



Flash Report

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The Coup May Be Over, the Revolution Is Just Starting

We continue to watch the fascinating developments in Russia. While the coup has failed and Yevgeny Prigozhin is either in exile or meeting a worse fate, the reality of the situation is that Russia is on a path to internal strife. These events were eminently predictable. In fact, *our team has been predicting them since day one of the Russian invasion in Ukraine*. Here is what we said in our *February 24, 2022* analysis:¹

Russian history is replete with examples of how aggression does not pay dividends for the country. The same advantages that have afforded Russia a near perfect record when playing defense – a vast expanse into which it can withdraw almost endlessly – make it difficult to project power over a long period of time. Ukraine itself is a large country. Although it neighbors Russia, supporting troops that far into hostile territory will be challenging.

Over the past 200 years, almost every Russian war of aggression has therefore ended in a bungled, embarrassing, tragedy that then bore fruits for a revolution.

Policymakers are not always aware of their material constraints. They may misjudge them. Or they may completely ignore them, irrationally. As such, the constraint-based framework is not always right, initially. However, if our assessment of the material constraints facing Russia in Ukraine is correct, then there will be consequences for President Putin for having misjudged them.

We reiterated this forecast in a recent commodity analysis as well, positing that internal strife in Russia would be one of the critical geopolitical risks that would provide a long-term tailwind for commodities:²

¹ Please see Clocktower Group, *Flash Report*, "Some Non-Linear Thoughts: Putin's End, China's Time, Return of Realpolitik, and the Coming Bond Carnage?" dated February 24, 2022, available on request.

² Please see Clocktower Group, *All Along the Clocktower*, Volume II, "Commodities: Is the Supercycle Still On?" dated April 2023, available on request.

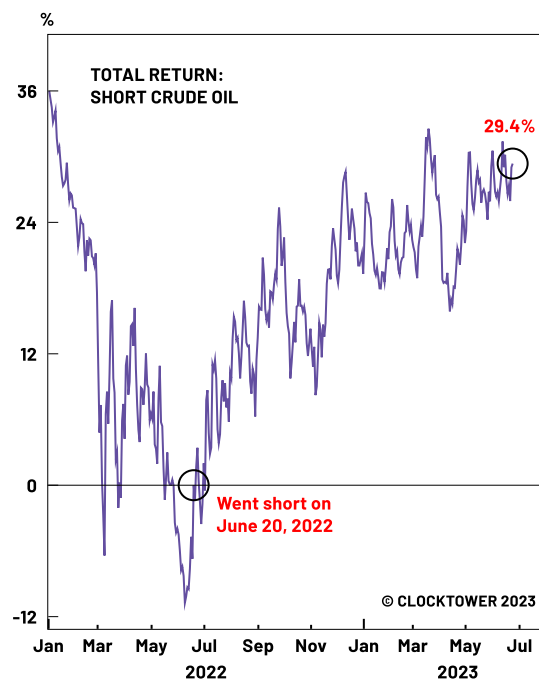
Russian destabilization: The war in Ukraine has been a disaster for Russia militarily, geopolitically, and potentially – in the near future – politically. Domestic political insecurity could create an environment uncondusive to capital investment – to put it mildly. Regime change could create complete chaos in the world’s largest exporter of commodities. This could lead to a severe decline in production. Russia has already announced oil production cuts amounting to 6.7% of its exports. While these cuts are flagged as retaliation for Western sanctions, that may simply be rhetorical cover for problems with maintaining production given a lack of Western technology and knowhow.

One thing investors should learn from the ongoing conflict is that second and third order effects are difficult to predict, but are critical for markets. Lots of people predicted Russia’s invasion into Ukraine correctly. We didn’t. But, once the invasion happened, we *shorted bonds* immediately – a controversial, to put it mildly, trade recommendation given their supposed safe haven status (**Chart 1**) – shorted oil in June 2022³ – also a controversial recommendation given the long oil consensus at the time (**Chart 2**) – and then went long EUR and European industrials in September 2022⁴ – ditto on the controversy given the massive, and truly idiotic, consensus that Europe would de-industrialize as result of the war (**Chart 3**).

