

## Tailwinds of terror

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Marko Papic | BCA Research | 17 November 2015

The tragic terrorist attacks in Paris are a product of many factors. From what we know at the moment, a few trends seem likely to emerge:

- The Islamic State militants appear to be shifting their focus to transnational attacks as their momentum stalls in the fight to establish a Caliphate via a conventional ground war in Syria and Iraq.
- The attacks will be linked at least partially to the immigration crisis. One attacker reportedly traveled through Greece as a "refugee" in October. Despite an ample supply of potential terrorists inside Europe's own population, a connection between the Paris attack and refugee crisis will inevitably be made. This will increase the opposition to liberal asylum rules in Europe, reinforcing an already emerging trend.
- The probability of an international military response, which includes "boots on the ground" has risen. It is unclear who will lead the effort, however, as the US remains reticent to re-commit to the Middle East. The attacks give further reason to expect European states to begin aligning with Russia over Syria in an effort to impose a resolution in that conflict. An improvement to US-Russian coordination in Syria is also in the cards.

In February 2013, BCA's Geopolitical Strategy examined several structural tailwinds behind a "coming bull market for terror."<sup>1</sup> Today, we revisit the 2013 report and add an additional tailwind to our list – the end of drastic electronic surveillance by Western intelligence services.

### THE COMING BULL MARKET FOR TERROR – REVISITED

The Islamic State (IS) militants have claimed responsibility for the Paris attacks. As we pen this report, we know little about the perpetrators or their background. Some could indeed be IS militants from Syria and Iraq. They also appear to involve radicalised European citizens who were either inspired by IS ideology over the Internet or received operational know how by fighting in the Middle East.

The Islamic State is a cyclical factor, not a structural one, in our thesis. In other words, our 2013 forecast of a bull market for terror did not hinge on the success of the Islamic State. In fact, IS militants are not very successful in conventional military terms. For example, on the same day of the Paris attacks, we learned that:

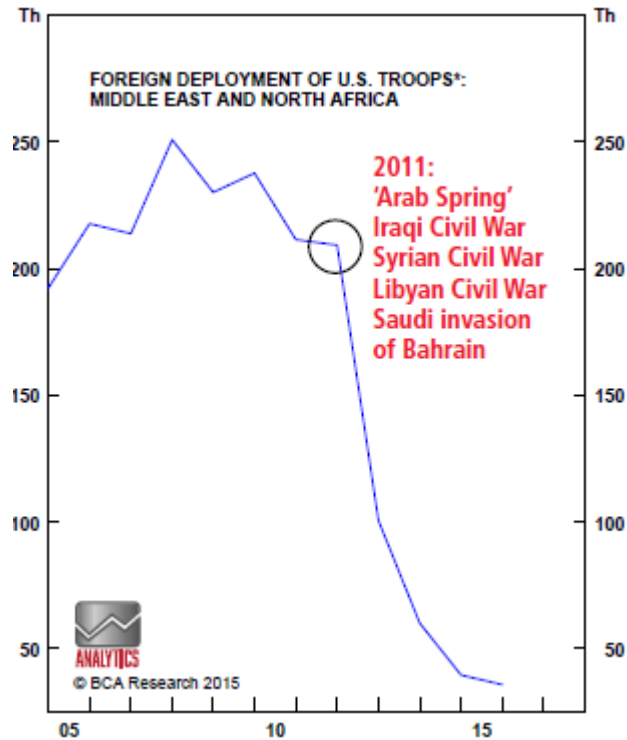
- Kurdish militias took over Sinjar, a strategic choke point astride Iraqi "Highway 47" that has allowed IS to communicate between its Syrian and Iraqi territorial possessions (specifically between Raqqa and Mosul); and,
- The Iraqi Army, led by Shia militias, surrounded IS-controlled Ramadi. It is the capital of Al-Anbar Governorate, a Sunni-majority region, and the third-most important city in IS possession after Raqqa and Mosul. The battle to re-take Ramadi is imminent.

