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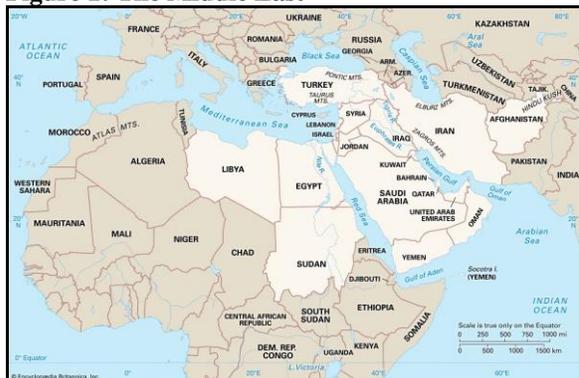
May 6, 2024

Middle East: Land of Fault Lines

Conflict in the Middle East is one of the most persistent themes in current events. Not only is this true today, but Middle Eastern discord has dominated the news flow throughout most of our lives. At Confluence, we recognize that this enduring pattern of strife reveals the presence of many major fault lines that run through Middle Eastern society, politics, economics, and relations with the rest of the world.

A fault line is defined as a [“divisive issue or difference of opinion that is likely to have serious consequences.”](#) A major fault line is one in which the competing forces have both deeply embedded positions and the resources to support those positions. Many issues of this type characterize those in the Middle East, which explains why conflict in the region is so common despite repeated attempts at resolution. Investors must be prepared for this trend to endure for the foreseeable future, which will continue to meaningfully impact global affairs.

Figure 1: The Middle East



(Source: Encyclopedia Britannica)

This report briefly reviews the main fault lines that define the Middle East from a geopolitical standpoint. This is not a complete list, but rather it is a selection of those we consider most enduring and impactful. Confluence does not take positions on these issues, but we will summarize and show how they produce complexity. We arrange these prominent fault lines in three layers: the ancient fault lines, the more modern ones, and the present-day issues that are currently causing “geopolitical earthquakes.” While these earthquakes do raise the risk of escalation into a broader regional war, we remind readers that the region has often witnessed this increased level of risk before without necessarily leading to further escalation. Rather than trying to predict the outcome, we recommend that investors pay attention to key implications, which we will highlight at the end of the report.

Note on the Current Gaza Conflict: We provide this report to address the understandably high level of concern among our readership about the current conflict in Gaza. It began on October 7 of last year, when [Hamas militants invaded Israeli communities neighboring the Gaza Strip, killing 1,200 people and taking 240 others hostage.](#) The next day, Hezbollah began shelling northern Israeli communities from their bases in Lebanon and have continued to do so throughout the conflict. On October 27, Israel launched a broad ground offensive into Gaza, with the stated objective of [removing Hamas as the governing authority in Gaza and destroying its military infrastructure to the point where](#)

[it is incapable of carrying out further similar attacks.](#)

Six months of fighting have generated considerable controversy, disagreement, tragedy, and loss of life. Addressing these issues is beyond our purview. Rather, we will focus on investment implications and concerns over whether this conflict will spark a broader war. In our view, the conflict will likely continue for months to come but will also likely *remain contained*. Still, we consider this a prescient opportunity to provide our readers with a deeper understanding of the region and a framework within which to contextualize the current and future news flow.

Ancient Fault Lines

In this section, we review the key Middle Eastern fault lines that extend back to ancient times.

Rival Nationalities. Since the fall of Rome, [fourteen different empires](#) have laid claim to parts of the Middle East. Most of these empires were of Arab, Persian, or Turkic origin. Those three national and cultural identities remain prominent in the Middle East today, most directly represented by the states of Saudi Arabia, Iran, and Turkey, respectively. As an extension of their deep roots in the region, these nationalities and countries have enduring interests that represent a natural continuation of ancient and sometimes competing national security imperatives. Occasionally, the intersections of these interests lead to varying levels of political, economic, and sometimes military conflict.

