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## **Iran Sanctions and Potential Responses: Part III**

The Trump administration withdrew from the Iranian nuclear deal earlier this year and plans to implement sanctions on the country in two phases, the first of which went into effect in early August with a second round in November. In Part I of this report, we introduced this topic and covered the first two potential responses from Iran, which were restarting the nuclear program and projecting power. Last week, we covered the threat to the Strait of Hormuz. This week, we will conclude with a discussion on the potential for Iran to deploy a cyberattack against the U.S. or use allies to end sanctions, along with the likelihood that Iran would enter into direct negotiations with Washington. We will conclude with market ramifications.

### **Response #4: Iranian Cyberattack**

Recent reports<sup>1</sup> suggest that Iran has taken steps to carry out extensive attacks on Western infrastructure, including electrical grids, water treatment facilities, hospital and health care systems and technology companies.

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<sup>1</sup> [https://www.nbcnews.com/news/us-news/iran-has-laid-groundwork-extensive-cyberattacks-u-s-say-officials-n893081?utm\\_source=Join+the+Community+Subscribers&utm\\_campaign=57b6abc3f8-EMAIL\\_CAMPAIGN\\_2018\\_07\\_24\\_02\\_43&utm\\_medium=email&utm\\_term=0\\_02cbee778d-57b6abc3f8-122505017&mc\\_cid=57b6abc3f8&mc\\_eid=9676368d73](https://www.nbcnews.com/news/us-news/iran-has-laid-groundwork-extensive-cyberattacks-u-s-say-officials-n893081?utm_source=Join+the+Community+Subscribers&utm_campaign=57b6abc3f8-EMAIL_CAMPAIGN_2018_07_24_02_43&utm_medium=email&utm_term=0_02cbee778d-57b6abc3f8-122505017&mc_cid=57b6abc3f8&mc_eid=9676368d73)

We suspect Iran would not immediately attack the U.S. or European targets. It would likely start by attacking nearby U.S. allies, such as Saudi Arabia, the UAE and Israel. The risk of an attack directly on the U.S. would be that the Trump administration moves to a full-scale war. The Pentagon has indicated it views a major cyberattack as worthy of a nuclear response.<sup>2</sup> That factor increases the risk of using this response.

Of course, one advantage of cyberwarfare is that attribution is difficult. It may be nearly impossible to know for certain who attacked critical infrastructure and the potential for “false flag” attacks would be high. At the same time, if Iran was able to disrupt energy production in the Gulf States through a cyberattack, it may be just as, if not more, effective than a blockade of the Strait of Hormuz and with less blowback. Thus, the attractiveness of a cyberattack is high.

### **Response #5: Finding Allies**

As noted above, the Trump administration is increasing pressure on several of Iran’s oil customers in Europe and the Far East. Both Japan and South Korea have indicated they are cutting purchases. European nations are trying to defy the U.S. on this issue but, we suspect, the risks of losing access to the dollar-based financial system will outweigh the benefits of buying Iranian oil. Iran is finding itself increasingly isolated.

However, there are two states that could offer Iran support. China’s relations with the U.S. are not all that positive and it’s unlikely the Chinese will support U.S.

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<sup>2</sup> <https://www.nytimes.com/2018/01/16/us/politics/pentagon-nuclear-review-cyberattack-trump.html>

sanctions. However, other than buying Iranian oil, there isn't much China can do to assist Iran. The People's Liberation Army-Navy isn't strong enough to take on the 5<sup>th</sup> Fleet; in fact, we doubt it could conduct aggressive operations outside the first island chain. In addition, if a conflict escalates, we would expect the U.S. Navy to blockade Iran and it is doubtful that the Chinese Navy would run the risk of trying to break the blockade. Thus, China will offer, at best, modest support.

Russia, on the other hand, could be more supportive. Russia has been actively trying to lift its stature in the region. During the Obama administration, when Syria violated the president's infamous "red line,"<sup>3</sup> Russia offered a face-saving compromise. Syria agreed to give up its chemical weapons<sup>4</sup> and, in return, the U.S. didn't bomb it. Russia's goals were to preserve the Assad regime (which has worked thus far) and gain sanctions relief from the Ukraine situation (which hasn't).

Although we don't know how much sway Russia has over Iran, if Putin could bring Tehran to the bargaining table, the U.S. may be open to easing sanctions over its actions in Ukraine. Such a decision would further infuriate Europe. After all, the Europeans liked the Joint Comprehensive Plan of Action (the official name of the Iranian nuclear deal) and want to maintain sanctions on Russia, so they would view this outcome as losing leverage over Russia due to a U.S.

