

Insights from the 2009 Impact Conference

The annual Schwab conference, Impact 2009, featured a variety of excellent speakers, educational sessions and insights. The opening keynote presentation featured a discussion with Larry Fink, Blackrock's economic guru, and Mohamed El-Erian, who, along with Bill Gross, does the heavy thinking at PIMCO. Prior to joining Pimco, Mr El-Erian worked for the IMF for 15 years, largely in a crisis management capacity.



While attending the conference I had an opportunity to chat with guest speakers, Newt Gingrich and Robert Reich (Economist and Former Clinton Administration

Labor Secretary). In the relaxed setting, they confessed their childhood names were Newty and Bobby. Compared to Newt, Robert Reich was more light-hearted and engaging, joking that he used to stand over 6' tall before getting pummeled by the economic downturn (he stands at 4' 10" tall). I asked what he was excited about and he said being a granddad and writing his second play.



The speakers acknowledged that though significant problems remain, we are in considerably better shape than a year ago when investment banks were failing and our economy seemed close to the precipice. In answering the question of how close our financial system came to the brink last fall, Mr. El-Erian shared that he told his wife to make cash withdrawals on two occasions, doubting whether banks would open the next day. Imagine not being able to use your ATM or debit card.

According to Mr. El-Erian, on a scale from 1 to 10 with 10 being the worst and 1 being the best, we reached a 9 last September. How far have we come back? El-Erian gave the current financial system a 4 while Fink gave it a

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What about the other 99%? Uncomfortable Information from Washington Insiders

Both Greg Valliere of the Washington Research Group and Washington Post editor Bob Woodward shared some disturbing information. During the NAPFA National Conference Woodward related this story about an unpleasant lunch with former vice president Al Gore. While Gore was pressing Woodward to devote more press coverage to global warming issues, Woodward changed the subject, and asked Gore: how much do we, the citizens, know about what's going on in the White House? The answer was shocking: Gore estimated that we typically know about 1% of all the events that go on. And he doesn't think we learn much more after the president leaves office.

Woodward said that he gets up every morning wondering what "the bastards" are hiding today, and believes that generally the electorate is not getting nearly enough truth out of Washington for democracy to function effectively. "You cannot know the future," he said to the audience, "because often you cannot even know the present."

Woodward concluded that "secrecy in government may be a bigger danger today than the economy or the environment. Democracies die in darkness. If we lose the capacity to find out what's going on, we'll end up jeopardizing both capitalism and democracy."

This brings us to the second story that is receiving scant press coverage and little mention from the Washington establishment, namely the increased likelihood of war against Iran. Two sources are used to elaborate on this possibility are commentary from Greg Valliere and Stratfor's Global Intelligence Reports on this topic. Please refer to the attachments for more information.

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6. Both expect subpar growth as the U.S. economy limps out of recession. El-Erian added that the markets almost certainly could not experience the kind of meltdown they did last year, because of the structural repair to balance sheets and market systems. But he warned of unintentional consequences. "We have accelerated the integration and reallocation of the global economy," he told the audience. "The Government has been a referee in the past, now government is one of the players. We have entered a very uncertain journey with unforeseen consequences."

Fink worries about who will become the new buyers and financiers of American growth. Consumers are saving more and spending less and have now reduced their borrowing for seven months in a row. Who's left to help us grow out of the recession? In a later session Robert Reich echoed this question, wondering "where will the economic growth come from?" In a partial answer, Reich stated that massive government stimulus spending, both here and abroad have been essential to priming the pump. The government, however, can only spend and borrow so much.

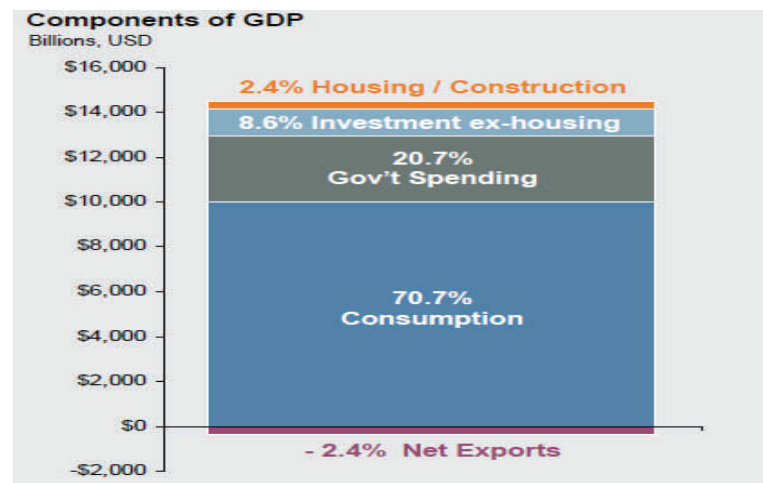
Furthermore, consumers account for the great majority of economic activity or about 70% of total spending (see the *Components of GDP Graph* to the right). Presently consumers are worried about jobs and are digging out from debt. One in six is either unemployed or underemployed. According to The Federal Reserve's recent statement "household spending has continued to show signs of stabilizing but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit." Most consumers are either unwilling or unable to spend. Frightened consumers have boosted their savings rate to above 5% and increased savings means reduced consumption.

