

## Intelligence Security Diary

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Major General Alan Pickering, CMM, CD (Ret’d), served in the Canadian Forces in a variety of operational and command positions. He holds a BSc (Mechanical Engineering) degree from the Royal Military College and Queen’s University. He is a graduate of the Royal Canadian Air Force Staff College and the United States Navy War College. His last posting was Chief Intelligence & Security – Department National Defence. He served for eleven years as Director General Information Technology Security at the Communications Security Establishment following retirement from the military in 1985.

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CF Intelligence Branch badge and motto:  
E Tenebris Lux  
From Darkness Light

The Minister of National Defence, Canada, upon recommendation of the Chief of the Defence Staff, approved the appointment of David A. Rubin to Honorary Lieutenant-Colonel of 2 Intelligence Company ("2 Int Coy"), Canadian Forces ("CF") Intelligence Branch. He served for many years in 2 Int Coy and retired with the rank of Captain.

Colonel Rubin is a member of CF Intelligence Branch Association, National Military Intelligence Association (US), Canadian Intelligence and Security Association, Jewish War Veterans of Canada, Royal Canadian Legion, Conference of Defence Associations Institute, Canadian War Museum, Reserves 2000 and St. John Ambulance Toronto.

As Honorary Lieutenant-Colonel his responsibilities include fostering esprit de corps, developing, promoting and sustaining strong community support for 2 Int Coy, establishing and maintaining liaison with unit charities and associations, establishing and maintaining a liaison with 2 Int Coy's commanding officer, participating in parades and official functions in which the unit takes part, and advising the commanding officer. Established in 1948, Toronto's 2 Int Coy is one of five combat deployable Reserve Intelligence Companies in Canada which provide a ready source of personnel to CF contingents in Canada and abroad.

### **1 May Israel – Middle East**

On Sunday, April 29th, senior Defence Force officials briefed the Israeli cabinet on the deteriorating situation the country is facing on three key fronts.

- Palestinian militants are reported to be amassing firepower and preparing defensive positions in the Gaza Strip. It is reported that Hamas fired "an estimated 21 rockets and 68 mortar shells into Israel on its independence day last week". Israeli intelligence and military officials want to confront the Palestinian militants.
- On its northern border there are reports Hezbollah is preparing for renewed fighting and has replenished the firepower, particularly the rocket-ordnance that it fired into northern Israel last summer. The Israeli Defense Force Chief of Staff Gabi Ashkenazi informed the cabinet at Sunday's meeting that "the only real solution to missile strikes by Hezbollah would be the use of ground forces."
- Syrian officials including President Bashar Assad indicate that Israel's refusal to enter peace talks without preconditions could lead directly to war. No peace agreement was signed following the 1967 Six Day War. Syria wants to regain control of the Golan Heights. Israel has indicated that Syria must first sever all ties with Hamas and Hezbollah and has frozen diplomatic discussions until this condition is met.

*[The probability of renewed conflict erupting this summer is increasing. The fact that the situation is deteriorating on three fronts is grounds for concern. Last summer only the Lebanon based Hezbollah, appeared to be fighting Israel. There were no major attacks from the Palestinian side and Syria stayed on the sidelines. Analysts are expecting a more coordinated and concentrated attack against Israel, on all three fronts, if hostilities erupt again.]*

### **3 May Oleg Deripaska**

Basic Element, the holding company of Russian aluminum tycoon Oleg Deripaska, announced it agreed to buy a 30% stake in Austria-based construction company Strabag for \$1.75 billion. The partnership will create the largest player on the Russian construction market, with total annual revenue of about \$2.5 billion.

*[The April 23rd entry in the Diary, entitled "Legal Representation", indicated that Robert Dole's law firm, Alston & Bird, has represented Mr. Deripaska in his effort to obtain a visa to visit the United States.]*

*The purchase of Srabag is being monitored closely. Deripaska is close to the Kremlin and intelligence analysts see it as another move by Putin to acquire control of foreign-based assets. Putin is recognized in ‘some circles’ as the world’s foremost expert on “capital structure governance”.]*

#### **4 May      *Yeltsin Obituary – OSINT Assessment***

OSINT analysts monitored the flow of commentary or “spin” following Boris Yeltsin’s death in late April. In a televised address, Vladimir Putin, credited Mr. Yeltsin with creating a “new democratic Russia, a state that is free and open to the world, a state in which the government really does belong to the people.” Despite these official laudatory comments the spin surfacing from the Kremlin is that Putin had to restore Russia’s confidence and stability following the lawless Yeltsin era, when the country was ruled by oligarchic millionaires, suffered from foreign interference and was at the mercy of Western oil companies.

