

June 17, 2019

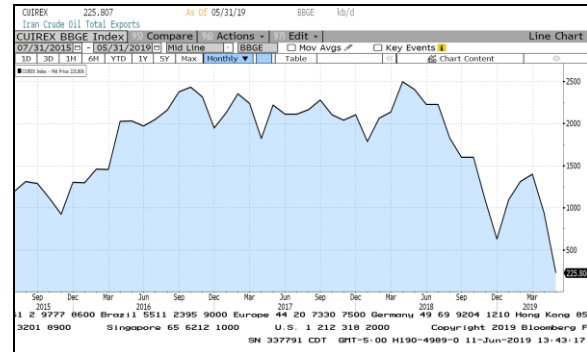
## War with Iran?

Over the past year, U.S. relations with Iran have deteriorated. In May 2018, President Trump announced he would [withdraw](#) from the Joint Comprehensive Plan of Action (JCPOA), a multinational treaty that was designed to slow, but not eliminate, Iran's nuclear development. As part of exiting the JCPOA, the U.S. reapplied sanctions that have reduced Iran's oil exports. Since the U.S. has taken this action, the Iranian economy has suffered, with inflation rising to dangerous levels.



This chart shows the yearly change in Iran's CPI. We have placed a vertical line at the point where the U.S. pulled out of the JCPOA. Note that inflation has jumped from a yearly increase of 10% to over 50%.

Sanctions have dramatically reduced Iran's oil exports, shown on the following chart. Before the U.S. withdrawal, Iran was exporting around 2.5 mbpd of crude oil. That number has declined to 0.3 mbpd.



(Source: Bloomberg)

Iran has been threatening to retaliate in the face of a weakening economy. In a previous report last year, we examined potential responses by Iran. These included [restarting the nuclear program](#), [projecting power into the Middle East](#), [closing the Strait of Hormuz](#), [deploying a cyberattack](#), [building a coalition against the U.S.](#) and [renegotiating the JCPOA](#).

Some of the actions that Iran might take could escalate into a hot war with the U.S. In this report, we will begin with an examination of the geography and geopolitics of Iran. Using this information, we will discuss what a war with Iran might look like. We will also reflect on the very nature of war and alternatives to the use of military force within the context of Iran. As always, we will conclude with market ramifications.

### The Geography and Geopolitics of Iran

Iran covers 1.7 million square kilometers (636,372 square miles), making it the [17<sup>th</sup> largest country in the world](#), similar in size to Libya or Mongolia. Its area is larger than the combined areas of France, Germany, the Netherlands, Belgium, Spain and Portugal.

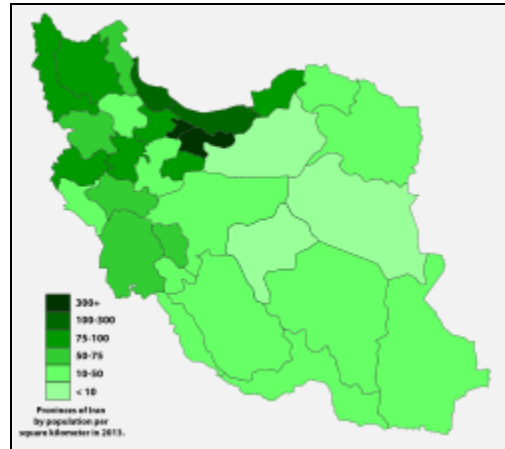
Iran is the 18<sup>th</sup> largest nation in terms of population, roughly the size of Germany or Turkey. Compared to its neighbors, Iran’s population is three times larger than Iraq and two and a third times larger than Afghanistan. In terms of land area, it is four times larger than Iraq and more than two and a half times larger than Afghanistan.

Iran is a mountainous country. The Zagros Mountains define the western region of Iran, running from the Turkish border to nearly the Strait of Hormuz in the southern part of the country. The Elburz range dominates the region south of the Caspian Sea. The middle of the country has two uninhabitable deserts, the Kavir and the Lut. Within the Kavir desert are thin salt flats covering thick mud. The salt veneer is unable to hold much weight, thus traversing it is extraordinarily difficult.



