

December 7, 2020

The Disputed Territory of Nagorno-Karabakh: Part II

After a six-week war, Armenia regretfully conceded some of the disputed region of Nagorno-Karabakh to its longtime rival Azerbaijan. Making matters worse, Armenian President Armen Sarkisyan admitted that he wasn't even involved in discussions regarding his country's surrender. As of today, ethnic Armenians have evacuated the conceded regions, while Russian peacekeepers have moved in to ensure a smooth transition. Although the peace treaty appears to be holding, it isn't clear that this conflict is fully resolved. However, the Nagorno-Karabakh conflict does appear to have caused a seismic shift in the power dynamics within the Caucasus.

The Caucasus has long been dominated by the Russia, but regional conflicts appear to be undermining its standing. The most recent standoff between Armenia and Azerbaijan has not only allowed Turkey, a NATO member, to encroach on traditionally Russian territory, but it has also given Turkey a stage on which to demonstrate its improved military capabilities. Even though this is the third conflict in which Turkey and Russia have taken opposing sides, the others being Syria and Libya, it doesn't appear the two countries are on course for direct conflict. That being said, as the West continues to withdraw from the region, it is likely that Turkey will look to fill the void.

In Part II of this report, we will focus on the significance of the Nagorno-Karabakh conflict in understanding the global shift in geopolitical dynamics. We will begin with a broad overview of frozen conflicts, particularly after the collapse of the Soviet Union. Afterwards, we will discuss the West's influence and its subsequent decline in mediating conflicts outside of its borders. We will then discuss the rising prominence of regional powers in resolving these issues and what it could mean for the West going forward. As usual, we conclude this report by discussing possible market ramifications.

Frozen Conflict Zones

In 1968, Syracuse University professor Louis Kreisberg defined frozen conflicts as "those conflicts in which both sides have remained fully committed to their incompatible positions but where neither has yet dared to attempt resolution through accommodation, withdrawal, or military conquest."¹ Although this definition vastly oversimplifies the conflict between Armenia and Azerbaijan over the Nagorno-Karabakh region, as there were several attempts to resolve the issue, it does broadly define the reality. Given the political stakes, neither side has genuinely sought a peaceful resolution and has been deterred by outsiders from seeking resolution militarily.

Following the collapse of the Soviet Union, Armenia and Azerbaijan fought a war in 1991 to settle their dispute regarding Nagorno-Karabakh. During the conflict, Armenia was able to capture Nagorno-

¹[https://www.lawschool.cornell.edu/research/ILJ/up
load/Grant-final.pdf](https://www.lawschool.cornell.edu/research/ILJ/upload/Grant-final.pdf)

Karabakh and 20% of the surrounding Azerbaijani territory. In order to resolve the conflict, a ceasefire was brokered with Russia and the Minsk Group, a group consisting of the U.S. and France. Although in 1994 Armenia agreed in principle to return some of the land taken during the conflict, it failed to follow through on the agreement, angering Azerbaijan. As a result, there was little progress in obtaining a final agreement. Since the settlement, Armenians have continued to occupy the region, which is internationally recognized as rightfully belonging to Azerbaijan.

Over the past 30 years, the two sides have had a series of small skirmishes but nothing that put the 1994 ceasefire in jeopardy. The deadliest conflict took place in 2016 but it lasted only four days. Nevertheless, there were several ceasefire violations leading up to the most recent conflict.

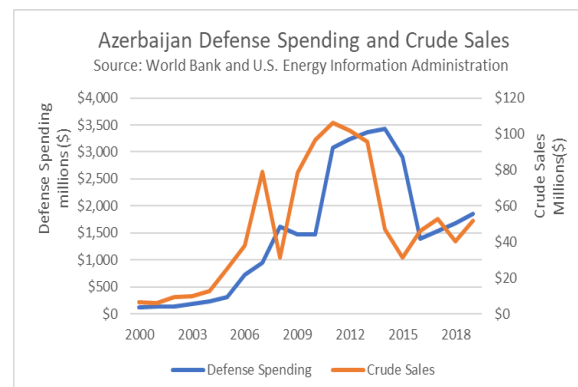
Separate but United?

One of the biggest hurdles to finding an agreement is figuring out a way that Nagorno-Karabakh can be considered a part of Armenia within Azerbaijan.² Even if Armenia were to recognize the international borders, the history between the two countries would make the arrangement politically untenable. Countries have attempted to peacefully mediate the situation but have been unsuccessful.