CHART 1 | Bonds Realized Quickly...



CHART 2 | ...What Took Oil Longer to See...



Each of these calls relied on our instinct to *fade* first order effects – whose effect on markets is known by experienced investors to be fleeting (**Diagram 1**) – and focus on the second and third order effects.

³ Please see Clocktower Group, *Flash Report*, “Oil, Prices, Multipolarity, and Ukraine,” dated June 20, 2022, available on request.

⁴ Please see Clocktower Group, *All Along the Clocktower*, Volume I, “Math Is for Suckers” dated September 2023, available on request.

Missing a first-order effect is like missing a shot in basketball. Even the best shooters will only hit around 55% of their shots. The question is what you do *after* you miss the shot. To be able to forecast second and third order effects, you must have a framework. We do. It is elucidated in *Geopolitical Alpha* and it works.⁵

CHART 3 | ...Which Is that Putin Is Constrained and Thus the Fallout of the War Is Contained

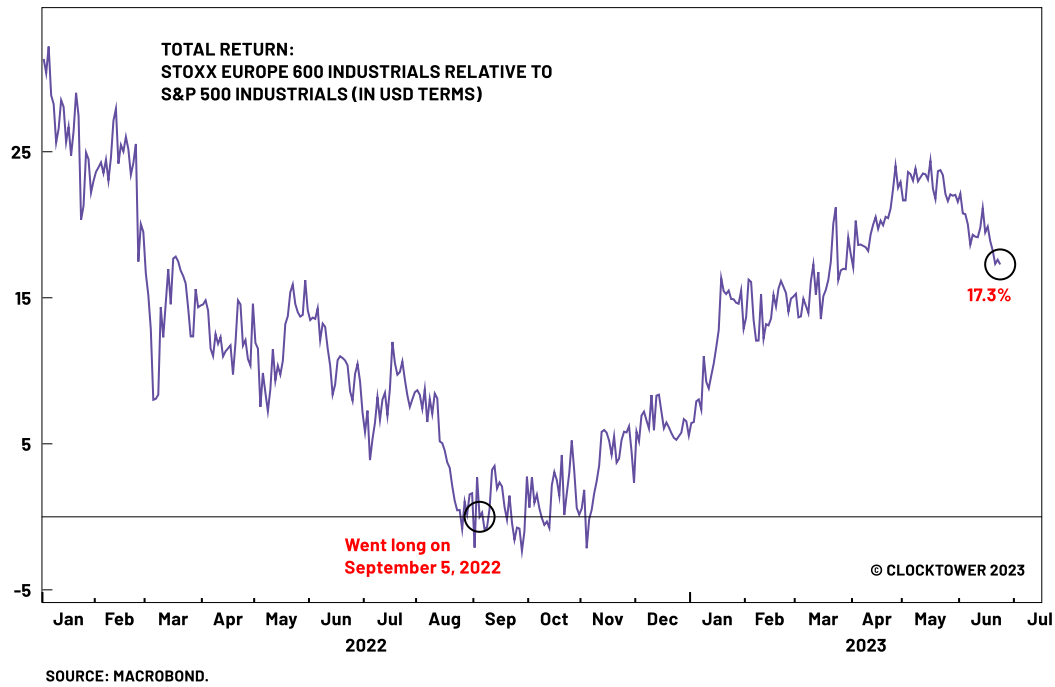
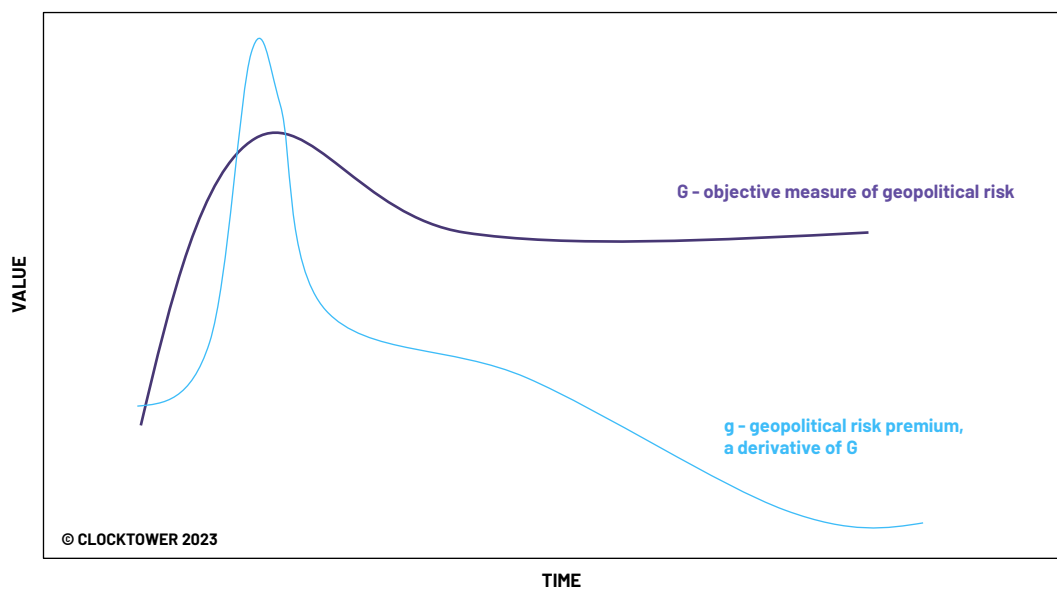