<sup>3</sup> See WGR, [Syria and the Red Line](#) (5/6/2013)

<sup>4</sup> If Syria did give them up, it appears they were replaced. President Trump has attacked Assad twice for using chemical weapons on his people. See: <https://www.nytimes.com/2017/04/06/world/middleeast/us-said-to-weigh-military-responses-to-syrian-chemical-attack.html> and <https://www.nytimes.com/2018/04/13/world/middleeast/trump-strikes-syria-attack.html>

policy error on Iran. At the same time, we doubt that Russia has enough influence over Iran to convince it to meet the likely demands of the Trump administration. However, the effort alone may soften the U.S. position on current Russian sanctions. And, even without sanctions relief, Russia profits if oil prices rise due to tensions in the Middle East, thus it would benefit Russia to support Iran in restricting oil supply. We would expect Iran to consider appealing to Russia and China for help but suspect it will find the exercise disappointing.

### **Response #6: Engaging in Negotiations**

Iran would be loath to engage in new talks with the U.S. One of the criticisms of President Obama's negotiations with Iran was that it appeared he wanted a deal more than Iran did. Thus, Iran was able to get a deal in which it didn't give up its nuclear program for good and did not have to curb its power projection in the region. President Obama was willing to give Iran a favorable deal because he had a larger goal of pivoting toward Asia.

Although it isn't completely clear just what exactly President Trump wants from a new deal with Iran, we suspect the administration will demand the following:

1. End the nuclear program completely and ensure compliance with a rigorous and intrusive inspections program.
2. End all power projection efforts in the Middle East and beyond, including support for insurgency groups such as Hezbollah, Hamas and al Qaeda.
3. End all covert actions outside the Middle East, including cyberwarfare and other terrorist activities.

In other words, something akin to surrender.

Iran will not agree to any such arrangement, which likely means the U.S. and Iran will return to relations similar to what we had prior to the nuclear agreement. Sanctions will effectively become permanent, although their effectiveness will be somewhat lessened due to weaker compliance outside the U.S.

Iran has been dealing with rising internal unrest. The weak economy and rising inflation have caused discontent. This problem was exacerbated by hopes raised by the nuclear deal. President Rouhani essentially “sold” the deal by promising that the economy would improve due to easing sanctions and increased foreign investment. Instead, sanctions have returned and Rouhani has been forced to side with the hardliners to maintain power. So far, the unrest has not risen to a level that would threaten the regime; we don’t expect it to, but such pressures have led to regime change in other nations.

At the same time, the U.S. may be making some unwarranted assumptions. When negotiating with North Korea, President Trump appeared to be well on his way to war. Rhetoric was hostile; the U.S. was conducting provocative military exercises that appeared to be a precursor to conflict. At the same time, sanctions were tightened which increased economic pressure on Pyongyang. However, due in part to aggressive diplomacy from South Korea, a weakening North Korean economy and mercurial leaders in the U.S. and North Korea, relations “flipped” from hostile to an unprecedented meeting between a U.S. president and a North Korean leader. It is possible the Trump administration thinks it’s working from a similar “playbook” with Iran. Unfortunately, that probably isn’t the case. Although the Ayatollah Khamenei is the supreme leader of Iran, the political

system is far more complex. Iran isn’t likely to “flip” like Kim Jong-un; in fact, the Iranian Republican Guard Corps would probably prevent a leader from making a rash overture to America. By comparison, Kim is a dictator with full control over North Korea’s political system. Although he can face internal opposition, the Kim dynasty has been very effective in suppressing and eliminating internal threats. Thus, if Kim Jong-un wants to shift policy, he can more readily do so. That isn’t the case in Iran, therefore the tactics that appear successful with North Korea are unlikely to work with Iran.

Iran may conclude that President Trump is a *sui generis*, a completely unique political figure that won’t be repeated. In other words, once Trump leaves office, the U.S. will revert to earlier policies. Perhaps Iran hopes that if the next president is a Democrat, a return to Obama’s policy direction would occur.

If this is the case, it might make sense for Iran to offer to talk to the Trump administration, ask for a suspension of sanctions during negotiations and then simply stall to “run out the clock.” This tactic isn’t a bad one, although one would only choose it due to the lack of alternatives. There are three risks to this policy:

1. *Trump may win re-election.* In the post-WWII era, only two presidents have not won re-election (aside from those who finished the term of an incumbent due to death) — President Carter and President Bush. History shows it’s hard to defeat an incumbent. Negotiating for six years to stave off sanctions probably won’t work.
2. *Trump is impatient and will see through the ruse.* Although this could work in Iran’s favor (“we want talks but the U.S.

doesn't" makes Iran a sympathetic nation in world opinion), it still leads to a crackdown.