Since the conquest of Ramadi in May 2015, IS militants have faced a string of conventional military defeats. It is only a matter of time before their self-proclaimed Caliphate is confined to Raqqa and the East Syrian desert. This looks even more likely now that terror attacks in the region and beyond, like the alleged bombing of Metrojet flight 9268 and now Paris, have unified not only the West and Russia but also, to some extent, Iran and Sunni Arab monarchies in the common goal of eradicating IS.

Regardless, a bull market in terror is underpinned by structural factors that will persist with or without the Islamic State:

- **American geopolitical deleveraging**  
American geopolitical deleveraging also allowed vast stretches of the Middle East to become lawless terra nullius (Figure 1). Baghdad has little control over Sunni-dominated western Iraq; Pakistan's Northern Waziristan remains a Taliban stronghold; Eastern Libya and most of Yemen are in a state of post-revolutionary anarchy; Egypt's control of the Sinai Peninsula is in doubt; Syria is engulfed in civil war; and, northern Mali is intermittently controlled by Islamist militants. By our back-of-the-envelope calculation, this is a stretch of territory comparable to the size of India. The US withdrawal from Iraq, specifically, gave Sunni militants in Al-Anbar Governorate space to breathe, consolidate, and re-focus on Syria. IS is originally an Iraqi insurgent group, founded in 1999, which allied with al-Qaeda in 2004 and cut its teeth fighting an insurgency against the US between 2003–2011.

Figure 1: U.S. deleveraging has created geopolitical chaos



Source: The Heritage Foundation and Defense Manpower Data Center.

- **The breakdown of the Mukhabarat state**

Mukhabarat is the Arabic phrase for intelligence agency, usually the domestically focused secret police. The US invasion of Iraq, the ousting of Libya's Muammar Qaddafi, and the ongoing civil war in Syria have put some of the region's top Mukhabarats out of business. The US and other Western powers specifically targeted the Mukhabarat regimes amidst the "Arab Spring" revolutions, helping along supposedly liberal revolutions to depose them. As these revolutions turned out to be anything but liberal, entire states have collapsed. This has allowed terrorists to use these spaces with little interference and has led to a massive influx of refugees into Europe.<sup>2</sup>

- **The proliferation of sophisticated weaponry and tactics**

The demise of the region's two strongest Mukhabarat states, Libya and Iraq, has helped fill the region with sophisticated weaponry. In addition, foreign nationals fighting in Iraq, Libya, and Syria have received on-the-job training and are now eager to deploy it on the streets of G7 capitals. This was the case well before IS became a threat in mid-2013 and will continue to be the case well after it is defeated. As long as there are lawless regions in the Middle East where Islamic militants can gain training and weapons, there will be a bull market for terror.

In addition to these factors, we need to add a fourth – the Snowden effect. The comprehensive nature of former NSA employee Edward Snowden's leaks has not only revealed the extent of technical capabilities, which were largely understood by anybody with even limited know how, but also the methods of intelligence agencies. In particular:

- **Revelations of surveillance methodology**

Revelations by Snowden were not just confined to surveillance of private citizens that grossly undermined civil rights. The data-dump was so vast that it also exposed the details of how intelligence agencies conducted cyber-surveillance against legitimate security threats. Security experts have warned that these revelations will allow criminals and terrorists to take precautionary measures to avoid detection, such as reverting to low-tech forms of communication.

- **Proliferation of encryption alternatives**

In the post-Snowden context, private enterprises – Google, Apple, Microsoft, etc – have moved to bolster encryption and mobile-device security. This was a business decision motivated by the public's outrage at the NSA's snooping on citizens' phone conversations and email accounts (any or all of them, in real time). The US intelligence community has asked that private companies insert "back doors" or "front doors" into powerful new encryption technologies, which may not be technically feasible.