DIAGRAM 1 | Markets Become Desensitized to "Flat" Geopolitical Risk, Collapsing the Risk Premium



⁵ Please see Marko Pasic, "Geopolitical Alpha: An Investment Framework for Predicting the Future," Wiley, October 2020.

President Putin ignored his material constraints and has been paying the price for it ever since the day one of the invasion. It's why the bond market ignored the silly nuclear threats, why oil prices collapsed when investors realized there was no risk to supply, and why European assets skyrocketed as the paucity of Putin's gamble was revealed. Every step of the way, material constraints were right, and Putin was wrong for ignoring them. He is now reaping what he sowed and what we predicted would occur: the war in Ukraine would become a massive threat to regime stability.⁶ His regime is on shaky ground, with the Kremlin no longer satisfying the basic tenet of sovereignty: **monopoly over the legitimate use of force in a given territory.**

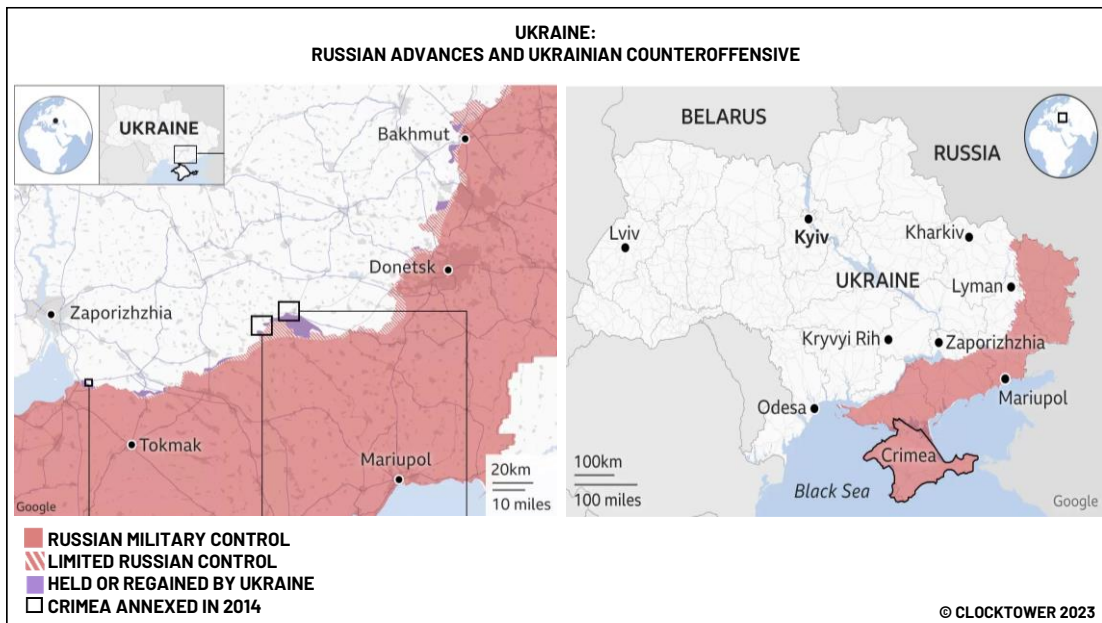
Where do investors go from here? Markets are unlikely to open on Monday with any perceptible reaction to the coup attempt. Oil may rally, but we believe that the imminent Chinese stimulus and the ongoing strength of the US economy – despite all the doom and gloom recession calls – are far more relevant to oil prices and commodities than short term political machinations within Russia.