Opposing Islamic Traditions. Of the nearly [500 million people who live in the Middle East](#), approximately 85% adhere to Islam. The two main traditions of Islam are Sunni and Shia. In the Middle East, an estimated

two-thirds of the Islamic population follow the Sunni tradition, while the remaining one-third follow the Shia tradition. This religious divide has endured for 14 centuries and represents a fundamental disagreement among Muslims concerning core elements of the faith. Although Sunni and Shia typically live peacefully together, [the divide occasionally instigates strife and sectarian conflict](#). This trend has been on the rise in the 21st century. Furthermore, since Persian Iran and Arab Saudi Arabia are generally viewed as the standard bearers for Shia and Sunni Islam, respectively, the current rivalry between these two states represents an intersection of two ancient and sometimes volatile fault lines.

Figure 2



Islamic traditions in the Middle East with Sunni Islam in light green and Shia Islam in dark green. (Source: Library of Congress)

Competing External Influences. Over the centuries, non-Middle Eastern powers have extended their influence over various parts of the region. In some cases, this has involved foreign empires conquering parts of the Middle East, such as the British and French empires in the 19th century. Although the empires receded, they retained significant economic relationships with the countries that have taken the place of former imperial territories. For instance, the [United Kingdom maintains extremely valuable ties](#)

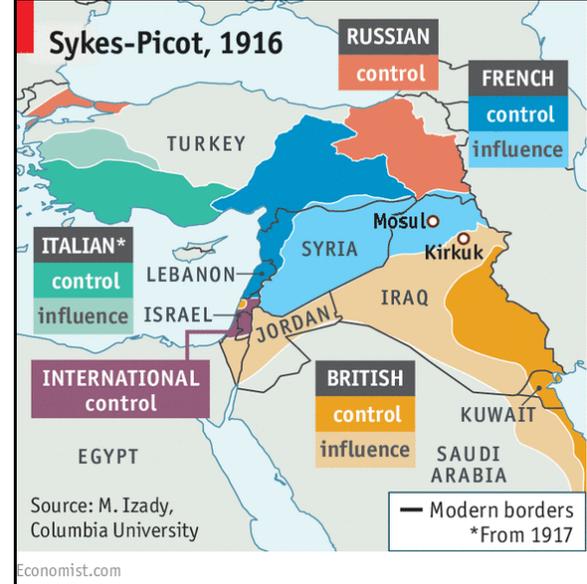
[with countries throughout the Persian Gulf](#), including the sale of more than half its global arms exports to the region. Meanwhile, [France retains strong economic interests in Iraq, particularly in the petroleum industry](#). These economic relationships occasionally set Middle Eastern countries at odds with each other.

Modern Fault Lines

The tumultuous 20th century added a new layer of fault lines on top of those from the centuries that preceded it. We highlight three of the most tremulous here.

Sykes-Picot Agreement. Named after its top British and French negotiators, this agreement was struck between the major allied powers (Britain, France, Russia, and Italy) during World War I. [The agreement sought to carve up the Middle Eastern possessions of the Ottoman Empire](#), which was collapsing under the strains of the war. The agreement divided the area along the lines of imperial economic interests. Although this bears a strong resemblance to the “External Influences” fault line described above, its conflict-causing effects on the region are distinctly different. The boundaries drawn between the areas of interest went directly through the homelands of various national, cultural, and religious groups, leaving them fractured by artificial borders. When the European powers eventually relinquished control and retreated, these artificial divisions became the borders between the newly independent countries of Iraq, Syria, Jordan, Lebanon, Israel, and the Palestinian territories. This has led to conflicts and sectarian violence among the countries, involving population groups who consider themselves underrepresented, disenfranchised, or betrayed by the original agreement.

