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## **Vladimir Putin, Teddy Roosevelt, the GIC & me on a Baltic Non-vacation**

August 24, 2008, David R. Kotok, Chairman & Chief Investment Officer

We left the Baltic region Friday morning concerned for the security of the EU. We suspect the Russians have a trifurcated strategy: (1) They will use the energy card (electricity, oil and gas production, pipelines, and the power grid) to project their power on the EU and NATO member states. (2) They will use their newly tested success in Georgia to undermine US alliances around the globe. (3) They will opportunistically use their military might or the threat of same with non-NATO, non-EU states in their neighborhood. How the EU handles this remains to be seen.

Some analysts found comfort in the Friday afternoon interview with the chief US diplomat in Moscow. "US Ambassador John Beyrle, in his first interview to Russia's media, spoke of the US-Russia's relations after that war. He emphasized that the US told Georgia the conflict couldn't be resolved by force....Moscow has gone too far, Mr Beyrle concluded." For the English language version of the Russian daily Kommersant see: [www.kommersant.com/p1014311/Beyrle\\_Georgia](http://www.kommersant.com/p1014311/Beyrle_Georgia).

Opinions about Russia/Georgia now range widely. At one extreme, America's critics blame the Bush Administration's arrogance. One seems to defend Putin for wanting only to restore the Russian "sphere of influence." An editorial in the FT (August 20, 2008) by Singapore's Kishore Mahbubani articulates the "let's sympathetically understand this Putin action" view. His op-ed doesn't defend tanks, but he does place the Western alliance in a troubling perspective.

Mahbubani writes: "Indeed, most of the world is bemused by western moralizing on Georgia. America would not tolerate Russia intruding into its geopolitical sphere in Latin America. Hence Latin Americans see American double standards clearly. So do all the Muslim commentaries that note that the US invaded Iraq illegally, too. Neither India nor China is moved to protest against Russia. It shows how isolated is the western view on Georgia: that the world should support the underdog, Georgia, against Russia. In reality, most support Russia against the bullying west. The gap between the western narrative and the rest of the world could not be greater."

The opposite extreme is best characterized as a US "neo-con" response which threatens to turn a developing 21st-century cold war into a 20th-century hot one. In our view these hawkish threats are the 21st-century version of scolding the child when the parent says, "If you take another cookie from the jar I will punish you."

Even more extreme is the harsh right-wing harrumphing of "shoot first and ask questions later." Armchair generals can easily say such things because they do not have to solve the problems of depleted troops or poor underlying economics or questionable reliance on allies and friends. It is easy to say what others should do. Much more difficult is the execution of policy in a practical sense when the policy originates from a political economy filled with Internet-informed, blogging voters.

We personally reject both of these extreme positions. Georgia does not equal the 1939 invasion of Poland by the German army. That 20th-century action forced a treaty-based response. Hitler wanted to bring all of Europe into a war of conquest. Britain had a defense treaty with Poland. Attacking Poland was a direct attack on Britain, and Hitler knew it.

We believe that Putin is way too smart to make that mistake. Furthermore, he has no need to do it. He seeks

regional hegemony, not grandiose empire building.

The challenge to the US and the EU is to recognize that we are in the 21st century and we have 21st-century tools with which to avoid a repeat of 1939-1945 experience. The key is to preserve and expand a now threatened global financial and economic integration which has raised the living standards of billions of people, including many Russians. We admit that the task is easy to articulate, but the achievement of a successful outcome is difficult to obtain during periods of belligerency.

To understand how we got here, we must start with the premise that Russian has achieved its present power through its extraction industries. As the world's mature economies became dependent on oil, metals, and other commodities, it empowered those who provided them. Western consumption profligacy and the growing global indebtedness of the United States made the Putins of the world stronger.

Thugs become statesmen when they have money. Or at least they try. Putin is not alone. Look at Chavez for a proximate example.

In the 21st century, the key to successful US policy is to manage a change from debt dependency, imported oil dependency, and commodity dependency to a restoration of balance. That may sound simple; it certainly is not easy in the US political system.