Referring to our government ownership's intervention and new ownership positions, Mr. El-Erian listed many companies that would have ceased to exist without government bailouts: AIG, GM, Chrysler, Wells Fargo, Bank of America and Merrill Lynch, among many others. The worst of the recession may be over, but the financial system still faces risks.

On the subject of governmental green energy initiatives, the speakers, Margo Thorning and Greg Valliere, stated green initiatives are mostly nonsense and won't do nearly enough to meet growing energy needs. Coal, oil and natural gas will remain the dominant energy sources for decades. The practical affordable solution is increased reliance on both nuclear power and natural gas (only half the carbon emissions of coal).

To end on a lighter note, I hope you enjoy these oxymorons which were humorously interspersed throughout the conference: government productivity, military intelligence, civil servants, congressional ethics, postal service, tax simplification, airline food, and working vacations.

And as always, we encourage you to call anytime with questions or to apprise us of changes that may affect your financial objectives. We wish you the very best.



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Mohammed El-Erian: We Have Not Reached Escape Velocity

By Robert Huebscher

September 15, 2009

The US Financial system has not fully emerged from the financial crisis, Mohammed El-Erian told an audience of nearly 1,000 advisors on Sunday night. His remarks kicked off this year's Schwab Impact conference in San Diego.

El-Erian, the CEO and co-CIO of the global manager PIMCO, called the crisis a “sequential contamination of balance sheets” that initially hit the sub-prime and housing markets. In 2007 the contamination spread to the financial services industry, and a year later it hit the global economy. Now public finance balance sheets are strained, creating a new level of concern for policy makers.

Full emergence from the crisis is analogous to a rocket reaching its escape velocity – and the US economy isn't there yet. It won't be, El-Erian said, until balance sheets are no longer contaminated.

Speaking with El-Erian was Larry Fink, the CEO of Blackrock, who generally agreed with El-Erian's forecasts, and specifically seconded El-Erian's assertion that the “New Normal” for the US will be slower economic growth.

Together, El-Erian and Fink addressed a number of issues related to the financial crisis, which I summarize below.

Are we safe yet?

In the narrowest sense, the US financial system is safe, in that El-Erian no longer believes a repeat of the cataclysmic events of last September and October are possible.

In a broader sense, however, the global economy still faces many risks. We are still dealing with the solvency of large institutions and have “inadvertently accelerated redesign of the global economy.” What's more, we are doing so in the context of a “shrinking pie” – the global economy is contracting. The government's new ownership stakes in numerous companies has fundamentally changed its role – once a referee, it's now a player.

Fink agreed that we are much safer than we were, but he did not say with any conviction that we are safe. Prior to the crisis, the source of the market's strength was a “myth” based on leverage, excess capital, and excess production capacity in industries such as automobile manufacturing. “We have a stronger system today than we did three years ago,” he said, but many of those fundamental problems remain unresolved.



The failure of diversification and other lessons from the crisis

The biggest lesson of the financial crisis, according to El-Erian, is that diversification is a necessary but not sufficient condition for maintaining adequate portfolio performance. He believes investors need more than just conventional diversification.

Diversification is no longer just about asset classes. Investors must recognize that markets will under- and over-price certain kinds of risk – and they won't necessarily do so at the asset class level. Over the next five years, he said, these considerations will become more important than asset class diversification.

El-Erian did not offer any specific examples of risk factors that he now considers mis-priced, nor did he say whether such a strategy could be employed over long time horizons or, instead, whether it would be useful only for short-term tactical decisions.

Using an analogy to explain the failure of asset class diversification, El-Erian said it was as if the oxygen had been suddenly sucked out of the room. The entire audience would quickly gasp for air – as the global markets did when the deleveraging process began last fall.

Once the oxygen was restored, those who were fit and healthy would recover first, and they would help others to recover – unless they were pulled down in their rescue attempts.

“It did not matter what market you were in when the crisis hit,” he said; all markets collapsed. When markets recovered, however, it mattered greatly where one was invested, as the healthiest markets performed best.