While we remain sanguine on the issue of the war in Ukraine and believe that both sides are exhausted and unlikely to make headway, the easy geopolitical alpha is no longer available to harvest. The “easy wins” are gone. Geopolitical risk premium does not appear to be embedded anywhere. As such, the risk skew is *to the downside* – particularly for European assets – *even if we are sanguine on geopolitics*. With nary a geopolitical risk premium anywhere in the market, it is difficult to find ways to fade the hysteria. We are therefore cautious in this eminently unpredictable moment. While *we* believe that the odds of Putin declaring victory in Ukraine are rising so that he can consolidate his regime at home, *he* may disagree with us. As such, we need to watch carefully for three data points:

- **Russian *esprit de corps*:** Far more important than any “order of battle” analysis that quantitatively lists tanks and guns is the psychological state of Russian troops. Our readers should remember the speed with which Taliban overwhelmed the US-trained Afghanistan military, or the speed with which ISIS did the same in Iraq. It is now June 25, 2023. The gains of the Ukrainian offensive are paltry (**Map 1**). If the Wagner mutiny has impacted Russian morale negatively, the Ukrainian gains over the next four weeks will be non-linear and dramatic. We are skeptical that they will be, but investors should monitor the movements carefully.
- **Domestic narrative:** Prigozhin accused the Kremlin of subverting Russian national interests by bungling an invasion into Ukraine. More than that, he accused Russian elites of pursuing a war for domestic political reasons. This is an extraordinary line of attack, but one committed by a nationalist mercenary with a brutal reputation. Prigozhin cannot be dismissed as some liberal NGO leader sitting in a comfortable St. Petersburg office and feasting on Western handouts. Investors should watch whether more “patriots” (read: hawks and nationalists) flock to his thesis. This will force Putin to reconsider the war, lest he gets outmaneuvered on the *right*.
- **China's response:** Beijing policymakers have already spoken to Kremlin elites, as reported by the media. Regime change in Russia is not in China's interest. Russian regime change has, in the past, led to 180-degree foreign policy turns. Who can forget Lenin leaving France and the UK in a lurch by abandoning the Eastern Front? Or Gorbachev, and later Yeltsin, simply ending the Cold War? We expect China to put pressure on Russia to end the war, not double down on supporting the failed offensive in Ukraine.

⁶ Please see Bloomberg, “[I Give Putin 12 Months’ or Less, Geopolitical Expert Papic Says](#),” dated March 4, 2022, available at Bloomberg.com.

MAP 1 | Ukrainian Gains in the Offensive Have Been Paltry



NOTE: MAPS AS OF JUNE 22, 2023.
SOURCE: BBC, INSTITUTE FOR THE STUDY OF WAR.

As our readers can tell, we continue to lean towards the war in Ukraine being a non-market event, a view we have now held *for an entire year*. We fear that our view is fully in the price. As such, the risk is that we are wrong, whereas the opportunity has been harvested by those who read our investment research.

Over the long term, the political crisis inside Russia will be a much bigger macro event for investors than the war in Ukraine. The obvious implication, for long term investors, is to position for a commodity supercycle. But the level of risk will vary greatly. Russian regime change could take the civilized, gentlemanly, route, with President Putin being replaced the way his predecessor Yeltsin was. With multiple guarantees to himself and his family. Or, Russia could devolve into a *Mad Max: The Road Warrior* route of instability. The permutations of those two options are so wide that it is difficult, at this point, to see clearly which route the future will take.

Questions/Comments?

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