifted. Although this agreement was limited, we suspect it was the first step in a plan to normalize U.S./Iranian relations and allow Iran to become the regional hegemon in the Middle East. It is likely President Obama assumed Hillary Clinton would win the 2016 election. The unexpected election of Donald Trump essentially scotched any further progress toward normalization.

One can argue that every president since George H.W. Bush has made significant mistakes in the Middle East. President Clinton escalated sanctions on Iraq with the goal of regime change with no clear idea of who should replace Saddam Hussein. George W. Bush invaded a weakened Iraq, removed Hussein from power, and failed to build a democratic government (which always had a low probability of success). By the time Bush handed the Oval Office to Barack Obama, the civil war in Iraq was quelled but the government wasn't functioning well. President Obama left Iraq too quickly and was unable to complete normalization with Iran.

Watching all these developments were the al-Sauds in Saudi Arabia. They counseled against George W. Bush's war in Iraq, fearing the key counterweight to Iranian power in the region would be crippled or lost. That prediction turned out to be the case. They likely watched in horror as President Obama negotiated with Iran. And so, when President Trump became president, the Kingdom of Saudi Arabia (KSA) moved quickly to rebuild relations with the U.S. They invited the new American president to

Riyadh early in his term and went out of their way to flatter him. MbS and Jared Kushner are said to have developed a rapport.⁵ There are reports he made an unannounced visit to the KSA in late October, not long before the events of the November 4 weekend.⁶

MbS appears to be trying to reverse President Obama's policy direction of favoring Iran. Although this action is quite reasonable, the KSA should be cautious about the degree of support it can expect to receive from Washington. The growth of the U.S. shale industry has made oil from the Middle East less critical for the U.S. economy. The idea of American soldiers risking their lives to protect the flow of oil so that Europe and Asia can enjoy supply security will be a difficult notion for this administration and, in fact, may become difficult for any future U.S. administration to justify.

Saudi Arabia has a long history of asking others to fight its battles.⁷ It wanted Pakistan and Egypt to join it in Yemen; both demurred, despite receiving significant aid from the KSA. President Trump offered verbal support for the KSA's actions in Qatar but Secretary of State Tillerson tried to negotiate a way out of the impasse. A similar situation developed with Hariri's resignation. President Trump offered supportive tweets, while Tillerson indicated

⁵ <http://foreignpolicy.com/2017/11/07/jared-kushner-mohammed-bin-salman-and-benjamin-netanyahu-are-up-to-something/>

⁶ <https://www.politico.com/story/2017/10/29/jared-kushner-saudi-arabia-244291>

⁷ A famous quote via Wikileaks from former Defense Secretary Robert Gates is indicative of this tendency, in which he said, "The Saudis will fight the Iranians to the last American."

<http://foreignpolicy.com/2010/12/01/gates-saudis-want-to-fight-iran-to-the-last-american/>

the U.S. would not support undermining stability in Lebanon.

We are sympathetic to MbS's desire to modernize the KSA. A Saudi Arabia that no longer acts as a rentier state with a diversified economy and a moderate religious environment would be a great development. However, it isn't obvious that this can be accomplished while the KSA is simultaneously trying to prevent Iran from becoming regionally dominant and trying to be the dominant power itself. Using the example of the young tech giants who "move fast and break things," much good can come from ending entrenched structures. But, there are always negative externalities which develop from major changes that need to be addressed. In fact, dealing with the fallout from structural changes is usually what determines the success or failure of such endeavors.

The U.S. is clearly struggling to manage its superpower role. The burdens of hegemony have distorted the U.S. economy and political system, and the growing dysfunction in American politics is mostly due to the inability to decide how to integrate American hegemony with domestic needs.

History suggests that a waning superpower can choose to reduce the burden of hegemony by ceding certain global responsibilities to others. The British faced this problem in the late 1800s. The U.S. economy was industrializing rapidly and would allow for the expansion of the military, especially the Navy. Britain faced a rapidly rising Germany and needed to manage a sprawling empire. The arms race that would be required to maintain naval superiority over the U.S. was simply going to be too costly; if Britain was going to allocate resources to quelling the U.S. it

would be forced to either give up its influence in Europe or reduce the size of its empire. It chose to simply cede the Western Hemisphere to the U.S., acknowledging that an American attack on Canada would not have been answered.⁸

At present, American policymakers are not having these discussions. Instead, political elites are pressing to maintain the full hegemonic role while populists want to dramatically reduce America's role in the world. Without a deliberate policy, circumstances will eventually force a choice.