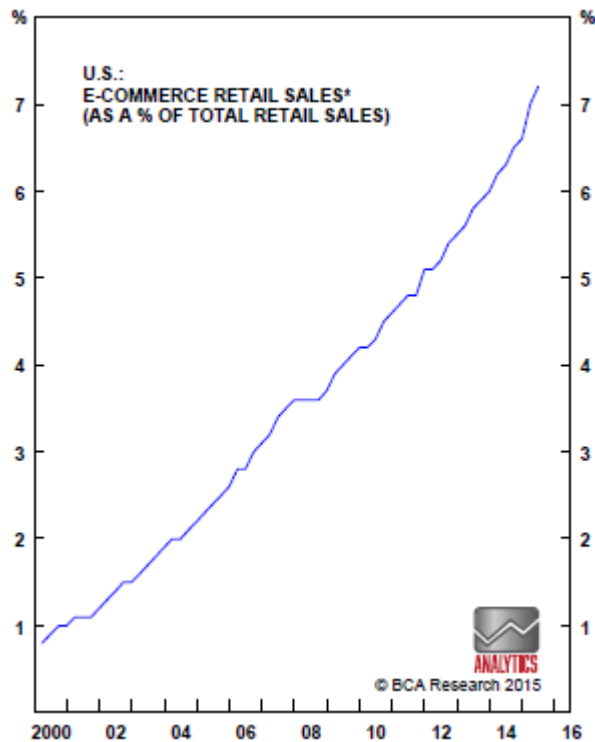
Militant Islamic terrorism is not new and the Islamic State did not invent it. In the immediate aftermath of the 9/11 attacks, intelligence agencies were in the dark about the vast network of domestic and foreign terrorist groups and their recruitment and operational methods. The 2004 Madrid train bombing – whose death toll exceeded that of the recent Paris attack – and the 2005 London bus bombings were the consequence of law enforcement constraints. Since then, the developed world has passed a full decade without a major, coordinated, security attack. This is not coincidence, luck, or magic. The number of violent Islamic militants desiring to do harm to the West has not exponentially increased since the mid-2000s. Rather, law enforcement capabilities – including draconian surveillance methods – grew exponentially after 9/11. Only lone wolf attacks like the Boston marathon bombing – planned with little or no coordination – were able to slip through the cracks.

Since then, the collapse of surveillance capabilities has allowed terrorists to leverage the Internet into another lawless terra nullius "geography". Snowden also revealed the methods – many of them clearly illegal – that intelligence agencies used to counter terrorist groups in cyberspace.

It is highly unlikely that the status quo ante will be restored. Even if terrorist attacks similar to Paris increase in frequency, it is unlikely that intelligence agencies will regain the powers they had over the previous decade. The reason is not public outrage over privacy, which can shift to greater outrage over insecurity, but rather the increasing importance of the Internet as a medium for economic exchange (Figure 2). It is difficult to see how today's commercial

demand for encryption – upon which innumerable commercial and financial transactions depend for security from hackers and ordinary criminals – can coexist with the surveillance capabilities that intelligence agencies had at their disposal.

Figure 2: The power of online markets



Source: US Census Bureau

### Bottom Line

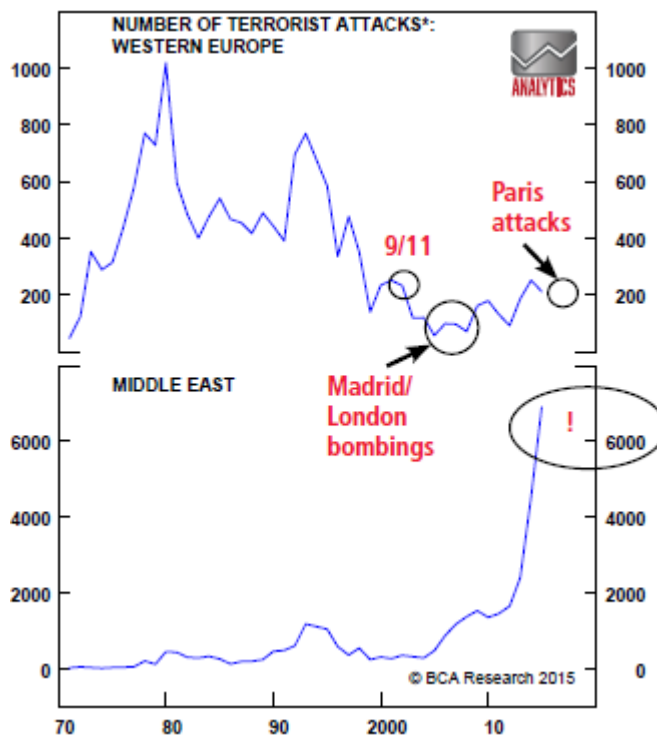
The bull market for terror is based on structural factors that have been in place well before the advent of the Islamic State, and they will remain in place well after its demise. In addition, due to privacy concerns and commercial demands, the tide is turning against law enforcement's ability to use electronic surveillance against terrorists. These are trends and factors that we do not see changing anytime soon.

