

June 17, 2013

## **The Snowden Affair**

Over the past two weeks, revelations published in *The Guardian* and the *Washington Post* reported on a massive data gathering program that the National Security Agency (NSA) has been operating since 2001. The NSA, created during the Truman administration, mostly monitors signal intelligence and is the primary cryptographer for the U.S. government.

Edward Snowden, a contractor for the NSA, was the source of the leaks. Snowden has been described as the “slacker leaker.” His history reveals a person of limited accomplishments. He failed to graduate from high school, dropping out and eventually earning a GED. He entered the military as a reserve but was reportedly injured in Special Forces training and washed out. He worked as a security guard for an NSA facility. However, he did have self-taught computer skills that allowed him to become employed as a CIA technology specialist. He was able to get top secret security clearance while working for the CIA. He moved into the private sector, using his security status for employment. As a contractor for Booz Allen Hamilton, Snowden provided systems analysis for the NSA and it was in this role that he acquired documents indicating the NSA was collecting phone records on Americans and had a program to monitor internet traffic on foreigners.

Unfortunately for President Obama, these revelations are part of a broader theme of seemingly inappropriate government

actions, including apparent selective IRS enforcement and the problems associated with Benghazi. In fact, the administration appears to be facing these problems, which have been revealed by government workers who have leaked them to the press. The response of the administration has been to aggressively prosecute leaks; so far, these prosecutions have not stopped this information from reaching reporters.

In this report, we will attempt to frame the Snowden affair within the context of the tension between the superpower role and domestic political conditions. From there, we will discuss the president's attempt to transition the Global War on Terrorism away from a strictly military response. An analysis of the dangers of data gathering will follow along with potential international issues. As always, we will analyze the ramifications of this situation on the financial and commodity markets.

## **Republic Versus Empire**

The United States was founded as a republic. The founding documents, the Declaration of Independence, the Articles of Confederation and the Constitution, were written for a republic that was not created with imperial objectives. The Founding Fathers observed the grasping behavior of European powers with their constant wars and colonization and wanted no part. So, the founding documents created a government with checks and balances designed to protect individual freedoms and limit the coercive power of the state. By plan, the goal was to prevent the government from becoming intrusive.

Instead of projecting power globally, the U.S. focused on the steady expansion westward (“manifest destiny”) and avoiding entanglements with Europe. This doesn’t mean the U.S. was pure; Native Americans were clearly on the losing end of westward expansion and this new America was not opposed to gaining territory through warfare, as exhibited by the Mexican War. But, the primary geopolitical position of the U.S. was that of a non-imperial power that was protected by two large oceans and pacified borders.

As the 20<sup>th</sup> century unfolded, the U.S. economy grew rapidly, benefiting from a growing, mostly immigrant, population, an industrial revolution and enormous natural resources. In fact, the U.S. has been a rare economic power in that it was able to develop without leaning heavily on exports for growth. Its domestic market and tranquil geopolitical conditions were nearly perfect for economic development.

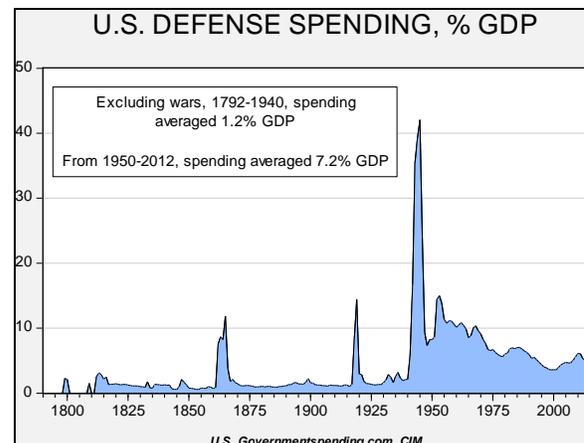
As the U.S. expanded, it was gradually being drawn into the world. President Theodore Roosevelt believed a nation the size of the U.S. needed a blue water navy, and acquired a few colonies as part of the process of expanding. However, the U.S. played a back seat role in global power structures, showing little interest in world affairs. America generally avoided involvement in WWI, entering the war only after Czarist Russia left the conflict to ensure Germany didn’t win. After the war, the U.S. purposely retreated to isolationism. The Great Depression was worsened by the fact that the prevailing superpower, Britain, was unable to maintain that role but the U.S. didn’t want to assume a larger position. Without a stable reserve currency and an importer of last resort, global trade collapsed and the world economy stumbled into a

horrible slump. These conditions eventually devolved into a second world war.