(Source: <https://www.freeworldmaps.net/asia/iran/map.html>)

The Iranian population lives in the mountains because the aforementioned desert lowlands are inhospitable. The following map of Iran’s population density shows this distribution.



(Source: Wikipedia)

Except for the lowlands near the delta of the Tigris and Euphrates River systems, Iran’s geography is mostly mountains and deserts. As such, the country is highly defensible. Only two large-scale successful invasions have occurred; Alexander the Great did so in 331 B.C. and the Mongols in 1219-21.<sup>1</sup> At the same time, logistics in a mountainous country are difficult and doom such a nation to a weak economy.



(Source: Wikipedia)

<sup>1</sup> An interesting side note to the Mongol invasion was that Shah Muhammad feared the military had designs on his leadership. Thus, he refrained from unifying his forces, which allowed Genghis Kahn to systematically destroy the Shah’s army in a piecemeal fashion. Internal unity has been an issue for Persian and Iranian leaders for centuries.

As the above map shows, Iran's ethnic divisions are numerous. The Kurds, Azeris and Baloch are significant minorities among the Persians. The Kurds and Baloch also tend to be Sunni as opposed to the Persian Shiites.

Iran's geopolitical issues include:

1. Iran's most significant challenge is internal cohesion. Central control of a mountainous nation is hard as tribal groups can enjoy a high degree of local autonomy due to logistical impediments. Outside powers attempting to take control of Iran often try to sow internal dissention. Exploiting these internal divisions is how European colonial powers managed Persia.
2. Iran has historically been secure from outside invasion due to its natural defenses. Invasion is possible, but rare.
3. To project power, Iran tends to look west into Iraq. It is most powerful when it controls that region of the Middle East. Unfortunately, Iraq's geography is mostly made up of plains, which makes it difficult to defend.

### **War with Iran**

Carl von Clausewitz, the German military theorist, postulated that there were three phases of warfare. The first is the conflict with another nation's military. This phase is what we usually think of as war. The second phase is the occupation of the conquered nation. The third is the destruction of the enemy nation's will to resist. In other words, to win a war, one must defeat the military, occupy it and break the civilian population's desire to oppose the invader.

The first goal is self-evident. If an enemy retains a military, they could attack at some point in the future. If the second goal isn't

achieved, even if the military is defeated, then the enemy could rise again. However, achieving the third goal is what "seals the deal." If the population still has the will to resist and can gain access to weapons, the occupier will face an unrelenting, if low-level, conflict.

In that case, the first goal for the defending nation is to repulse the attack with one's own military. If that fails, the next goal, ultimately, is to undermine the conquering nation's will to maintain the war by making the costs of occupation and subjugation high. The prospect of a never-ending, low-level insurgency will tend to weaken the resolve of the invader. In other words, the nation being invaded doesn't necessarily have to win; it just needs to outlast the invader's civilian support.

Recent wars have borne out this issue. In the 2003 war in Iraq, the U.S. military swiftly destroyed the Iraqi military's ability to fight back. However, occupying Iraq turned out to be much more difficult than expected and the U.S. was never able to fully break the civilians' will to resist. The conflict in Afghanistan had a similar outcome. Occupation was never successful, so both wars have been a steady drain on resources, making them increasingly unpopular with American voters.

If the U.S. decides to go to war with Iran, it is imperative to determine the outcome policymakers want. If the goal is to simply destroy the traditional military (something the U.S. excels at) but not occupy Iran or destroy the civilian population's resistance, then such a task should be relatively easy to accomplish. Of course, such a conflict won't eliminate Iran's risks to the region or to U.S. policy goals. It would merely act as a temporary check on Iran's ability to project power. If a more permanent solution

is desired, then a land invasion is necessary. However, Iran's geography makes a land invasion very difficult and expensive. It would be a bit like trying to invade Utah through Colorado. Iran's biggest weakness is potential internal divisions; an attack from an outside power will probably foster at least some degree of unity. In addition, Iran's greatest strength militarily is its unconventional capacity. Thus, even defeating Iran's conventional military may not significantly reduce the threat of Iranian power projection.