### INVESTMENT IMPLICATIONS

Our forecast of a bull market for terror has not necessarily been correct so far. While the number of attacks has definitely increased in the Middle East, there has only been a minor increase in attacks in Western Europe, though clearly the latest one in Paris is significant (Figure 3). In fact, the Paris attack is the first transnationally coordinated terrorist attack

outside of the Middle East since our 2013 Special Report, including the assault on the offices of Charlie Hebdo.<sup>3</sup> As such, it may be an anomaly.

Figure 3: Regional disparities in terror



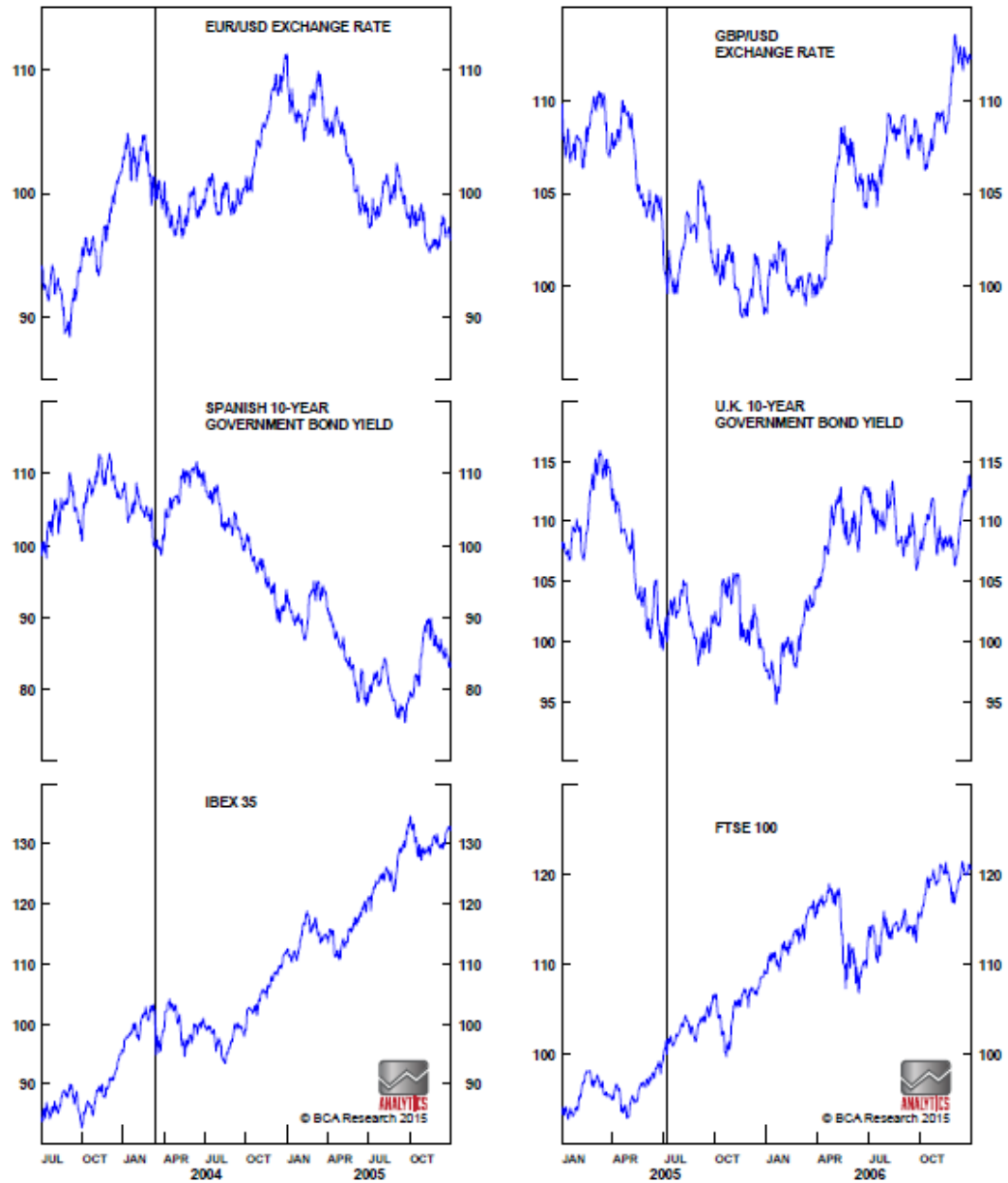
Source: Global Terrorism Database, University of Maryland.