After WWII, U.S. leaders decided that a retreat to its earlier isolationist stance would inevitably lead to WWIII. To prevent that from occurring, the U.S. reluctantly became a superpower, offsetting the other major power, the Soviet Union.

Unfortunately, the basic governmental structure of the U.S., derived from its founding documents, was not conducive to its new role. Superpowers need strong executives. The superpower is required to engage in small wars, like global policing actions, that cannot require constant legislative approval. Governments need to be large to ensure enough aggregate demand to provide a global reserve currency.

This chart highlights the change.



This chart shows U.S. defense spending from the creation of the republic as a percent of GDP. Note how spending spiked for each war and rapidly decelerated after the war ended as the military demobilized. After WWII, spending remained elevated as the U.S. needed a large standing military to fulfill its superpower role. The U.S. has fought numerous conflicts since WWII; none have been authorized by an official

declaration of war, as required by the Constitution.

Essentially, since 1945, the U.S. has been required to create a government necessary for a superpower within the parameters of a Constitution designed for a republic. The original founders could not have conceived of a CIA or even an FBI. They would have been very uncomfortable with a large standing military and would have disliked the military-industrial complex as well as the technology-intelligence complex.

And so, these government bodies, which rest on constitutionally shaky grounds to begin with, face periods where there is heavy outside scrutiny and periods of nearly complete freedom. Phillip Agee, a former CIA operative who wrote several books revealing covert activity in Latin America, along with other “leakers,” led to the Church Commission, a move by Congress to bring oversight to the intelligence community. This committee outlawed political assassinations, domestic spying and created the Foreign Intelligence Surveillance Court (FISC). For the most part, the intelligence agencies lived with these restrictions, which were established in the mid-1970s. By then, the Cold War was in its third decade and there was less need for the sort of “swashbuckling” behavior of the earlier period.

### **The Global War on Terrorism**

Al Qaeda’s attack on the U.S. on 9/11 caused a fundamental change in perspective on intelligence and covert activity. The U.S. was facing an amorphous, stateless enemy that could attack using the country’s own infrastructure by covert means. In response, the Bush administration passed the Patriot Act, which granted a significant expansion of power to the intelligence agencies. As the U.S. ramped up the effort, agencies were

forced to extensively use private contractors to fill positions. The government employs 854,000 persons in intelligence work and spends \$80 bn per year on the effort. Of this group, 265,000 have top secret security clearances. Given these numbers, perhaps the greater mystery is why leaks don’t occur more often.

From 2001 until 2006, the Bush administration was collecting data on U.S. telephone records without warrants. A *New York Times* report detailing the lack of warrants led to a revision of the Patriot Act, requiring the government to receive authorization for this data gathering. It remains in place to date.

Candidate Obama ran against the Bush record (as one would expect), including promises to protect civil liberties. However, President Obama made little changes to the program in place. Although many of his supporters (including Mr. Snowden, it seems) were disillusioned by his failure to rein in the intelligence bodies, it appears the president had good reason to keep (and maybe even expand) the programs he inherited.

In common parlance, President Bush’s plan to thwart future terrorism was to “drain the swamp.” The plan was to move Middle Eastern governments away from authoritarianism to democracy in the hopes that democracies would be less likely to produce Islamic terrorists. That was, in our opinion, the real reason for overthrowing Saddam Hussein. The weapons of mass destruction reason was simply a selling point. The problem with the Bush plan was that implementing democracy proved much harder than expected and ousting Hussein upset the balance of power in the region, setting off problems we are still dealing with today. In addition, using the military for

these tasks has proved to be difficult as well. Militaries are rather blunt instruments in dealing with terrorist organizations.

The other theory of dealing with terrorists is best described as “defend the shores.” The Bush foreign policy team, dominated by neoconservatives, was critical of this option, calling it “criminalizing” terrorism. However, the costs of draining the swamp were high and President Obama seems to have opted for defending the shores.

This method allows for the president to reduce military spending in an effort to address fiscal deficits and still prevent terrorist strikes. But to work, it requires two elements. First, it needs competent and deep Special Forces units that can attack budding terrorist groups; in addition, the use of drones, which allows for narrowly focused attacks, is also useful. For the first point to work, the second element, solid intelligence, is necessary. And so, despite Candidate Obama’s promises of protecting civil liberties, President Obama needs even more intrusive data collection and analysis compared to the “drain the swamp” plan so threats can be identified and eliminated.