Investors must focus on the “left tail” of the return distribution to insure against extreme adverse outcomes, he said, noting that PIMCO has recently introduced funds with insurance against the worst outcomes.

El-Erian cited two other lessons of the crisis: that policy makers must recognize that financial innovations (like securitization) will always be “over-produced and over-consumed,” and that we must have a strong infrastructure to support innovation. Financial institutions must recognize that incentives matter – compensation must be structured to reward managers for long-term and not short-term results.

The future of regulation

Two kinds of regulation are likely to emerge from the current crisis, according to El-Erian: “smart ones and dumb ones.” The smart ones are, like smart parenting, very hard to implement.



The combination of irrational resistance from the financial industry and politicians who just want to say they did something (but not necessarily the best thing) will produce the dumb regulations, he said, as may bad implementation of otherwise good ideas.

Barriers that restrict access to certain activities (such as access to the capital markets for certain types of funding) are ill-advised, El-Erian said, because they will impede growth. Such regulation is like reducing the speed limit on the highway, he said – “it’s safer, but it carries a cost.”

Caps on executive compensation fall into to the “dumb” category, El-Erian said, and are like a parent telling a child that he or she cannot go out to play. Instead, regulators must insist on clawbacks in contracts, which defer some portion of compensation to be based on multi-year performance.

Smart regulations will focus on insuring that financial institutions maintain proper capital cushions, and that those cushions are countercyclical. During periods of prosperity less capital should be required, and vice versa, he said.

The big issue in Fink’s eyes – which is really more than a regulatory one – is determining who will be the ultimate buyer of certain types of assets: mortgages, credit card and automobile loans, and other previously securitized assets. Banks can no longer buy them, and life insurance companies, once the largest purchasers of commercial real estate, need greater liquidity and have reduced their exposure to such assets. Endowments face the same problems – the need for liquidity has reshaped their asset allocations.

The buyers of formerly securitized assets will now likely be foreign entities, Fink said. It is critical to maintain the stability of those capital markets in the short term, he said, but that the longer term effects of foreign ownership are uncertain.

El-Erian recalled his 15 years of experience at the International Monetary Fund, which was constantly managing financial crises. Comparing his experience to airplane travel, he said that when conditions become turbulent and the cockpit door is closed, passengers assume the pilots know what they are doing.

If the cockpit door were open, however, passengers would see pilots banging on the instruments, trying to determine whether the problems were real or whether they were simply instrument failures. They would see the pilots turning the steering wheel, but the plane failing to respond. They would see pilots arguing with each other, as policy makers and regulators do in times of crisis.

As a result, El-Erian believes, successful oversight requires opaqueness – market participants should not seek complete transparency from institutions like the Fed. And



the Fed must maintain its independent status, he added, so it can respond quickly to liquidity needs in times of crisis, wherever they may occur.

The dollar as the reserve currency

“Even though we have abused our privileges,” El-Erian said, “we are luckily still in control of our destiny,” and the dollar will maintain its status as the reserve currency.

Reserve currency status confers “amazing privileges,” he said, including an enormous ability for an economy to finance growth beyond the means otherwise available to it at a low cost.

In another analogy, El-Erian said the global economy was like a huge airplane driven to high altitudes and high speeds by one big engine – the US consumer.

In the future, though, the global economy will be a plane driven by multiple engines, including the economies of China, Brazil, and other emerging markets. The transition to a multi-engine global economy will take place over the next 20-30 years, and may not be a smooth one.

At the margin, the dollar is losing its status, and eventually other currencies may have lesser roles as reserve currencies, but this process will take decades to unfold.

Will the US experience a Japanese lost decade?

This recession is driven by a process of balance sheet deleveraging, and not by insufficient flows within the capital markets. That distinction, El-Erian said, separates the current crisis from the lost decade that crippled the Japanese economy.

He maintained that an experience like Japan’s remains possible, though. We are still struggling to accommodate lower leverage and reduced industrial capacity in many sectors, including automobiles, airlines, and financial services. Slower economic growth, as forecast by the New Normal, will make it difficult to ensure we avoid a lost decade.

Fink noted that US demographics are markedly stronger than Japan’s, as we have a much younger population. He believes policy makers should encourage immigration and specifically should allow and encourage foreign students to remain in the US after graduation to help build the workforce.

The New Normal for the fixed income markets – inflation versus stagflation

The bond markets are engaged in a massive tug-of-war, El-Erian said. Low inflation is keeping rates low, but uncertainty as to whether the rest of the world will continue to



fund US debts periodically pushes rates higher. These forces, he said, explain the volatility over the last month of 10-year Treasury rates, which fluctuated from 3.3% up to 4% and then back to 3.3%.