The April 24th *Wall Street Journal* article, *Yeltsin’s Legacy: Pretext for Putin To Crack Down*, described this as the “traditional treatment” received by Kremlin leaders since World War II – successors aggrandizing themselves at the expense of the leader they replaced. After coming to power in 1953, Nikita Khrushchev revealed many of the crimes of the Stalinist purges. His successor, Leonid Brezhnev, chided Mr. Khrushchev for dangerously un-Soviet behavior. Under Mikhail Gorbachev, the Brezhnev era became known as the period of stagnancy. Mr. Gorbachev who had hailed the West as a force for reform – was blamed for Russia’s diminished world stature.

The Kremlin’s assessment of the Yeltsin years is extremely critical. The Yeltsin reign is seen as a period of “national humiliation”. Putin describes the period as a time in which Russia was on the brink of collapse, regions were breaking away from Moscow and the nation’s wealth was falling into the hands a clique of corrupt businessmen. Key institutions such as the press, parliament and the judiciary were becoming tools of tycoons confiscating the country’s prime assets. Putin has reined in the independent media, locked up critical businessmen and reshaped parliament “to his liking”. Putin “has righted all the wrongs!”

*[Intelligence analysts generally agree that the Kremlin’s ‘spin doctors’ very effectively used the ‘Yeltsin obituary’ to rationalize the Putin style of ‘state stewardship’. They provided an image of Putin as Russia’s ‘White Knight’ – saving the country from further denigration and bringing economic stability and a higher standard of living. This point of view is reflected in the polls where Putin continues to be highly rated. ... .. **Putin will not be leaving us next March – he will retain all of his current power – they will amend the constitution to accommodate this – Vladimir will simply get a new title – one that he will create himself! It is called the “art of governance”. Putin is a master!]***

#### **9 May      *Magna International Inc. – Deripaska***

***The Diary’s Editors work within a 30-day time horizon. Even with this short ‘time-line’ events can overtake you! The Diary’s Editors chose to leave the May 3rd entry in place, in addition to what is described in this entry concerning Magna International.***

Under strong Kremlin influence, Russian companies are aggressively investing in entities around the world – and Canada is increasingly in their “cross-hairs”. Magna International announced yesterday that Russian billionaire Oleg Deripaska would invest \$1.54-billion (US) to purchase 20-million Magna subordinate voting shares. The Friday, May 11th issue of the *Globe and Mail*, Page B5, carried an article entitled, *Stronach Met With Putin Last Fall*. The following is direct quotation. The *Diary’s* Editors felt a précis summary would not capture the precise nuance in the commentary.

***“We asked a lot of friends who would be a good strategic partner for us in Russia and always the name came up, Oleg Deripaska”, Mr. Stronach said yesterday, sitting beside his new partner in the ante-room at Toronto’s Roy Thomson Hall after Magna’s annual meeting.***

***After their initial summer get-together, Mr. Stronach had what he called a long meeting with Russian President Vladimir Putin in November, where the Magna chairman sketched a plan that outlined the creation of 300,000 automotive jobs in Russia over the next 10 years.***

***Operating under the code name Project Pearl, Mr. Deripaska dispatched a team of his executives to Toronto early in May to huddle with U.S. and Canadian lawyers and negotiated with Mr. Stronach and a special committee of independent Magna directors led by former Ontario premier Mike Harris."***

A few days ago, MMS Norilsk, a Russian nickel giant, launched a \$5.3-billion bid for Toronto-listed LionOre Mining International. In 2005 OAO Lukoil purchased Nelson Resources Ltd. for \$2-billion, a Toronto company with assets in Kazakhstan, and, OAO Gazprom wants a stake in the liquefied natural gas plant scheduled for construction by Petro-Canada in Gros Cacoun, Quebec.