On the other hand, France has one of the best intelligence and security apparatuses in the world. It is possible that ISIS and their affiliates are improving their capabilities and reach, particularly as the focus of its leadership shifts away from conventional military campaigns – that they are losing – and back to traditional terrorism. France has also long stood as proof that Western states, even those frequently engaged in military actions against Muslim countries, can remain secure despite their troubles assimilating Muslim immigrants. This dynamic could be breaking down.

**If Paris is not an anomaly, and the frequency or magnitude of terrorist attacks against soft targets in G7 cities increases, what will be the geopolitical, economic and investment consequences?**

First, investors should not forget that the 9/11 attacks, the 2004 Madrid train bombings, and the 2005 London bus bombings, though major transnational attacks against hard targets, had little lasting impact on markets (Figure 4). In fact, all major terrorist attacks have produced only temporary market reactions (Figure 5).

Figure 4: Madrid and London attacks produced little market effect



**Figure 5: U.S market most resilient to terrorist attack**

Average abnormal returns on global capital markets following the Sept 11 terrorist attacks

Equity index	Event day AR (%)	6-day CAR*	11-day CAR*	Days to rebound
NYSE	-4.79	-6.69	-0.45	13
London	-10.09	-8.64	-14.14	22
Frankfurt	-10.06	-14.54	-15.79	42
Europe – Bloomberg	-8.54	-11.5	-14.82	40
Helsinki	-6.17	-6.43	-11.35	31
Norway	-5.79	-14.18	-15.55	107
Tokyo	-6.5	-1.7	-12.18	6
Hong Kong	-7.87	-11.02	-14.34	30
Korea	-13.33	-13.78	-19.84	28
Jakarta	-2.83	-3.73	-6.23	86
Kuala Lumpur	-5.2	-13.36	-18.68	65
Australia	-3.98	-9.46	-11.07	26
New Zealand	-3.67	-11.39	-14.93	33
Johannesburg	-5.27	-14.43	-11	162

Sources: IMF, Chen, Andrew H., and Siems, Thomas F, 2004, "The effects of terrorism on global capital markets", *The European Journal of Political Economy*, Vol. 20. PP. 349–366. \* CAR denotes cumulative average abnormal returns.

Second, human societies adjust to new security threats surprisingly quickly. Israel has lived with the constant threat of terrorism for decades. Its stock market and economy have become dislodged from the incessant attacks (Figure 6). Meanwhile, various European states have lived under the threat of terror in previous decades. Figure 3 above shows that the last bull market in terror began with the 1968 social revolutions. In the UK, the IRA became active leading to "The Troubles" which claimed well over 3,000 lives over three decades. In Spain, ETA launched its terror campaign that killed nearly 900 people by the end of the 1990s. A number of left-wing terrorist groups – from the Red Army Faction in Germany to