3. *Negotiations raise hopes domestically and, when talks fail, unrest increases.* Iran has been able to quell unrest but there is the chance that a revolution ensues anytime such tensions develop.

### **What response will Iran choose?**

In order, we expect the first action Iran will take will be to expand its asymmetric activities around the Middle East and the world. That response is less of a direct challenge to the U.S. because most of these activities are ongoing. However, if Iran escalates Hezbollah's threat to Israel, for example, that could trigger a broader U.S. response. Nevertheless, for now, we expect that Iran will avoid a direct confrontation with either U.S. soldiers or Israel. Instead, look for Iran to bolster its position in Iraq, increase the Houthi threat in Yemen and attempt to foster unrest in the Gulf States.<sup>5</sup>

The second response will likely be to find allies. Look for Tehran to try to get China and Russia to help it deal with sanctions and the broader U.S. threat. The third response would be to draw the Trump administration into negotiations, perhaps with the aid of Russia or China. If the administration cannot be lured into talks, the responses become more serious.

If, by November, sanctions resume and the Europeans comply (as we expect they will), then we would expect the next step to be to remove the constraints on its nuclear weapons program and restart the process. We don't expect Iran to actually test a bomb

<sup>5</sup> <https://www.ft.com/content/c5f9633c-90c6-11e8-b639-7680cedcc421?emailId=5b5a86bc1cef690004ad23d7&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

but to move rapidly to the nuclear threshold. We would not be surprised to see the implementation of a cyberattack at the same time.

Finally, we would view closing the Strait of Hormuz as a last resort. Not only would closing the strait reduce or end Iranian exports (which will continue at a reduced rate even under sanctions), it would be universally seen as an act of war by Iran. The Iranians are rarely this direct; they prefer covert and asymmetric tactics. Thus, closing the strait would be out of character but might be enacted if Iran is "cornered."

### **Ramifications**

Iran has a series of actions it can take in response to sanctions. We do not expect a major escalation in the very near term, although the odds of escalation increase if the Trump administration returns to a full sanctions regime in November as it has promised.

If conditions deteriorate, will the U.S. go to war with Iran? President Trump doesn't seem inclined to deploy troops. He has expressed anger about the continuing war in Afghanistan<sup>6</sup> and has promised to pull U.S. troops out of Syria.<sup>7</sup> His base is Jacksonian—they are isolationist unless the U.S. is directly attacked.<sup>8</sup> Sending American soldiers to die in Iran so the rest of the world can have access to Iranian oil is exactly the kind of conflict citizen Trump

<sup>6</sup> [https://www.washingtonpost.com/politics/in-private-chat-with-senator-trump-hints-at-policy-shift-in-afghanistan--and-a-return-to-isolationism/2018/04/30/e0e9b1ec-4995-11e8-827e-](https://www.washingtonpost.com/politics/in-private-chat-with-senator-trump-hints-at-policy-shift-in-afghanistan--and-a-return-to-isolationism/2018/04/30/e0e9b1ec-4995-11e8-827e-190efaf1f1ee_story.html?utm_term=.a31acb626bb1)

<sup>7</sup> <https://www.nytimes.com/2018/04/03/us/politics/trump-foreign-policy.html>

<sup>8</sup> [https://www.confluenceinvestment.com/wp-content/uploads/weekly\\_geopolitical\\_report\\_04\\_4\\_2016.pdf](https://www.confluenceinvestment.com/wp-content/uploads/weekly_geopolitical_report_04_4_2016.pdf)

would have opposed. However, the president is surrounded by Iran hawks; as noted above, three of his highest ranking foreign policy leaders likely favor regime change in Iran and will argue for a conflict. Thus, the risks of a conflict could escalate, especially after November when the U.S. intends to enact sanctions against nations that purchase Iranian oil.

The most obvious market impact would be higher oil prices; Brent will likely rise faster than WTI because the U.S. oil market hasn't yet created the logistical infrastructure for

exporting. The rise in oil prices could be mitigated by an SPR release, but the risk of actually announcing a release is that the infrastructure of the global reserves may not operate optimally.

Other risk-off assets, such as Treasuries, the yen and precious metals could benefit as well. We may also see strength in defense company stocks if a "hot war" develops.

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