We must add a troubling caveat. In our opinion both of the extreme views noted above are fraught with risk. Why the higher risk? There are two reasons.

First, we note that the present-day US is a political economy which is weary of war. That means the arguments of paradigm shift made by America's critics can have resonance. War weariness is a constraint on any political leader, especially one newly elected in the US.

Secondly, an otherwise low probability of hawkishness is currently high because of 21st-century imaging. Emotional buttons are easily pushed by professional media warriors. That is what you get in this century of instant Internet and TV communication. In the 20th century we learned of things from radio and then "Movietone News" in the WWII era. We enhanced this with live video only after the Viet Nam-era images changed global politics. In the 21st century, the Russians know how to embed journalists for their advantage, just as Americans do.

In this century, the Internet and the use of video imagery combine to make cyber warfare into a powerful weapon. The US and the EU need to stress that in their preparedness. The Russian incursion into Georgia was preceded by a cyber attack of several weeks. Anyone who thinks that was a coincidence is delusional. In the 20th century you bombed the beaches to degrade physical defenses, and you attempted to disrupt communication with paratroopers behind enemy lines. This is all antiquated in the 21st century. Much more damage can be done by disabling an electronic network. Imagine if all the world's Blackberries were simultaneously disabled. Picture a 3G wireless communication disruption precisely at the onset of hostilities. The thought is frightening.

Who is speaking softly and who is carrying a big stick?

In our view, soft-spoken Vladimir Putin has successfully tested the US, NATO, and the EU with a big stick. All three organizations (much overlapped) failed because they were not prepared. They had convinced themselves that Putin would not use an armored rifle division with coordinated close air support in such a heavy-handed yet efficiently executed way. They did not believe the cyber attack was a warning sign. Thus they were caught by surprise. Russia's Georgian exercise has skillfully executed the 21st-century equivalent of the mid-1930s Nazi invasion of the Sudetenland.

The West's reactions now are a "ratcheting up" of tensions as we phase into the 21st-century version of the Cold War. Each Western reaction begets a Russian counteraction.

The US-Poland missile deal is viewed by Russia as a response. It is answered by a Russian negotiation of a Syria air defense deal. Russia will also court Raul Castro to demonstrate its reach. Putin has specifically said he plans on "restoring our position in Cuba." Military movement induces fear, and it works. It appears that Kazakhstan is now accepting the prospect of pumping oil through Russia instead of via the Baku-Tbilisi-Ceyhan (BTC) pipeline, according to the Turkish daily Referans, August 21 (source: Stratfor).

Meanwhile the US faces an Iraqi government now asking us to leave. We are failing in the quiet attempt to negotiate some settlement with Iran. We see Taliban escalation in Afghanistan. There is growing turmoil in nuclear-armed Pakistan. I will stop listing here and leave the rest of the list for our readers to complete.

Washington will not admit that the policies of the last few years have weakened the United States. We entered the 21st century as the most technologically advanced military power in the world, yet our "big stick" has been broken by our own leadership. And we have not learned to "speak softly."

A Republican president, Teddy Roosevelt, launched the 20th century with "Speak softly and carry a big stick, and you will go far." He followed this prescription and won a Nobel Peace Prize for negotiating the end of the Russo-Japanese war. He projected American economics with the advancement of the Panama Canal and achieved environmental milestones like our National Park system. He initiated the Interstate Commerce Commission and the Pure Food and Drug and Meat Inspection Acts of 1906. We have quite a legacy from this 20th-century Republican president, notwithstanding his "cowboy" image. I will leave it to readers to compare this with the legacy of the 21st-century version.

We are also seriously wounded in the financial sector.

We will not dwell on this issue, since Cumberland has discussed it at great length in our commentaries. See [www.cumber.com](http://www.cumber.com). Let me only note that Russia holds half a trillion dollars of reserves accumulated because of its oil producer status. Also note that the Bush Administration leaves office and a new president takes office in the middle of a fiscal year when the cash deficit of the United States will approximate 600 billion dollars. At the same time the US Congress has positioned the country with a two-thirds dependency on foreign-sourced oil.