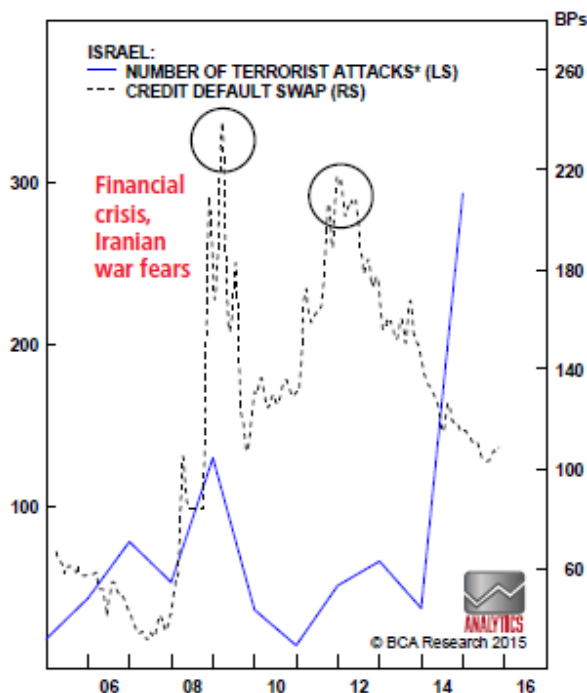


the Red Brigades in Italy and the Revolutionary Organization 17 November in Greece – evolved into militant groups following the collapse of the 1968 revolutions. In addition, a number of Palestinian militant groups – from the Popular Front for the Liberation of Palestine to the Black September Organization – launched several attacks against Israeli and Western targets in the 1970s, including plane hijackings and the infamous Munich Olympics attack. Obviously, differences exist between militant groups then and now, but the degree of violence and fear factor are not as easily distinguishable as one might think. Europe not only persevered through these attacks but ultimately became desensitised to them.

Our view is that the probability of soft target attacks in the West has increased due to structural factors outlined in our research. As such, we are surprised it took this long to have a Mumbai-style terrorist attack in the West.<sup>4</sup> At the same time, if we are correct, and the frequency of such attacks increases, recent history teaches us that societies gradually adjust to the threat. This is why soft-target terrorism is ultimately ineffective. At some point, it ceases to be terrifying and becomes the norm.

In the short term, a tick up in terrorist attacks of the Mumbai/Paris type could well rattle the markets – the US and other G7 cities are certainly vulnerable. In our October Monthly Report, we warned investors that the economy and markets are operating with zero margin of safety.<sup>5</sup> Given our view that several geopolitical risks remain underappreciated – namely the risk of an accident in East Asia and domestic political risks in emerging markets – terrorist attack frequency could become market relevant in the near term.

Figure 6: Israeli resilience to terror

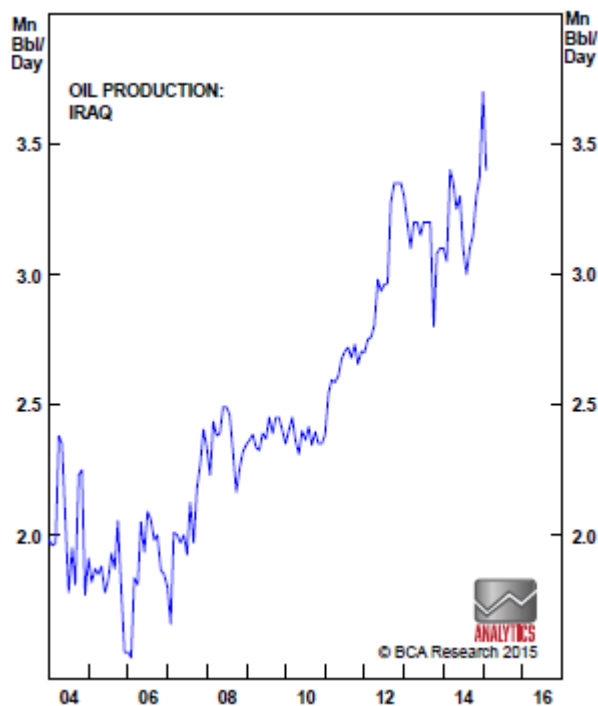


Source: Global Terrorism Database, University of Maryland.