Ultimately, yields will be higher, El-Erian said, but he did not offer a specific timetable.

Inflation is not a concern, because the demand for goods is far less than its supply, he said. "It is very difficult to generate inflation under these conditions."

Stagflation – slow growth combined with inflation – may emerge at some point, and El-Erian said it is starting to show up in some industries. For example, as the demand for air travel slackened, airlines cut fares and then cut back flights. Once the supply (number of flights) reaches an equilibrium with the demand for air travel, prices will rise again – creating stagflation within that industry.

Other industries – automobiles, real estate, and financial services – may undergo a similar stagflationary transition, but El-Erian said it is hard to generalize those trends to the overall economy.

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Greg Valliere Monthly Commentary

Update as of 9/29/2009



Greg Valliere
Chief Political Strategist
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GREG VALLIERE: Well, hello, everybody. It's Greg Valliere from the Washington Research Group recording on September 29th, at the end of quite a quarter. A quarter in which optimism finally returned and the market obviously did quite well. So on today's call I'm going to be a killjoy and talk about what might go wrong in the fourth quarter after all of this optimism.

First of all, I think you've got to say that the assumption of a decent economic recovery is fully baked into the market, and I continue to worry that the consumer is not going to spend very robustly, that we'll have a statistically good second half in terms of GDP, with inventory building producing maybe 3% growth in the second half. But the jury is out in the first part of 2010, with consumers still pretty scarred by what's happened with foreclosures, with unemployment producing more anxiety, as the jobless rate in all likelihood goes a bit higher. It's entirely possible that the consumer, who accounts for about two-thirds of the U.S. economy, will move very, very slowly to return to normal shopping habits.

So with that kind of outlook, I guess the good news is that the Fed is prepared to keep the funds rate at zero for maybe another year. There's been new speculation about how aggressively the Fed eventually might take away the punch bowl, but that's still a long, long way off. I think the risks still are that the economy is weaker than we hope for, rather than the economy really blasts off.

But that's not the biggest concern. I continue to feel, as I've said on these calls during the course of this year, that the really big risk is geopolitical. For President Obama, Afghanistan represents a political risk in his own party. The growing anxiety on the left over committing more troops has presented Obama with his first big challenge politically. And, intriguingly, he's got some growing uneasiness with people on the right wing, with people like George Will arguing that Afghanistan is really not worth fighting for, that we can do much of our work against the Taliban through drones, these airplanes that are unmanned, can spot encampments of the Taliban and take them out. On both the right and left, there seems to be a feeling that Obama has not perhaps pursued the right policy, and I think this is going to be a real albatross for him as we get into late 2009.

The big story, though, the one that really concerns me, and I think eventually will begin to concern the markets, involves Iran. And many of you have heard me say for the last couple of

years that the Iranian nuclear facilities represent the greatest threat to the world, and I continue to believe that. I mean, obviously, some rogue domestic terrorist could commit some horrible act, and you can't dismiss how barbaric the Taliban and Al Qaeda are, but I think the one story that is going to start getting people's attention, obviously, is what's going on with Iran. My conclusion is a depressing one, and that, of course, is that eventually the Israelis are going to have to act on their own, and it could be a very messy process taking out these Iranian nuclear facilities. I would point to four developments over the last week or so that will probably convince the Israelis that they're going to have to act on their own.

The first development is, of course, the decision by the U.S. to toughen sanctions. Well, I know sanctions sound tough, and the U.S. is now talking about perhaps going after the insurance companies and reinsurance companies that underwrite the shipments of Iranian goods around the world. But you've got to ask the question: Do sanctions really work against dictatorial governments? They haven't worked against Fidel Castro. They haven't worked against Kim Jong-Il. If anything, sanctions provoke those despots. And I think you've got to also say that sanctions perhaps will make life more miserable for ordinary citizens in Iran, but the prospect of an uprising against the Ayatollahs, in my opinion, has no better than a 20% chance of succeeding. The Revolutionary Guards and all these goons have the guns, and the students and the dissidents don't. And I think that, unfortunately, the repression will succeed in Iran.

A second factor that has to be weighing on the Israelis is that two of the key players in winning United Nations support for sanctions, Russia and China, seem to be wavering. Maybe we'll get Russia to go along with some modest sanctions because of our decision to abandon missile defense in central Europe, which undoubtedly pleased Putin and Medvedev. But the Chinese, who have extensive business dealings with the Iranians, I think, are not inclined to go along with any kind of tough sanctions. And, again, I think you've got to ask the question, even if the U.N. agrees to sanctions, does anyone seriously believe that sanctions would dissuade Iran from its nuclear ambitions?