*[The Editors of this 'august journal' would like to inform the Kremlin and any of their plenipotentiaries that the Diary is available at the right price. It has an estimated readership of 50,000 and reaches into the highest levels in the business, government, military and security-intelligence communities. We understand there are even several enthusiastic 'closet readers' in the Kremlin itself. The Diary's Editors would consider any offer above \$2.5 billion .... Only serious parties need apply!]*

#### **14 May Chief Rabbi – Russia**

Rabbi Berel Lazar is the Chief Rabbi of Russia. He is an ultra-Orthodox follower of Chabad-Lubavitch, a Hasidic sect based in Crown Heights, Brooklyn. Devotees of the sect are known for their love of the Rebbe – their late spiritual leader who died in 1994. The sect has become a dominant force and the Federation of Jewish Communities of Russia (the "Federation"), Rabbi Lazar's organization, is one of Russia's leading charities – with schools, clinics, orphanages and community centers across the country.

Rabbi Lazar's 'gain of influence' coincided with Mr. Putin's rise to power. Less than a decade ago, Chabad had only a small presence in Russia. The more established Jewish groups aligned themselves with the Jewish oligarchs. The biggest was the Russian Jewish Congress, a group established in 1996 by media mogul Vladimir Gusinsky. Gusinsky used his media outlets to attack the Putin regime. Tax police raided Gusinsky's media company, it was taken over by a state entity, and then Putin threw his support to the rival Federation. The Kremlin was able to deny any anti-Semitic motive.

Rabbi Lazar and the Israeli diamond dealer Lev Leviev created the Federation in 1999. Organizations loyal to Putin, like the Federation, are protected and promoted. The Federation's founding was extensively covered in the state media and it claimed to represent the Russian Jewish community. Rabbi Lazar was selected as its Chief Rabbi. Shortly thereafter Gusinsky was arrested, then managed to 'escape', and has never returned to Russia.

In media interviews, Rabbi Lazar denied that the crackdown on Gusinsky had anything to do with anti-Semitism. He visits Washington frequently to give speeches and lobby members of Congress. Rabbi Lazar's Federation has proven very effective in organizing community life and its willingness to send emissaries to some of Russia's most depressing and remote provincial towns has gained it respect. The Federation has restored dozens of synagogues, built sixteen community centers and recently fed 150,000 people with free Passover meals.

*[Rabbi Lazar is now part of the Russian establishment. In 2005, President Putin appointed him to the Public Chamber, a newly created consultative body of prominent citizens. Rabbi Lazar's critics, however, see a "Faustian bargain" between himself and the Kremlin. They claim Lazar has deliberately down played anti-Semitism in Russia and acted as a lobbyist for Putin on the world stage. "In exchange, Chabad-Lubavitch enjoys unparallel political influence and has been allowed to gain control of millions of dollars worth of communal property from the Russian state – in several instances negating the claims from other Jewish organizations.]*

**16 May "Signes de Refroidissement"**

The *D.C. Current* column in the May 14th issue of *Barron's* commented on an editorial in France's *Le Monde* dealing with the cooling relations – "signes de refroidissement" – between Russia and the European Union. The editorial coincided with sharply worded comments made by President Putin at the Victory Day celebration commemorating World War II, in which he compared "U.S. foreign policy to the unilateralism of the Third Reich". He also lashed out at Estonia – a U.S. coalition partner – for relocating a WWII monument erected by the Red Army in the heart of the Estonian capital. The old Soviet monument and the remains of twelve Red Army soldiers were moved to a cemetery. Putin described the relocation as a "desecration".

*[The D.C. Current contained the opening statement, The "surely" Russian bear is making moves in the Baltic, strengthening our view that Russia is no fit place to risk investment capital. Vladimir Putin uses the media very effectively – one might say, 'exploits it brilliantly' – he comments infrequently but always to maximum effect. He is skillful in the use of 'spin' and always frames his more 'geo-political' maneuvers in euphemistic terms. OSINT analysts, however, monitor his 'official statements' very closely and note that there has been a 'noticeable' increase in 'confrontational rhetoric' – commensurate with his expanding 'geo-political' influence. President Bush telephoned Mr. Putin last Thursday to complain about the analogy to the Third Reich... .. Nothing like a call from the President to set things straight!]*

**18 May Caspian Pipeline**

Vladimir Putin and the Presidents of Turkmenistan and Kazakhstan agreed to build a pipeline along the Caspian Sea coast to ship Turkmen natural gas to Western markets via Kazakhstan and Russia. Turkmenistan is the second-largest natural-gas producer in the former Soviet-Union after Russia and its resources play a very influential role in the geopolitics of the region. Russia is the world's biggest natural-gas exporter and the deal maintains its monopoly on Turkmen and Kazakh exports to Europe.