In the long term, terrorism against soft targets becomes ineffective once social attitudes adjust to its higher probability. In order for terrorism to be effective and market relevant, it has to strike hard targets, targets with immediate and direct ramifications for the economy (energy, transportation, communication, and public services infrastructure). The Islamic State, for example, has been unable to strike such targets even in the Middle East where it has the highest operational capability. Despite ruling a third of Iraq for over a year, the Islamic State has been unable to launch attacks against energy production and transportation facilities, allowing Iraq to boost its oil production by a million barrels (Figure 7).

At this point, we cannot say with any certainty that the ability of terrorists to strike hard targets has increased. Only time will tell. We assume that the target selection thus far is a form of revealed constraints, if not revealed preferences.

Figure 7: Iraqi resilience to the Islamic State



Source: Global Terrorism Database, University of Maryland.

Finally, a word on geopolitical ramifications. Local elections in France in mid-December will bear watching to gauge the public reaction. In Europe, a tougher response toward Syrian refugees is already developing and enhanced border controls should not be assumed to obstruct intra-European trade. Meanwhile, the ongoing paradigm shift in the Middle East has created a void in several countries in the region.<sup>6</sup> Fuelling the lawlessness is the ongoing

proxy war between Saudi Arabia and Iran, two regional powers that are looking to fill the vacuum of American geopolitical deleveraging. A military operation against the Islamic State in Syria by a new "coalition of the willing" may be in the cards. The US and Russia have even shown some willingness to coordinate on Syria and IS after Paris. If the U.S. is willing to separate other disagreements, like Crimea, then it could remove impediments to Russia–West cooperation on Syria, which many European leaders already want.

However, it is difficult to see, at this time, how such a military campaign will change the underlying dynamics. Once IS is eradicated, the conditions that allowed it to emerge will still be present. As long as Iran and Saudi Arabia are fighting over influence in the Middle East, they will continue to support proxies that could evolve into radical militant or terrorist organizations.

If anything, the lack of international response to the Islamic State, whose military defeats at the hands of the Kurds and Iraqi Shia militias belie their purported military prowess – reinforces our theme of global multipolarity. In a world where multiple global and regional powers can pursue their foreign policy independent of one another, global coordination will suffer. Problems, whether they are Ebola or the Islamic State, will be allowed to fester until they become serious. Today it is the Islamic State, tomorrow it could be something else. This world of uncertainty is one that will persistently create a tailwind for safe–haven assets.<sup>7</sup>

### **Bottom Line**

A Mumbai–style attack in the heart of Paris, amid the ongoing refugee crisis, is likely to add some momentum to efforts among a range of nations to impose solutions on Syria. A rising frequency of soft–target attacks could well shake up markets in the near term. But it remains to be seen whether IS and IS–allied militants are gaining the ability to pose a more systemic threat to economies and markets. We would need to see a shift from soft to hard targets before proclaiming terrorism the main geopolitical risk facing investors.

## ENDNOTES

1. Please see BCA Geopolitical Strategy Special Report, "Terrorism Redux: Investment Implications," dated February 13, 2013, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).
2. Please see BCA Geopolitical Strategy Special Report, "The Great Migration – Europe, Refugees, And Investment Implications," dated September 23, 2015, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).
3. The Charlie Hebdo attack was a "lone wolf" attack, in our view. Such an attack is characterized by its minimum reliance on coordination with transnational terrorist networks. At most, the individuals are radicalized via communication with outside groups, but the planning and execution of the attack are insulated.
4. By "Mumbai-style" we are referring specifically to an attack where small groups of terrorists select a multitude of soft targets in a low-technology attack. The November 2008 Mumbai attack led to 166 deaths and was perpetrated by only ten assailants. The Paris attack resembles Mumbai because it involved militants using unsophisticated weapons – assault rifles and explosives – in attacking multiple targets with limited security presence.
5. Please see BCA Geopolitical Strategy Monthly Report, "Margin Of Safety," dated October 14, 2015, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).
6. Please see BCA Geopolitical Strategy Special Report, "Middle East: A Tale Of Red Herrings And Black Swans," dated October 14, 2015, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).
7. Please see BCA Geopolitical Strategy Special Report, "Geopolitics And Safe Havens," dated November 11, 2015, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).

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