### **The Dangers of Data Collection**

The massive dragnet of data collection being done by the NSA has strong potential for abuse. Although there are reasonable doubts that the body can really analyze the flood of data it captures, improvements in data analysis and more sophisticated computers can ferret out patterns that may signal a terrorist conspiracy is developing. As the president noted, it’s unlikely anyone is listening to our phone conversations. However, this is true because it probably isn’t necessary.

The same pattern recognition that exposes a terrorist conspiracy is probably also able to

divine other activities as well. Perhaps a bank robbery, merger negotiations, a budding romance, adultery (the theme of the movie *True Lies*), an employee considering a position at another company, etc., could likely be isolated in this process. Using such knowledge will be a strong temptation.

To prevent such misuse, oversight mechanisms are established. However, we have serious doubts about the effectiveness. The first line of examination is the FISC. However, this secret court is essentially a “rubber stamp”—it has approved an estimated 99.97% of all requests; since created in 1975, only 11 requests have been rejected. Why are so few rejected? Simply put, there is no upside for a judge to reject a request. Suppose a judge were to turn down an intelligence agency, only to see a major terrorist event occur that could have been prevented if the warrant had been approved. No judge can live with this risk and so it makes sense that virtually all requests will be granted. The same problem exists for congressional oversight, which is complicated by the problem that time spent on the thankless job of oversight is time that cannot be spent on fundraising and other, more interesting, legislation. In addition, suppose you do approve a request that thwarts a terrorist attack. Secrecy and protecting sources and agents may require the congressman not to divulge his role. It’s hard to take credit for a secret success.

Sadly, the collecting process may not work. The Boston Marathon bombers escaped the dragnet. Such failures simply increase the demand for even more information. But, against small scale terrorists, the “lone wolf” attacker, data collection is less likely to be successful.

Finally, there is a real danger to civil liberties. As the IRS scandal showed, the

temptation for abuse of the information gained is very high. At some point, if it hasn't occurred already, it will occur. To the best of our knowledge, angels are not employed in intelligence gathering. Until that is the case, exploitation is inevitable.

### **International Issues**

The international ramifications of this situation are quite significant. The primary problem is that involvement by major technology and telecom firms as providers of this information to U.S. intelligence services will make foreigners less willing to work with these firms or even allow these companies into their nations. Iran and China have tried to create national internets and have taken criticism for doing so. After these revelations, their actions appear prudent.

China will surely use these disclosures as a defense against their own hacking. Although the NSA's actions are, in theory, different than actively trying to virtually burglarize someone, in the realm of public opinion, China will be able to argue that the U.S. has lost its moral standing on this issue. In similar fashion, Russia will likely use this issue to "prove" America is no better in terms of human rights given this high degree of "snooping."

For Europe, especially for the former communist regimes, this news is terrifying. Already, Chancellor Merkel has sharply criticized the U.S. for the data gathering; fresh from her experience living under the watchful eye of the Stasi and with memories of the Gestapo, this program will look frighteningly familiar. Other nations in the EU will likely use this information to restrict market access to American technology firms.

### **Ramifications**

Wilt Chamberlin used to note that "no one roots for Goliath." The superpower is always criticized for its actions or lack thereof. To a great extent, what the U.S. is doing with its data gathering program is consistent with a superpower trying to protect itself from stateless terrorists without invading every country that houses them. Finding the proper balance between protecting citizens and honoring privacy and civil rights is always difficult; mistakes will be made.

Politically, the problem is that most Americans have either never considered that the U.S. has replaced Britain as the dominant power or, if they have, they are not comfortable with the change. The strange political union between left-leaning privacy advocates and right-wing libertarians shows how little political discussion has developed around this issue. If Americans accepted that the U.S. is the global superpower, then the NSA's actions would not be a big deal; in fact, polls suggest that most Americans, though a bit uncomfortable with the revelations, believe they are probably necessary to protect us. However, this acceptance is seen from the perspective of protecting citizens, not in the context of how superpowers manage the world.

The biggest fallout from these disclosures is international. We would expect the technology giants to face increasing scrutiny from foreign governments. In addition, the global connections that come from a wired world may become less global as nations try to avoid the "prying eyes" of the NSA. The second serious ramification is that President Obama will be further hampered by this scandal and be less able to exercise power. As long as major decisions are not required, this isn't necessarily a bad thing; markets

can do well during periods of gridlock. However, in a world of rising tail risks, an emasculated president may not be a welcome outcome.

likely have modest effects on financial markets.

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Overall, this situation will tend to, in some minor way, further deglobalize the world. A world that is less globalized is a world that is less efficient and more prone to wars. In the long run, this situation will support commodity prices. In the short run, it will

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