It appears to us that of the three aforementioned potential conflict zones in the world, the U.S. has decided it will reduce its involvement in the Middle East. The invasion of Iraq, which ended Baghdad's capacity to balance Iran, the support of the Arab Spring and America's decision to allow the territorial integrity of the region to disintegrate suggests the "thaw" is underway.

There is no evidence to suggest this decision is a well-defined program that will be consistently maintained regardless of administration. Unlike George Kennan's Cold War policy, we have seen significant shifts in Middle East policy among the last two administrations and now with President Trump. With Bush, the plan was to keep expending resources until Iraq stabilized. President Obama wanted to reduce U.S. influence and leave Iran in charge. We suspect President Trump also wants to reduce American involvement in the region but leave the KSA in control. Given these policy inconsistencies, the "locals" are going to decide the outcome themselves.

⁸ Allison, G. (2017). *Destined for War: Can America and China Escape the Thucydides's Trap?*. New York, NY: Houghton Mifflin Harcourt. Pp. 194-199.

Although clearly not an ideal outcome, it appears to us it is the most likely.

If our assessment is correct, it means the level of turmoil in the region is likely to increase. This is a delicate moment and into this situation comes a hard-charging MbS who is trying to make massive changes in a short time frame. We suspect the U.S. will try to slow him down as America does not want to be pulled into a regional war.⁹ At the same time, there is growing evidence that MbS is trying to manage the fallout in the royal family by arranging plea bargains (which will likely also boost the government's coffers).¹⁰ Still, the chances of miscalculation are quite elevated and the potential for unexpected outcomes is rising. There is no doubt that the KSA is in need of reforms and the plans that MbS has outlined make sense. However, plans are one thing, execution is another. The world is full of elaborate plans made by consultants and intellectuals that are elegant and well-conceived. Unfortunately, it takes political skill to bring such plans to fruition. It isn't clear that MbS has those skills. If he does, history will show him to be a great leader. If he doesn't, he could drag the region into a significant conflict.

⁹ <https://www.al-monitor.com/pulse/originals/2017/11/us-counseling-restraint-saudi-arabia-israel-syria-back-druze.html>

¹⁰ <https://www.ft.com/content/e888a676-caa9-11e7-ab18-7a9fb7d6163e>; https://www.washingtonpost.com/opinions/global-opinions/saudi-arabias-prince-is-doing-damage-control/2017/11/16/e3710ba4-cb14-11e7-8321-481fd63f174d_story.html?utm_term=.fd98aec375af; and <https://www.reuters.com/article/us-saudi-arrests-assets/saudi-arabia-swapping-assets-for-freedom-of-some-held-in-graft-purge-sources-idUSKBN1DH0YZ>

Ramifications

Wars in the Middle East raise the threat of oil supply disruptions. Most of the time, the disruptions are short-term in nature. In addition, the availability of strategic reserves should dampen the price risk of a disruption. However, everything we know about market action has occurred with the U.S. playing a major role in stabilizing the Middle East. If we are no longer as involved, history is less useful in guiding price forecasting. We suspect that a broadening conflict would lead to a much stronger price reaction than the recent past would suggest.

Fear of conflict would also increase flight to safety buying. The most positively affected assets would be energy, the dollar, gold, Treasuries and perhaps cryptocurrencies. A broader conflict would increase refugee flows which would have an adverse impact on European economies and assets.

At this point, we don't see a looming conflagration. The Saudis are tied up in Yemen and don't have the capacity to open up a war in Lebanon. We doubt the KSA can convince either Israel or the U.S. to fight a war on its behalf.

Iran tends to fight in the shadows; it specializes in asymmetric warfare and will not likely do anything overt (e.g., interdict KSA shipping, invade anywhere, etc.). Instead, we expect Iran to use cyberattacks, try to foster religious divisions and support disaffected members of the Saudi royal family. Thus, an overt conflict from Iran is unlikely. Still, the mercurial nature of MbS increases the likelihood of deteriorating stability and bears watching.

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