A third factor that I think the Israelis have to be looking at is that rather than any sign of conciliation, the Iranians are ratcheting up the tensions. As I record this, right after the very solemn Jewish holiday, we've had 48 hours of Iranian missile testing, and the Iranian defense minister said, in what I thought was a shockingly provocative statement, that they're getting ready to destroy Israel. I would like to think that perhaps this coming Thursday when they meet in Geneva, the U.S., the Iranians, and some other countries, that maybe something constructive could come out of that meeting, but I sure wouldn't bet on it.

And then, finally, I think maybe the most important factor of all is that the U.S. Defense Secretary, Robert Gates, has indicated both publicly and privately that the U.S. is not inclined to strike Iran, and there have been similar remarks from people in the Obama Administration. And that leads me to conclude one of three things: either, one, the U.S. is sincerely convinced that such strikes would be futile, that the Iranians would just rearm, or that it could lead to a much bigger war. Or, number two, the U.S. is simply trying to distance ourselves from an inevitable Israeli strike, saying, in effect, you know, 'We don't want to have our fingerprints on

it.' Or, third, maybe the U.S. is simply encouraging the Israelis to go it alone, saying, in effect, 'You guys do it.'

There's little doubt in my mind that the Israelis are prepared to move. There have been leaks in many newspapers in the last couple of years. The most impressive leak came over this past weekend in *The Wall Street Journal Weekend Edition*. If you didn't see it, I highly recommend it. It was written by Anthony Cordesman, who is among the leading military strategists in America, and I know he talks to the Israelis all the time. You know, he listed in great detail what the Israelis are planning to do. That would include midair refueling of the F-15s and F-16s, and the use of very sophisticated bunker-busting bombs. Cordesman points out there are challenges. It's not easy. It certainly isn't like what Israel has done in the past, which was pretty neat and clean. But the plans are, I think, in place, and I do feel there's a growing chance the Israelis will have to act by winter.

Well, finally, what would happen if the Israelis strike? I think these strikes would last for several days, and I think they would prompt a ferocious retaliation from the Iranians. Ahmadinejad has promised to place mines in the Persian Gulf and in the Strait of Hormuz. Obviously, the price of oil would rise dramatically. Ahmadinejad has vowed to launch terror squadrons around the world, and, sadly, I take him seriously. And he's got a huge supply of missiles that have the range to hit Tel Aviv and other cities, as the Iranians demonstrated just a couple of days ago. You know, whether those missiles could penetrate Israeli air defenses is unknown. I think in a brief but very ugly war like this most countries, including the U.S., would publicly condemn the Israelis, but in private, I think most countries, maybe even including Saudi Arabia, would welcome an attempt to halt Iran's drive for hegemony throughout the Middle East.

I think there are some positives that could arise from this, from destroying the Iranian nuclear capacity, and maybe putting them in their place. But I think the potential negatives are immense, because Iran and the Ayatollahs in Iran and many of the fanatics in that part of the world do have a suicide mentality, and no one could be certain of what types of unconventional weapons they may have.

So on that somber note, again, I hate to be a killjoy after a very nice quarter, I think that we have to worry more about geopolitics. And as the year comes to a close, my fear is that this story, the Iranian story, will be a dominant one hanging over all of us.

That's it for this month. I look forward to talking to you again soon.

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Wednesday, October 7, 2009

Russia Responds on the Iran Issue

AFTER A WEEK OF SILENCE following the Oct. 1 talks with Iran in Geneva, Russian officials issued a series of statements Tuesday. First, Deputy Foreign Minister Aleksey Borodavkin told Itar-Tass directly that Russia intends to continue its military-technical cooperation with Iran, though within the strict framework of international laws on such matters. Borodavkin's statement comes in response to U.S. and Israeli demands for Russia to stop supporting Iran. Later in the day, National Security Council chief Nikolai Patrushev denied a report in Britain's Sunday Times that stated Israel had confronted Moscow with evidence that Russian scientists were aiding Iran in the development of a nuclear weapons program. Russia has been in a tense position since the Geneva talks. Though the P-5+1 and Tehran reached a tentative agreement to allow Iran's nuclear facilities to be inspected, under the authority of the International Atomic Energy Agency (IAEA), Washington and Tehran are still heading toward a crisis. At the heart of this crisis is Russia: It is Russia that is helping Iran with its civilian nuclear program, and Russia is the country that could undermine the effectiveness of U.S. sanctions against Iran. Moscow also occasionally raises the specter of more significant military assistance to Iran, in the form of modern strategic air defense systems like the S-300.