Figure 3



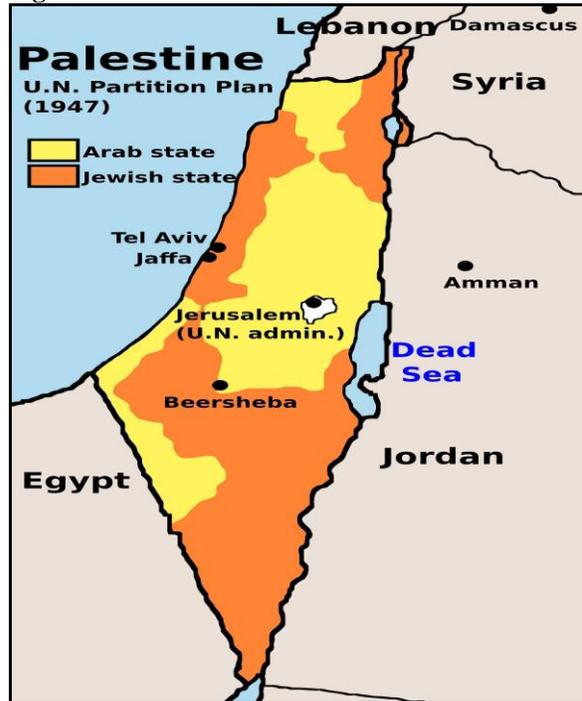
The Sykes-Picot Agreement. (Source: The Economist)

Israel/Palestine. The modern state of Israel declared its independence in 1948, within an area called the “Palestinian Mandate,” a part of the former Ottoman Empire that had been under British control since the end of World War I. This immediately sparked a war as [five Arab nations that opposed this declaration invaded the area](#). At the heart of the conflict was that both the Palestinian Arabs and the Jews represented by the Zionist Federation recognized this territory as their ancestral homeland. External entities including the British Empire and United Nations had provided conflicting assurances of support to both groups. Although a partition of the Mandate into two states, one for each group, had been approved in 1947 by the UN, the two sides and their supporters had not come to terms by the time of Israel’s declaration. The war ended in 1949 with an independent Israel but no established Palestinian state.

Countries throughout the region and the world quickly adopted divergent positions on the issue. Despite several international attempts to achieve a lasting resolution, the

issue has been the cause of conflict ranging from terrorism to full-scale war throughout the nearly 80 years since the original plan. The [UN officially declares the matter unresolved](#).

Figure 4



The 1947 UN Partition Plan. (Source: Substack, Pieter's Newsletter)

Cold War Proxies. As the Cold War between the US and USSR began to unfold in the late 1940s, the two opposing sides sought to develop alliances with like-minded countries throughout every region of the world, and the Middle East was no exception. For the two Cold War competitors, the need to geopolitically counterbalance each other typically outweighed any positions they might have had on pre-existing issues. As two prominent examples, Turkey became a member of NATO, whereas it had been a wartime ally of Germany, and Syria became a key regional ally of the Soviet Union, although it had been part of the pre-war French Mandate. Throughout the Cold War, Turkey and Syria played key roles in their

respective alliances with the US and USSR, including hosting air and naval bases for their patrons. The Cold War ended 33 years ago, and yet these relationships remain strong today. Turkey's [Incirlik Air Base](#) has served a vital role in US air operations in the region since 9/11, and [Syria's Tartus naval base serves as Russia's base of operations in the Mediterranean Sea](#). As the US and Russia have taken opposing positions on a range of issues in the region, such as the Syrian civil war and combating ISIS, this fault line has continued to cause tremors.

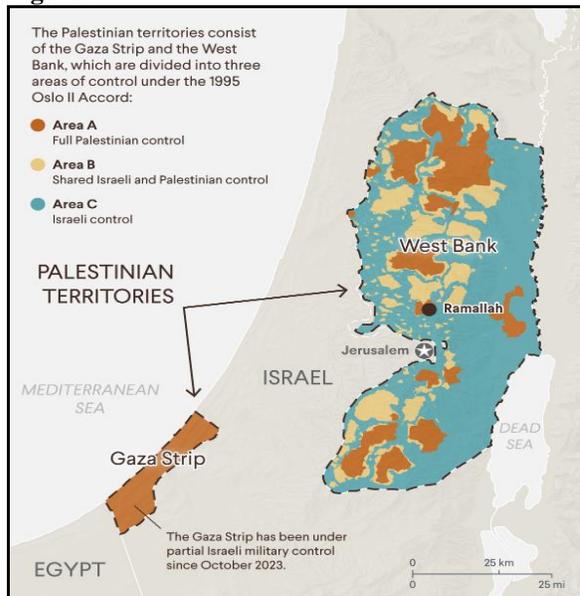
Today's Earthquakes

This section discusses the major fault lines and resulting earthquakes affecting the Middle East today.

