

*August 3, 2015*

## **Reflections on the Iran Deal**

Last month, the P5+1<sup>1</sup> and Iran concluded negotiations on a nuclear deal. In this report, we will offer some reflections on the agreement, including why it occurred, and the major reason why the U.S. negotiated this agreement and the underlying issues. As always, we will conclude with market ramifications.

### **Why a Deal was Reached**

An agreement occurs because parties to it have reasons for making it. How good the deal is depends upon the starting positions, who needs the deal more and how well they negotiate.

The U.S. has been continually involved in the Middle East since WWII. From the time President Roosevelt and Saudi King Ibn Saud met in Egypt on Valentine's Day, 1945, to the present, the U.S. has had interests in the region. The primary American goal was to prevent any other power from gaining significant influence. Mostly this was done to prevent the U.S.S.R. from spreading communism in the region and deny the Soviets a warm water port. As the area's oil production rose, the U.S. wanted to ensure the security of energy supply from the region.

The U.S. engaged in the region in a number of ways. In 1953, the U.S. covertly

participated in a coup against Iranian PM Mohammad Mosaddegh to prevent him from nationalizing the Anglo-Iranian Oil Company and perhaps creating conditions for communist infiltration. In the 1956 Suez Incident, the U.S. made it clear to former colonial powers, France and Britain, that their interference would not be tolerated. U.S. support of Israel increased significantly after France withdrew its support after the Six-Day War. Nixon's decision to resupply Israel during the Yom Kippur War led to the Arab Oil Embargo. The U.S. implemented sanctions against Iran after the Shah was overthrown in 1979 and the new regime held Americans hostage. America supported both sides, at different times, during the Iran-Iraq War. After the Cold War ended, the U.S. ousted Saddam Hussein from Kuwait and enforced a no-fly zone and sanctions against Iraq. Under President Clinton, the U.S. attempted to isolate both Iran and Iraq through sanctions and other means.

Global superpowers often control regions by creating a balance of powers in various regions. The British were very adept at such actions; the U.S. was less so, but because America's economic might dwarfed Britain's, the U.S. was still able to manage the world. In Europe and Asia, the U.S. simply dominated both regions, preventing pre-WWII powers from recapturing their powerful pre-war positions. In the Middle East, the U.S. tended to manage the region through strong relations with Israel (at least during the Cold War) and balancing power between Iran and Iraq.

---

<sup>1</sup> These are the five permanent members of the UN Security Council (U.S., U.K., Russia, China and France) plus Germany.

President Bush's decision to oust Saddam Hussein in 2003 was based on the assumption that the U.S. would be able to create a strong and friendly government to replace the mercurial Hussein. The thinking behind this idea suffered from serious flaws; the most critical was not understanding the sectarian divides in Iraq. Ousting Hussein was a direct threat to the minority Sunnis and building a new government with Iraqi Shiites was likely to create one sympathetic to Iran, which is exactly what occurred. A civil conflict emerged; the U.S. was able to temporarily end it by supporting Sunni tribes as part of the 2007-08 "surge" but a unified government never emerged. The country appears headed toward a breakup into Sunni, Shiite and Kurdish regions.

#### **American and Iranian Goals**

The U.S. has three goals in the Middle East. First, it wants a free flow of oil out of the Persian Gulf. It won't tolerate any power interfering with oil flows. Second, it won't allow a single power to dominate the area around the Persian Gulf, because it would make that nation very powerful. Third, it needs to accomplish these two goals as economically as possible. The U.S. is a global power. It has responsibilities in other parts of the world and cannot devote excessive attention to the Middle East without increasing the risk of other areas becoming unstable.

Iran's primary goal is regime survival. Its second goal is that Iraq will never be a threat to the regime; in other words, Iran will not tolerate a repeat of the Iran-Iraq War. Third, it wants to represent and defend Shiites across the region.

When President Obama took office, he faced a difficult set of circumstances. Iran had a nuclear program going back to the days of the Shah, but was accelerating it after the

ouster of Saddam Hussein. After all, Iran was a member of President Bush's "axis of evil" and felt that the best guarantee that the U.S. would not try to invade Iran was to be a nuclear power. The war against Muammar Gaddafi in Libya after he had given up his nuclear program appeared to support Iran's need for a nuclear weapon.

