Fund Manager's Diary
Iain Little 26 to 30 October 2015

"Action Replay: The Great Game, Ottomania and The Fatimids"

Once in a while, a piece of research makes us gasp. This one from Gavekal, written by its founder Charles Gave. We've followed Charles for 30 years. Reproduced with Gavekal's permission, with a couple of edits to save space and mostly my own emphases in **red bold**. No comment necessary. The baleful geopolitical effects are obvious. One effect would be the destructive impact on the European Project. The refugee crisis already hugs front pages. If Charles is right, expect the fracturing of much of the economic and political order in the West. This scenario does not have to happen. But it might. We'll be on the *"Qui Vive"*. We hope that western politicians, like Mr Putin, are also awake.

*Russia and Turkey are at loggerheads as Moscow escalates military engagement in Syria. Turkey's President Erdogan has threatened to find another gas supplier after Russian jets breached its air space, and Ankara has initiated legal action against Gazprom over the price charged for piped gas.....**For the last 3 years, I have argued that Vladimir Putin's strategic goal was to see the Sunni monarchies of the ME toppled, thereby crude oil prices at USD200 a barrel and a controlled market for Russia's only real source of income**. The key strategic power with the ability to influence events in the Sunni world is Turkey.....the ME's biggest Sunni army and even though the Arab states would be loath to see Turks back on their soil, Ankara could intervene. **Tthe neutralization of Turkey had to be a central part of any grand plan that Putin had for the region**. Russia has a naval base in Syria and planes to the north on Syria's Mediterranean coast. Moscow now needed to project power from Turkey's northern flank, and that meant control of the Black Sea—**hence the 2013 annexation of Crimea which delivered the key city of Sevastopol.** Moscow's hope must have been that Turkey would have one of its economic crises..... Given the bad backdrop for emerging markets and bad policymaking Ankara now looks on its way to full scale crisis. The deteriorating position of Assad in Syria's civil war demanded response. Moscow could not stomach the toppling of the Alawite president in favour of a Sunni regime, nor could Iran. Tehran's problem until recently was that it was limited by sanctions, hence do a deal over its nuclear program and free up USD150bn locked in the dollar system. **Russia's response was to bide its time and maintain the outside world's focus on Ukraine, which was always a side-show that the Western media and politicians dutifully obsessed on while missing the real story**. Then Washington played into the hands of Tehran and Moscow by doing a deal over the Iranian nuclear program. The consequences of this new "Munich": Russia and Iran could clean up the Saudi/Sunni Frankenstein that is Isis. This could all be over in a matter months with the result that the US army and its drones look incompetent or accomplices of the Saudis. **American prestige in the region will take a huge hit**. Syria's 2nd city Aleppo will return under the "control" of Assad, but will be run by Iran. Iraq will go the same way as Lebanon. **We are seeing a re-run of the Fatimid Caliphate, the only Shiite caliphate in history, which ruled much of N Africa and part of the ME between the 10th and 12th centuries.** The flood of refugees from the ME stems from Sunni populations in Syria and Iraq. They will look to move first to Turkey and then to Europe—large numbers heading towards Germany only a foretaste of what could be to come. The question is how such a shift reshapes the ME. Since 1913, the east of the Arabian Peninsula has been under Saudi control (location for all Saudi oil fields) and also their export terminals—they are on the "wrong" side of the Straits of Hormuz. This region could well have a Shiite majority and is more ethnically Persian than Arabic. The local population has been treated brutally by the Saudis for the last century; ready recruits in any effort by Iran and Russia (via weapon supplies) to destabilize this region and destroy the oil terminals. In this scenario, Saudi will quickly run out of money and private jets will ferry princes to Nice and New York. Further south sits Bahrain, population 75% Shiite but run by a Sunni Sheikh. (Bahrain also home to the US Fifth Fleet, whose main job is defending the Strait of Hormuz. But the USS Theodore Roosevelt, the only aircraft carrier in the region, is being withdrawn). In effect US military power removed. It will become an imperative for Egypt, Jordan and Israel to form an alliance, followed by an effort to crush the Tehran-backed Hezbollah group and Hamas which has received funding from Iran. These events will create turmoil and waves of refugees. The possibility of the Sunni-Shiite civil war again tearing apart Lebanon is not out of question. What does such a scenario mean for markets? **Firstly the USD would soar as USD will be needed to pay for high-priced oil.** After the 1973 Arab-Israeli War, the following year saw the USD rise 35%, while oil went from USD4/bbl to USD11/bbl. **World stock markets crashed by more than -75% from their peak in this period**. I would expect the impact of an oil price super-spike to be profoundly deflationary shock, so investors should carry a large position in medium-dated US bonds. Sell the Saudi equity market and short the Saudi riyal peg. The Egyptian pound would be a sell as is not clear that the military-backed regime in Cairo could survive without Saudi money. **Russia would be a big winner and its assets would rally across the board.** Among developed markets the Canadian loonie should rise on rocketing oil prices, while the Swiss franc would come under pressure due to the exit of Saudi money, although in this case the offset may be **a flood of Russian money heading back to the Alps.***