“If Russia was directly linked to the crisis, it would wreck Moscow’s ability to negotiate not only with the United States but with the West as a whole, including Europe.”

In the past week, a [flurry of leaks](#) has escalated tensions between the United States and Iran. There was a leak from the IAEA stating that Iran's nuclear program is much more advanced than previously thought, as well as leaks from the United States that the government is re-examining its intelligence estimates on Iran's program. But what was really interesting was the leak about Israel's evidence that Russia is helping Iran with its nuclear weapons program (instead of nuclear energy for civilian purposes). This leak not only heightened the sense of an impending crisis between the United States and Iran, but also pointed a finger directly at Russia.

Yet Russia was silent for a week after the Geneva talks, and for three days after the Sunday Times reported the accusations against it. But the silence has now been broken.

The Russians took their time deciding how to respond on all fronts. As expected, Moscow denied that it was helping Iran develop a weapons program. For Russia to achieve its goal, it must be seen as supportive of Iran, but not as the cause of the turmoil between Washington and Tehran. If Russia was directly linked to the crisis, it would wreck Moscow's ability to negotiate not only with the United States but with the West as a whole, including Europe.

While Russia distances itself from the leaked Israeli accusation, it is the statement from Borodavkin that is critical. Russia is reserving the right to continue its military relationship with Iran, despite the U.S. and Israeli demands to stop. Russia is pushing the United States into a dilemma.

Moscow sees three possible outcomes of the crisis.

First, the United States could try to cut a deal with the Russians: Washington would concede on issues in Moscow's sphere of influence, in exchange for Russia backing away from Iran. But the United States would have to give up much more than [missile defense in Europe](#). Russia wants control in the former Soviet sphere and in Europe.

The second possible outcome would be the United States backing down on the Iran issue, which Russia would see as a very public demonstration of Washington's weakness.

The third possibility is that the United States would take military action against Iran and get involved in a third war in the Middle East. The Russians believe that as long as Washington is focused on Iran, it cannot also be focused on their actions.

Moscow is playing a complex and dangerous game with Iran and the United States. For the past several years, Russia has made it clear to the United States that it wanted Washington to quit meddling in its periphery and recognize Russia as the predominant Eurasian power. The United States, under the previous and current administrations, [ignored Russia's demands](#). Russia has proven recently — through the August 2008 Russo-Georgian war, for example — that it cannot be ignored. As it seeks to push back against the United States, Moscow does not see a downside to the U.S.-Iranian crisis, except possibly one: A short, sharp air and naval campaign that hurls Iran back a generation, combined with a U.S. pullout from Iraq and Afghanistan, would leave Russia without its Iran card, and looking at an angry United States that has a very free hand.

FOR THE INTERESTED READER - ADDITIONAL INFORMATION AND INSIGHT:



Two Leaks and the Deepening Iran Crisis

October 5, 2009



By George Friedman

- [The Iranian Nuclear Game](#)

Two [major leaks occurred this weekend over the Iran matter](#).

In the first, The New York Times published an article reporting that staff at the International Atomic Energy Agency (IAEA), the U.N. nuclear oversight group, had produced an unreleased report saying that Iran was much more advanced in its nuclear program than the IAEA had thought previously. According to the report, Iran now has all the data needed to design a nuclear weapon. The New York Times article added that U.S. intelligence was re-examining the National Intelligence Estimate (NIE) of 2007, which had stated that Iran was not actively pursuing a nuclear weapon.

The second leak occurred in the British daily The Times, which reported that the purpose of [Israeli Prime Minister Benjamin Netanyahu's highly publicized secret visit to Moscow](#) on Sept. 7 was to provide the Russians with a list of Russian scientists and engineers working on Iran's nuclear weapons program.

The second revelation was directly tied to the first. There were many, including STRATFOR, who felt that [Iran did not have the non-nuclear disciplines needed for rapid progress toward a nuclear device](#). Putting the two pieces together, the presence of Russian personnel in Iran would mean that the Iranians had obtained the needed expertise from the Russians. It would also mean that the Russians were not merely a factor in whether there would be effective sanctions but also in whether and when the Iranians would obtain a nuclear weapon.

We would guess that the leak to The New York Times came from U.S. government sources, because that seems to be a prime vector of leaks from the Obama administration and because the article contained information on the NIE review. Given that National Security Adviser James Jones tended to dismiss the report on Sunday television, we would

guess the report leaked from elsewhere in the administration. The Times leak could have come from multiple sources, but we have noted a tendency of the Israelis to leak through the British daily on national security issues. (The article contained substantial details on the visit and appeared written from the Israeli point of view.) Neither leak can be taken at face value, of course. But it is clear that these were deliberate leaks — people rarely risk felony charges leaking such highly classified material — and even if they were not coordinated, they delivered the same message, true or not.