The administration had two options to prevent Iran from developing a bomb. The first was to develop sanctions so crippling that Iran would capitulate and give up its program. Getting a significant number of nations to maintain sanctions is difficult. There is always an incentive to cheat. The second was to use military force to eliminate the nuclear threat, which increased the risk of a full scale invasion of Iran and the overthrow of the government.<sup>2</sup> Neither option looked appealing. The sanctions route was taken, although the president made it clear that he was open to negotiations unlike the Bush administration's stance.

President Obama's goal has been to "pivot" in order to focus on other parts of the world. To do this, the U.S. needs to reduce its exposure to the Middle East. The need to increase American "bandwidth" is important and not generally recognized. It is worth noting that as the U.S. became bogged down in Iraq, Russia has invaded Georgia and recently moved aggressively into Ukraine. China has become increasingly aggressive in the South China Sea. So, being able to

---

<sup>2</sup> One could argue that a full-scale invasion would not be necessary. We suspect if military action would have been taken, it would not have started with that in mind. However, to ensure that (a) all the suspected sites were attacked, (b) the bombing was effective, and (c) the infrastructure to start over was eliminated, occupation would have probably been necessary. It should be noted that nearly 13 years of sanctions and no-fly zones didn't change Saddam Hussein's behavior in Iraq.

reduce American forces in the Middle East would be useful in that it would allow the U.S. to act against Russian and Chinese aggression in other parts of the world.

Although the chances of adding more sanctions looked low five years ago, the aggressive behavior of Iranian President Ahmadinejad allowed the U.S. to push through a broad set of sanctions. The U.S. was able to put an oil embargo on Iranian sales to Europe and the administration was also able to remove Iran from the S.W.I.F.T. network, effectively cutting Iran out of the global financial system. The administration was successful in ratcheting up sanctions because it had a definitive purpose—managing Iran’s nuclear threat. It is doubtful that purely open-ended sanctions, with the purpose of regime change, for example, would have been widely adopted. In fact, they probably would have never emerged from the U.N. Security Council.

These sanctions steadily pressured the Iranian economy. The election of President Rouhani in 2013 signaled that Iran was probably open to negotiations. Although it took two years, a deal was reached.

Essentially, the deal that was struck will make it difficult for Iran to build a bomb for 10 years. An inspection regime will be in place; although no inspection program is perfect, this one should make it hard for Iran to build a bomb quickly. In return, Iran will have sanctions lifted; if all goes according to plan, U.N. sanctions will be lifted first, followed by European sanctions and then U.S. sanctions will be suspended.

#### **What does the U.S. want?**

Although administration officials continue to argue that this deal is only about Iranian nukes, we strongly doubt this is the case. Instead, we believe the administration’s goal

is to change the balancing arrangement in the region. The ideal situation was a strong Iraq to counter an aggressive Iran. Even this arrangement, which existed from 1979 until 1990, was difficult to manage. Iraq was a constant threat to its neighbors. It was a particularly brutal regime in a region known for brutality. The U.S. wanted a strong Iraq that wasn’t run by a murderous, unstable despot. However, removing Saddam Hussein was easier than creating this ideal state. Trying to create a democracy in a state with unresolved ethnic and sectarian divisions has proven to be nearly impossible. The rise of IS and the proto-Kurdish state essentially means Iraq is fracturing and will probably devolve into Sunni, Shiite and Kurdish states.

In order to balance against Iran, the U.S. would have to permanently station a large contingent of troops in Iraq indefinitely. Or, the U.S. could normalize relations with Iran and force the Sunni powers to build an anti-Iranian coalition. The U.S. has taken the latter option.

What should be understood is that the administration faced a difficult choice. Maintaining a large military force in Iraq would have been problematic. It would have offered permanent targets to enemies. Iran and others would have been constantly attacking these troops. Second, as long as the U.S. was willing to act as the primary blocking power, the Sunni states, Turkey and Israel, would have been more than happy to allow us to take that burden. Third, the attention required to keep peace in the Middle East would have given China and Russia greater opportunity to expand their influence and power in their respective regions.