Palestinian Statehood. The unresolved status of Palestinian Arabs has become its own separate fault line, apart from its connection to the 1948 establishment of Israel. The [Oslo Accords](#) of 1995 established the West Bank and the Gaza Strip as recognized "Palestinian Territories," with the understanding that future agreements would complete their establishment as a combined and fully independent state of Palestine. Nearly 30 years later, a list of disputes, [such as disagreements concerning the legitimate governing authority in the territories](#) and the status of Israeli settlements within them, has prevented further progress toward statehood. As a further complication, more than half of the total Palestinian population lives outside of the territories, typically as refugees or settled diaspora. Their status in countries where they have settled or taken refuge tends to present an unresolved question, and their presence is not always welcome. Arguably the most complicating factor is the involvement of other countries, which politically, financially, and sometimes militarily support competing Palestinian

factions. Most conspicuously, [Iran is a well-known supplier of funding, weapons, and training to Hamas](#), the organization that has governed the Gaza Strip since 2007. The current conflict in Gaza between Israel and Hamas is the latest of many earthquakes along this fault line, such as the [two uprisings known as intifadas that occurred in the late 1980s and just after the turn of the century](#).

Figure 5

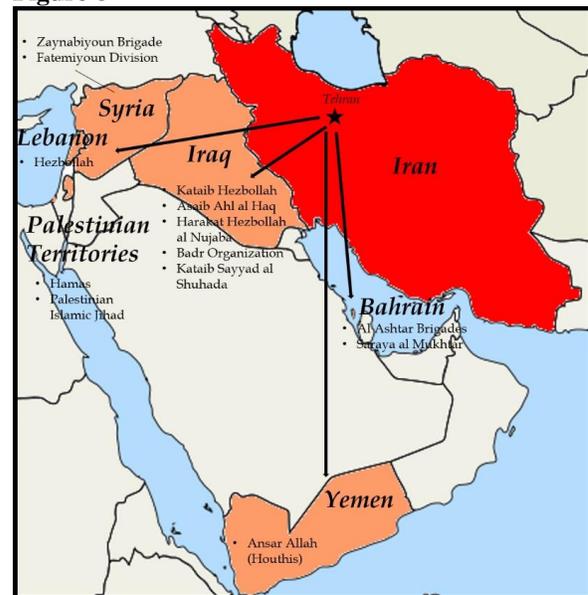


Palestinian territories. (Source: Council on Foreign Relations)

Iranian Regional Ambitions. Since the 1979 revolution in Iran that brought the current regime to power, Iran has conducted and designed its foreign policy to achieve dominance in the Middle East. From the beginning of this bid for regional power, the regime of Saddam Hussein in Iraq, which had regional ambitions of its own, stood as Iran’s main source of opposition. [The two countries fought an extremely costly war from 1980 to 1988](#) as part of their struggle for dominance. The United States’ 2003 invasion of Iraq that toppled the regime of Saddam Hussein removed this impediment to Iranian ambitions, enabling the regime to accelerate its drive to expand its influence.

Iran’s main method of expansion has been support for allied organizations and governments throughout the region, such as the [Assad government in Syria](#), [Hezbollah in Lebanon](#), [Hamas in the Gaza Strip](#), [numerous paramilitary groups in Iraq](#), and [the Houthi rebels in Yemen](#). The current attacks on shipping through the Red Sea and Suez Canal by the Houthis, whose resultant effects on shipping costs and transit times have caused ripple effects throughout the global trading system, is an earthquake on the fault line between Iranian ambitions and the opposing interests of the other regional powers and their allies.