The Iranian Time Frame and the Russian Role

The message was twofold. First, previous assumptions on time frames on Iran are no longer valid, and worst-case assumptions must now be assumed. The Iranians are in fact moving rapidly toward a weapon; have been extremely effective at deceiving U.S. intelligence (read, they deceived the Bush administration, but the Obama administration has figured it out); and therefore, we are moving toward a decisive moment with Iran. Second, this situation is the direct responsibility of Russian nuclear expertise. Whether this expertise came from former employees of the Russian nuclear establishment now looking for work, Russian officials assigned to Iran or unemployed scientists sent to Iran by the Russians is immaterial. The Israelis — and the Obama administration — must hold the Russians responsible for the current state of Iran's weapons program, and by extension, Moscow bears responsibility for any actions that Israel or the United States might take to solve the problem.

We would suspect that the leaks were coordinated. From the Israeli point of view, having said publicly that they are prepared to follow the American lead and allow this phase of diplomacy to play out, there clearly had to be more going on than just [last week's Geneva talks](#). From the American point of view, while the Russians have indicated that participating in sanctions on gasoline imports by Iran is not out of the question, [Russian President Dmitri Medvedev did not clearly state that Russia would cooperate](#), nor has anything been heard from Russian Prime Minister Vladimir Putin on the subject. The Russian leadership appears to be playing “good cop, bad cop” on the matter, and the credibility of anything they say on Iran has little weight in Washington.

It would seem to us that the United States and Israel decided to up the ante fairly dramatically in the wake of the Oct. 1 meeting with Iran in Geneva. As IAEA head Mohamed ElBaradei visits Iran, massive new urgency has now been added to the issue. But we must remember that Iran knows whether it has had help from Russian scientists; that is something that can't be bluffed. Given that this specific charge has been made — and as of Monday not challenged by Iran or Russia — indicates to us more is going on than an attempt to bluff the Iranians into concessions. Unless the two leaks together are completely bogus, and we doubt that, the United States and Israel are leaking information already well known to the Iranians. They are telling Tehran that its deception campaign has been penetrated, and by extension are telling it that it faces military action — particularly if massive sanctions are impractical because of more Russian obstruction.

If Netanyahu went to Moscow to deliver this intelligence to the Russians, the only surprise would have been the degree to which the Israelis had penetrated the program, not that the Russians were there. The Russian intelligence services are superbly competent, and keep

track of stray nuclear scientists carefully. They would not be surprised by the charge, only by Israel's knowledge of it.

This, of course leaves open an enormous question. Certainly, the Russians appear to have worked with the Iranians on some security issues and have played with the idea of providing the Iranians more substantial military equipment. But deliberately aiding Iran in building a nuclear device seems beyond Russia's interests in two ways. First, while Russia wants to goad the United States, it does not itself really want a nuclear Iran. Second, in goading the United States, the Russians know not to go too far; helping Iran build a nuclear weapon would clearly cross a redline, triggering reactions.

A number of possible explanations present themselves. The leak to The Times might be wrong. But The Times is not a careless newspaper: It accepts leaks only from certified sources. The Russian scientists might be private citizens accepting Iranian employment. But while this is possible, Moscow is very careful about what Russian nuclear engineers do with their time. Or the Russians might be providing enough help to goad the United States but not enough to ever complete the job. Whatever the explanation, the leaks paint the Russians as more reckless than they have appeared, assuming the leaks are true.

And whatever their veracity, the leaks — the content of which clearly was discussed in detail among the [P-5+1](#) prior to and during the Geneva meetings, regardless of how long they have been known by Western intelligence — were made for two reasons. The first was to tell the Iranians that the nuclear situation is now about to get out of hand, and that attempting to manage the negotiations through endless delays will fail because the United Nations is aware of just how far Tehran has come with its weapons program. The second was to tell Moscow that the issue is no longer whether the Russians will cooperate on sanctions, but the consequence to Russia's relations with the United States and at least the United Kingdom, France and, most important, possibly Germany. If these leaks are true, they are game changers.

We have focused on the [Iranian situation](#) not because it is significant in itself, but because it touches on a great number of other crucial international issues. It is now entangled in the Iraqi, Afghan, Israeli, Palestinian, Syrian and Lebanese issues, all of them high-stakes matters. It is entangled in Russian relations with Europe and the United States. It is entangled in U.S.-European relationships and with relationships within Europe. It touches on the U.S.-Chinese relationship. It even touches on U.S. relations with Venezuela and some other Latin American countries. It is becoming the Gordian knot of international relations.