A total victory over Iran that meets all three phrases of Clausewitz's warfare theory is possible, but the costs to the U.S. would be massive. Not only would it require a large logistical operation and a huge occupying force, but it would also likely require a commitment similar to the Marshall Plan and a long-term occupation to win all three phases. Given the threats from China and Russia, Iran isn't that important. The most rational position for the U.S. to take is a limited conflict that would reduce Iran's ability to affect shipping in the Persian Gulf and set back its ability to build a nuclear weapon. And, even these steps could be costly; Iran will likely deploy its unconventional assets to sow terror in allied nations in the region and beyond. At the same time, Iran isn't a threat to U.S. hegemony. A better option would be to isolate the country and allow internal divisions to eventually lead to regime change. Such policies are not inspiring but are probably the most reasonable and the ones that the U.S. will most likely follow (and, arguably, has been following).

That option doesn't mean there isn't the potential for a mistake. The U.S. and Iran don't have clear communication lines, thus it is possible to misinterpret an action as hostile. In addition, Iran uses proxies to

project power and might not be able to fully control them. If the U.S. views a proxy attack as being ordered by Tehran, then a counterstrike could occur that might escalate into a broader conflict.

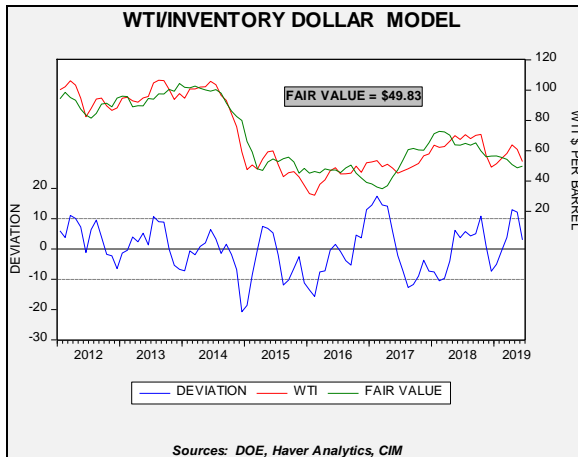
The problem for the U.S. would be a conflict without clearly defined objectives. That would lead to the potential for "mission creep" and an outcome similar to both the conflicts in Iraq and Afghanistan but on an even larger scale.

So, what are the odds of war? We think they remain rather low. President Trump is a [Jacksonian](#) and will therefore tend to avoid international military involvement unless provoked. Iran should know this and avoid such actions. At the same time, U.S. sanctions have effectively cut off Iran's oil exports, thus there is an incentive for the country to attack oil shipments. In the past, Iran tended to avoid such attacks as they could trigger a similar response against its own oil exports. However, in light of the decline in Iran's oil exports, the costs of attacking oil shipping has declined...unless the U.S. is willing to use military force in retaliation. As a result, we still expect Iran to avoid a direct provocation, but the probability isn't zero.

### **Ramifications**

The most obvious market impact of a war with Iran would be higher oil prices. A war wouldn't remove all Middle East oil exports, but it would reduce them. The uncertainty surrounding oil supplies would certainly add to hoarding, which would boost prices even further.

The key to the level of oil price fluctuations is based, in part, on how much geopolitical risk is already discounted into oil prices. At this point, we believe the oil markets are probably underestimating geopolitical risk.



This chart shows our WTI model that uses U.S. commercial crude oil inventories and the euro for independent variables. The lower line shows the deviation from fair value. In general, the lower line shows the “unexplained” level of price. A potential unexplained variable can be the geopolitical risk premium in the market. The current

level is only \$3.00 per barrel after being nearly \$13.00 a barrel in April. Although \$13.00 was probably excessive, \$3.00 is likely insufficient. Of course, if a disruption occurs, U.S. commercial inventories are very high and the SPR can be tapped. But, a risk premium around \$7.00 to \$8.00 is probably justifiable.

If there is a military escalation, we would expect Treasuries, the dollar and gold to rally. Risk assets, especially equities dependent on oil consumption, could be vulnerable.

Bill O’Grady  
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