Figure 6



Iranian Proxies. (Source: Wilson Center)

Tremors Beyond the Region. As a natural part of pursuing security and prosperity interests, all countries involve themselves in the affairs of not only their own regions, but those of neighboring regions as well. For example, the Russia-Ukraine war is arguably the biggest earthquake on the world stage today, and Middle Eastern powers are heavily involved. Iran and Russia have an established and growing defense partnership, which has included [Iran providing Russia thousands of battlefield](#)

[drones](#). In return, Russia is providing Iran advanced military aviation assets, including fighters and helicopters. Meanwhile, a burgeoning defense partnership is forming between Turkey and Ukraine. In addition to the fleets of drones Turkey has already supplied, the two countries are now partnering on a drone that uses a [Ukrainian-built engine, which they call a “Turkish bird with a Ukrainian heart.”](#) We would be naïve to view these relationships as simply economic opportunities or initiatives to extend influence outside of the Middle East. As indicated earlier, the Turkish-Persian rivalry, represented today by competition for influence between Turkey and Iran, [is as ancient as it is intensifying in the modern environment](#). By playing meaningful roles in the big earthquake next door, these two Middle Eastern powers are working to gain leverage against each other in their ongoing rivalry.

Investment Implications

While we view the future path of conflict and the possibility of escalation into a broader Middle Eastern war to be unpredictable, at Confluence we focus on pointing out the most likely investment implications.

Transportation Costs and Timelines. We have already seen transportation costs and delivery times lengthen, and we expect this to continue. In terms of global trade, the Middle East serves as a global crossroads, with key ocean shipping routes, rail lines, roads, and petroleum pipelines passing through it from one region to another. For instance, the Red Sea-Suez Canal shipping route, which the Houthis are holding hostage with their missile attacks in the Bab-el-Mandeb Strait, normally carries 15% of global maritime trade. [Volume through this route has dropped 50%](#). Not only do we expect this disruption to continue, but we

further recognize the risk that similar disruptions could occur along other key Middle Eastern conduits.

Oil Prices. Rising oil prices are a well-known result of the trademark tension in the Middle East due to global dependence on the region’s oil exports. Thus far, it seems that oil prices have not responded as expected to the earthquakes we have highlighted, possibly due to the offsetting effects of US shale oil production. However, we think there is a limit to the buffering effect that this factor might be providing. With shale production expected to level off in the US and Middle Eastern disputes continuing to produce tremors, [investors should prepare for rising oil prices](#).

At the intersection of transportation and oil prices is the Strait of Hormuz. Despite tensions over the past four decades, Iran has never completely closed the strait. As long as this passage remains open, the Gulf States can continue to export oil and keep prices from spiraling higher. Since the bulk of the world's excess oil production capacity lies within these states, the strait is critical. One reason that Iran has never acted to close the strait is that it would likely lead to the country losing access to its export markets as well. Thus, so far, the impact of friction in the region has tended to be short-term in nature.

Gold. Investors typically react to heightened geopolitical tensions by shifting money to “safe haven” investments. The two most classic choices for safety are US Treasuries and gold. The price of gold has already risen recently, mostly due to buying by Asian countries. Our expectation is that this trend will continue, regardless of issues in the Middle East. Treasury prices have recently come under pressure due to concerns about the increasing size of the US

budget deficit, which may have an effect on the reputation of Treasuries as a safe haven. This could inspire even more interest in gold as conflicts continue to increase.

Defense Stocks. At Confluence, we view rising conflict in the Middle East within the context of our broader perspective that the post-Cold War global order is breaking down. As this trend continues, heightened tensions and conflicts will increasingly become the order of the day, and not just in the Middle East. Countries will continue to raise their defense budgets, as is currently underway, and we expect defense stocks,

which have already shown strength, to continue to benefit. We also note that the idea of “defense stocks” is elastic; civilian aerospace (think low-earth orbit satellite internet networks) and cybersecurity should also be considered as part of “defense.”

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May 6, 2024

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