The Minsk Group, which has been brokering ceasefire agreements since 1994, has been somewhat ambiguous in its support of either country. It acknowledges the region as being part of Azerbaijan but has never formally asked the Armenians to respect the internationally recognized borders. The reason for this ambiguity could be attributed

to political and economic reasons. Armenia has a large diaspora of people across the world and, as a result, this group has been able to lobby governments on the country's behalf. Meanwhile, Azerbaijan has become a major energy producer and is a key partner in Europe's goal to diversify its energy sources.

Although the Minsk Group has been criticized for having a pro-Armenian bias, especially by Azerbaijan and Turkey, it appears the group may have become more indifferent toward the country in recent years. So far, none of the members appears to be against Azerbaijan's return to the region it ceded to Armenia. In fact, all the mediators seem to be pushing Armenia to restart negotiations to prevent further escalation.



Crude sales calculated by multiplying Crude production and Brent Crude price.

The change of heart may have something to do with the discovery of natural resources in Azerbaijan. Although its energy production has moderated in recent years, its production of crude oil surged from 280 mbpd to 1,035 mbpd from 2005 to 2010. The rise in production has allowed the country to drastically increase its defense spending as noted on the above chart. The improvement

² It is true that the Azerbaijan exclave Nakhichevan is surrounded by Armenia, but it is currently protected by Russian units.

in production has allowed Europe to secure more oil resources and has given Russia a new customer for its military equipment.

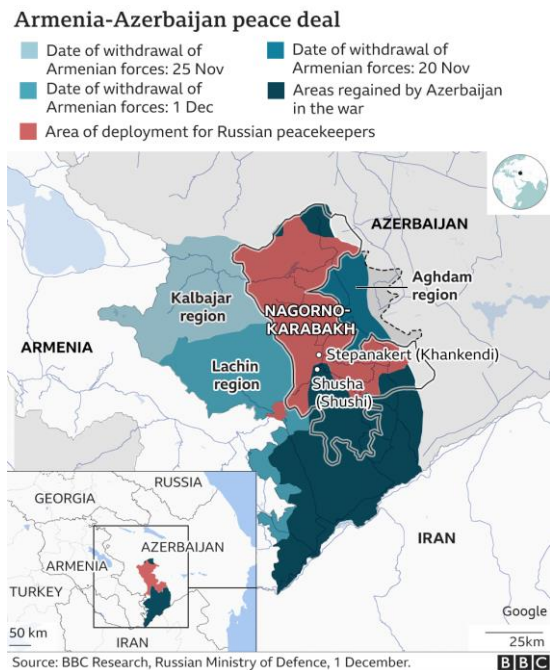
In addition to the economic gains from Azerbaijan's rise, the West and Russia may have cooled toward Armenia for strategic reasons. A huge part of the conflict took place on land where the South Caucasus Natural Gas Pipeline is being built. When finished, the pipeline, which is part of the Southern EU energy corridor, will be crucial in the EU bloc's energy diversification efforts as it will allow the bloc to import energy from Azerbaijan rather than from rivals Russia and Iran. Furthermore, given Armenia's ties to Russia, it is possible that Europe prefers the land to remain under full control of Azerbaijan, which has strong ties to NATO ally Turkey. Meanwhile, Russia was allowed to send its peacekeepers into Nagorno-Karabakh, therefore expanding its presence within Azerbaijan, something it has been aiming to do since the dissolution of the Soviet Union nearly three decades ago.

As mentioned earlier in this report, the land ceded by Armenia has always been recognized internationally as being part of Azerbaijan. Hence, possible retaliation on Armenia's behalf for the land grab was highly unlikely. That being said, we don't expect the recent ceasefire will become permanent as tensions between Armenia and Azerbaijan are more elevated than they have ever been. The former, especially those living in what is left of the Nagorno-Karabakh region, will never accept Azeri rule. Likewise, the latter will likely push for more control over the breakaway state. Although it isn't clear whether this conflict will ever be resolved, it is apparent that the Minsk Group's influence over the region has been surpassed by Turkey.

Along Came Turkey

In Part I of this report, we showed that Azerbaijan and Turkey's relationship goes back centuries. Turkey's allegiance to Azerbaijan, especially with respect to the dispute over Nagorno-Karabakh, has never been more apparent than in this recent conflict. Turkey supplied Azerbaijan with military equipment, logistical support, and, possibly, Syrian mercenaries. Its involvement in the Nagorno-Karabakh conflict as well as its conflicts in the Mediterranean, have led many to speculate that Turkey may have aspirations of becoming a regional hegemon.