The 27 EU countries face an economic slowdown and are starting to report their share of global financial losses. Their structure is less cohesive than that of the united 50 states of the US. Their domestic governments still think in nationalistic terms. They still compute the current account deficits between countries. Think for a moment about how 20th-century nationalism raises costs and adds to barriers. Does anyone even know the trade deficit between New Jersey and Pennsylvania?

Can Europe coalesce and achieve a coordinated policy response to Russia? This is where the risk is also high.

Our repeated travels to European countries leave us with skepticism. The leadership in many of them understands the problem. But they are dealing with a socialized form of political economy. Their citizens look to government entitlements and worry not about the financial liabilities that are mounting. And their finances are imbalanced.

The European Central Bank has more credibility than many EU governments. It has preserved its independence because it was enshrined in a treaty. But monetary policy has its limits. A strong currency alone is not enough of a weapon against a large external threat like Russia. Europeans are in for a tough, cold winter when Putin plays his energy cards.

A new American president can achieve a reversal of the imbalances. To do so, he must avoid sanctions and eschew bellicosity. Speaking softly will help. Using the big stick of market-based choices and transparent financial policy is important. The more we advance global financial integration, the more stakeholders take root in every country of the world. Stakeholders do not want war. They have something to lose, and hence they tend to seek options besides tanks. New Russian entrepreneurs are included.

Global financial integration and commercial expansion is a distinctly American contribution. These are among our best tools.

In our anger with the Russians we must not let the neo-cons prevail and construct barriers. We must not apply sanctions. Instead we should remove them. The examples of failed barriers are everywhere. I will mention just one.

The US embargo hasn't toppled Castro. Opening up may be more helpful. Would we rather see Russia drilling for oil in Cuba's Gulf of México waters, or do we want US companies doing that exploration? Readers may want to read Rens Lee's essay, entitled "In Havana, waiting for Obama or for Putin," at [www.FPRI.org](http://www.FPRI.org).

The other powerful American tool is our technological advantage. We are still a global leader in IT. We can still create distinctly American companies and products. Google is a corporate example. So is Intel.

Teddy Roosevelt's 20th-century initiatives may provide guidance for our new president. McCain and Obama would do well to read this history.

The investment implication is clear.

Finally, we believe the battleground is in IT. That means more government spending in the tech area will pile on top of business spending. We expect the increasing defense cost to raise deficits in nearly all the OECD countries. Much of that money will be spent in the tech sector. IT gives the fastest productivity payback for each dollar spent. And cyber war is here to stay and has been proven effective in Georgia. Cumberland's portfolios are at maximum overweight in this broad sector.

Why we went to the Baltic region.

During the past week we have traveled from one end of the Baltic Sea to the other. On August 21 there was a public conference dealing with energy and security. Discussions included perspectives of Central European, Baltic, and Scandinavian countries. In addition we heard about the broader approach of the European Union (EU). There was much analysis focused on the Russian/Georgian experience. Two Russian-language journalists were in attendance at the public portion.

The speakers presented multiple views and were very thought-provoking. More than a dozen countries were represented in the panels and among the audience discussants. The various presenters' slides will be available publicly on the Estonian Central Bank website, <http://www.bankofestonia.info/frontpage/en> .

For those in the GIC delegation ([www.interdependence.org](http://www.interdependence.org)) a great additional value were the private conversations with central bankers, economists, private investors, diplomats, and government officials. Achieving this dialogue without the public and press scrutiny is a key benefit of Global Interdependence Center conferences.

It was a personal privilege for me to chair of the GIC delegation. That organization is trying to make the world a better and more peaceful place, a noble purpose in this very difficult world. GIC's goal is to sponsor dialogue. It supports the use of economic, monetary, and trade openness and transparency and seeks to do so with integrity. The GIC is a nonpartisan think tank; thus its members hold diverse views. Those written here are our own and do not reflect the organization's views.

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**David R. Kotok, Chairman & Chief Investment Officer**

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