However, there are significant risks with normalizing relations with Iran as well.

First, an invigorated Iranian economy, mostly free of sanctions, will likely return to strong levels of growth. This economic growth will support its efforts to project power. Although optimistic pundits suggest that Iran will likely need to spend much of that money on rebuilding its economy and energy infrastructure, we doubt that Iran will use this influx of growth to improve domestic conditions. That would be a major change from its pattern of behavior since the 1979 Iranian Revolution. Second, building and maintaining a Sunni bloc against Iran will be devilishly hard. The Saudis are clearly working hard to build a coalition; it has been trying to improve relations with Muslim Brotherhood groups which it has historically opposed. Recent talks with Hamas show the level of Saudi commitment to building a bloc against Iran. However, Turkey's recent decision to attack Kurdish groups in Syria shows that there is still a high level of intra-Sunni discord that will make building this bloc difficult. In addition, it would be perfectly natural for the Sunnis to work out an "arrangement" with IS. Not only is IS in an active war against Iranian-backed Shiite groups, it is probably in direct conflict with Iranian Republican Guard Corps forces. Thus, the U.S. is trying to "defeat" IS but the Sunnis are probably less than committed to this goal (even with the recent Turkish bombing of IS positions and the change of Turkish airbase use by the U.S. Air Force). After all, IS is a serious impediment to Shiite power in the region.

If the Obama program works, the U.S. will act as an "offshore rebalancing" force that keeps both Shiite and Sunnis from dominating the region. Unfortunately, the U.S. may find that its efforts to reduce its exposure in the region simply leads to greater instability. At that point, the U.S. will have to decide whether to intervene or simply allow conflicts to develop. Given

that the U.S. has become less energy dependent due to rising North American oil production, an American president may be tempted to stand back and allow the region to destabilize.

Given that this is an election year, we would expect nearly all the candidates, regardless of party, to be critical of President Obama's Middle East policy. However, it is important to note that the U.S. truly faces a Hobson's choice in the region. Sanctions cannot be sustained indefinitely. China has been undermining the sanctions regime for some time and others will be tempted to do so as well. Since the Europeans are essentially on board to restrict Iran's nuclear program, converting the sanctions into an open-ended arrangement is unlikely. Maintaining the current commitment to the region means that Russia and China will continue to expand their influence and power. To address Chinese and Russian expansionism, the U.S. probably needs to create conditions in the Middle East that rely on less American involvement.

On the other hand, the administration possibly could have gotten a better deal. Iran probably knows that the next president would most likely be less amenable to a deal; this is especially true if the GOP candidate wins. U.S. negotiators probably should have stalled until at least the summer of 2016. It isn't obvious why the administration was in such a rush. Sanctions did work in that they got Iran to the negotiating table. And while they could not last forever, they probably could have lasted another year. Would the pundit class still hate the deal? Sure, but the Iranians wanted an agreement and would have likely seen the looming election as a deadline. Thus, it was probably a tactical mistake from the U.S. standpoint to make a deal this early.

### **Ramifications**

In the short run, the agreement is bearish for oil prices. Iranian oil will be coming on the market over the next year, the Saudis are boosting output to lift market share and U.S. production is holding up better than expected; as a result, supply factors will be negative for prices. At some point, however, the Saudis will decide they cannot live with low oil prices and will end the current market share war or instability will rise, threatening regional oil production. Once this occurs, prices will recover. This outcome probably won't occur within the

next 12 months, but the odds increase over the next three years.

If the U.S. continues to reduce its influence in the Middle East, we would expect an arms race to develop. Although we don't share the fear that a nuclear arms race will occur, a conventional arms race is probably unavoidable. This outcome would likely boost the global defense industry.

Bill O'Grady  
August 3, 2015

*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.*

### **Confluence Investment Management LLC**

---

Confluence Investment Management LLC is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, fundamental company-specific approach. The firm's portfolio management philosophy begins by assessing risk, and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.