Prior to this conflict, Turkey's increased assertiveness was putting many countries, including NATO allies, on edge. Its maritime dispute with [Greece and Cyprus](#) has caused friction among members of the EU that believe Turkey is violating the maritime rights of EU member countries. Meanwhile, its involvement in Libya and Syria have put it at loggerheads with France. Additionally, the U.S. was angered by Turkey's decision to purchase a Russian missile defense system. Tensions



(Source: BBC)

came to a boiling point in a December NATO meeting, when U.S. Secretary of State Mike Pompeo criticized Turkey for not behaving more like an ally.

Despite the rising animosity toward Turkey, the country does appear to be considered a strategic partner within NATO. Turkey has been fundamental in preventing a surge in immigration in Europe, has been willing to offer military support when needed in the Middle East, and has acted as a counterweight to Russia in Eastern Europe and the Middle East. Suffice it to say, it isn't likely that the country will be forced out of the alliance anytime soon. Nevertheless, if Turkey continues to undermine other members within the NATO alliance, it could find itself increasingly isolated.

And Then There's Russia

The Southern Caucasus has historically been under Russian influence. Russia views the region as a strategic barrier along its southern border. However, the last few months have tested just how much it values this region. Fraudulent elections, coups, and wars have made securing the region exceptionally costly. As Russia struggles to contain the coronavirus domestically, it appears that it is too preoccupied to focus on projecting its power throughout the region. This may have contributed to its decision to force Armenia, a country that it has a military pact to defend, to accept an unfavorable settlement with Azerbaijan. That being said, it is unlikely this arrangement will continue indefinitely as Russia has been notoriously protective of countries along its borders.

Broadly speaking, Armenia's defeat likely weakened Russia's standing as a global

power. By allowing Turkey and Azerbaijan to bully Armenia into submission, it suggests that Russia may not be totally committed to defending its allies. Worse, it shows that under the right circumstances Russia is willing to disadvantage an ally if presented with a suitable offer. In this case, Russia supported an agreement that forced Armenia to cede land in exchange for allowing Russia to place its peacekeepers in the remaining Nagorno-Karabakh territory.

At the same time, it is unlikely that Russia will be willing to tolerate future Turkish incursions. After Azeri soldiers accidentally downed a Russian helicopter, Putin threatened a military response if the country didn't immediately end its military operations. As a potential warning, it is believed that Russia launched a missile of "unknown provenance" into an occupied area of the [Azerbaijan capital Baku](#).^{3, 4}

Ramifications

The conflict over Nagorno-Karabakh between Armenia and Azerbaijan likely boosted Turkey's presence throughout the Caucasus. By providing military support to Azerbaijan, Turkey was able to display its military capabilities and assert its role as a regional power within Eastern Europe. Meanwhile, Russia's reluctance to come to the full defense of its ally, Armenia, likely suggests that, at least for the time being, it may be pivoting away from its traditional hard-power tactics, especially while it is combating the coronavirus. The biggest unknown is how the West fits into the equation as it had virtually no say in the recent ceasefire agreement.

If Turkey continues to emerge as a regional power in the Caucasus, it could potentially

³ There were no casualties.

⁴<https://www.nytimes.com/2020/12/01/world/europe/nagorno-karabakh-putin-armenia-azerbaijan.html>

be on a collision course with Russia. Although war is unlikely, it is becoming clear that Turkey doesn't mind stepping on Russia's toes in order to achieve its goals. Hence, the conflict likely foreshadows future friction between the two countries. Additionally, Turkey's increased assertiveness will likely make it vulnerable to sanctions by its allies. Unlike President Trump, who views him as a friend, Turkish President Recep Erdogan does not have a good relationship with President-elect Biden. In fact, Biden called Erdogan an [autocrat](#). Given Turkey's already tense relationship with the EU, it is unlikely that Turkey will scale back its military activities

anytime soon. As a result, we suspect that Turkey's assertiveness could lead to some instability in the Caucasus and the Middle East. If Turkey were to get drawn into a full-scale war it will likely create supply-chain bottlenecks and a flight to safety to U.S. Treasuries and dollar assets. Gold and oil would also likely benefit. At this time, we believe the likelihood is low that Turkey gets drawn into war, but we do acknowledge the risk will remain elevated as long as Turkey continues to assert itself on the global stage.

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This report was prepared by Thomas Wash 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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