STRATFOR first focused on the Russian connection with Iran in the wake of the Iranian elections and resulting unrest, when [a crowd of Rafsanjani supporters began chanting "Death to Russia,"](#) not one of the top-10 chants in Iran. That caused us to focus on the cooperation between Russia and Iranian President Mahmoud Ahmadinejad and Supreme Leader Ayatollah Ali Khamenei on security matters. We were aware of some degree of technical cooperation on military hardware, and of course on Russian involvement in Iran's civilian nuclear program. We were also of the view that the Iranians were unlikely to progress quickly with their nuclear program. We were not aware that Russian scientists were directly involved in Iran's military nuclear project, which is not surprising, given that

such involvement would be Iran's single-most important state secret — and Russia's, too.

A Question of Timing

But there is a mystery here as well. To have any impact, [the Russian involvement](#) must have been under way for years. The United States has tried to track rogue nuclear scientists and engineers — anyone who could contribute to nuclear proliferation — since the 1990s. The Israelis must have had their own program on this, too. Both countries, as well as European intelligence services, were focused on Iran's program and the whereabouts of Russian scientists. It is hard to believe that they only just now found out. If we were to guess, we would say [Russian involvement has been under way](#) since just after the Orange Revolution in Ukraine, when the Russians decided that the United States was a direct threat to its national security.

Therefore, the decision suddenly to confront the Russians, and suddenly to leak U.N. reports — much more valuable than U.S. reports, which are easier for the Europeans to ignore — cannot simply be because the United States and Israel just obtained this information. The IAEA, hostile to the United States since the invasion of Iraq and very much under the influence of the Europeans, must have decided to shift its [evaluation of Iran](#). But far more significant is the willingness of the Israelis first to confront the Russians and then leak about Russian involvement, something that obviously compromises Israeli sources and methods. And that means the Israelis no longer consider the preservation of their intelligence operation in Iran (or wherever it was carried out) as of the essence.

Two conclusions can be drawn. First, the Israelis no longer need to add to their knowledge of Russian involvement; [they know what they need to know](#). And second, the Israelis do not expect Iranian development to continue much longer; otherwise, maintaining the intelligence capability would take precedence over anything else.

It follows from this that the use of this intelligence in diplomatic confrontations with Russians and in a British newspaper serves a greater purpose than the integrity of the source system. And that means that the Israelis expect a resolution in the very near future — the only reason they would have blown their penetration of the [Russian-Iranian system](#).

Possible Outcomes

There are two possible outcomes here. The first is that having revealed the extent of the Iranian program and having revealed the Russian role in a credible British newspaper, the Israelis and the Americans (whose own leak in The New York Times underlined the growing urgency of action) are hoping that the Iranians realize that they are facing war and that the Russians realize that they are facing a massive crisis in their relations with the West. If that happens, then the Russians might pull their scientists and engineers, join in the sanctions and force the Iranians to abandon their program.

The second possibility is that the Russians will continue to play the spoiler on sanctions and will insist that they are not giving support to the Iranians. This leaves the military option, which would mean broad-based action, primarily by the United States, against Iran's nuclear facilities. Any military operation would involve keeping the Strait of Hormuz clear, meaning naval action, and we now know that there are more nuclear facilities than

previously discussed. So while the war for the most part would be confined to the air and sea, it would be extensive nonetheless.

Sanctions or war remain the [two options](#), and which one is chosen depends on Moscow's actions. The leaks this weekend have made clear that the United States and Israel have positioned themselves such that not much time remains. We have now moved from a view of Iran as a long-term threat to Iran as a much more immediate threat thanks to the Russians.

The least that can be said about this is that the Obama administration and Israel are trying to reshape the negotiations with the Iranians and Russians. The most that can be said is that the Americans and Israelis are preparing the public for war. Polls now indicate that more than 60 percent of the U.S. public now favors military action against Iran. From a political point of view, it has become easier for U.S. President Barack Obama to act than to not act. This, too, is being transmitted to the Iranians and Russians.

It is not clear to us that the Russians or Iranians are getting the message yet. They have convinced themselves that Obama is unlikely to act because he is weak at home and already has too many issues to juggle. This is a case where a reputation for being conciliatory actually increases the chances for war. But the leaks this weekend have strikingly limited the options and timelines of the United States and Israel. They also have put the spotlight on Obama at a time when he already is struggling with health care and Afghanistan. History is rarely considerate of presidential plans, and in this case, the leaks have started to force Obama's hand.

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