The United States and Europe wanted a route under the Caspian Sea to Azerbaijan and Turkey, bypassing Russia, which supplies Europe with a quarter of its natural gas and is its second-biggest source of oil. The deal means Russia will control the bulk of Central Asian energy exports and intensifies Western fears that Moscow will use its energy 'leverage' for geopolitical objectives. Putin indicated the new pipeline will carry as much as "20 billion cubic meters of gas annually by 2012."

*[President Putin journeyed to the Turkmen City of Turkmenbashi to announce the deal. He is quoted as saying; "We are opening the Caspian route at the request of Turkmenistan", and, "We very responsibly take our role in the global energy sector". The Editors of the Diary compliment President Putin for assuming the 'role of responsibility' so effectively. One can only applaud 'CEO' type leadership that knows its markets thoroughly and is involved directly in them.]*

**GAME – SET – MATCH – Putin****21 May G-8 "Inn Keeper"**

Over the weekend the G-8 Finance Ministers met at an exclusive resort at Lake Schwielow in East Germany. Hans-Hermann Tiedje and Axel Hilpert own the resort. Mr. Tiedje is a former political advisor to German Chancellor Helmut Kohl and he and Axel Hilpert won government subsidies in 2004 to build the prestigious Lake Schwielow resort.

The *Wall Street Journal* carried an article entitled, "*Secret Police Past Doesn't Cramp Style of Stasi Agent*". The article indicated that Axel Hilpert was a former high-level undercover agent for Stasi, code name "Monika", and was decorated by both the German Democratic Republic and Fidel Castro's Cuba. In the 1970s and 1980s Hilpert was senior operative with East Germany's "KoKo", a business enterprise that acquired art and antiques and resold them for 'hard-currency' in the West.

The firm tracked down individuals who owned 'collectibles', paid them 'near-worthless' East German currency, and then resold them in the West. If people were unwilling sellers – tax inspectors and the Stasi visited them. The Cuban deals involved arranging the delivery of U.S.-made firearms via Europe. The Cubans made Hilpert an honorary colonel in recognition of his contribution.

*[At one point the Stasi's anticorruption division suspected Mr. Hilpert of skimming from the deals, but the investigation was quashed by the deputy minister for state security, "according to an internal report dated November 1985". After Germany was unified in 1990 Hilbert went into the real-estate business. Many former Stasi officers are thriving as a result of the connections made during the Cold War. The Wall Street Journal article indicates that, "former Stasi recruiter Matthias Warnig went to work for Dresdner Bank, a firm he used to spy on". He now heads a Russian-German group building a natural-gas pipeline under the Baltic Sea. "Martin Schlaff, an Austrian who helped the Stasi get around trade embargoes to acquire Western computer technology is a successful private-equity financier."]*

**28 May "Cellule Africaine"**

***And now ... .. something that deserves to be in a Frederick Forsyth novel!***

The "Cellule Africaine" ("the Cell") is a three-person office hidden behind the Elysee, France's presidential palace. For approximately fifty years, the secretive and powerful Cell has overseen France's strategic interests in Africa, controlling governmental functions in its former colonies. It acts as a 'general command', using the French military as "a hammer" to install leaders friendly to French interests. These countries then provide French industries predominate access to their oil and other natural resources.

The Cell was created in the late 1950s after France's retreat from South East Asia. General Charles De Gaulle instructed Jacques Foccart, the Cell's first head, to maintain control of Gabon, Ivory Coast, and several other sub-Saharan colonies. The Cell's efforts were directed at protecting France's economic interests. For example:

*"In 1964, Leon M'ba, Gabon's first elected president, was overthrown; the state-run oil firm that later became Elf Aquitaine had already begun production there. Mr. Foccart and Pierre Guillaumat, head of the state-run oil firm, decided that the French military should reinstall Mr. M'ba. Total SA, the oil company that now owns Elf, commands about a third of Gabon's oil output." ... .. The success became the model for future operations."*

*[Mr. Sarkozy, France's newly elected president has vowed to reshape its relationship with its former colonies – including possibly eliminating the Cellule Africaine's secretive military operations. Michel de Bonnecorse, the current Cell Chief, has stated that its objective is strictly to preserve stability, help French companies deal with African bureaucracy, and provide support to African leaders who need "to get their daughters into a prestigious high school in France." The Cell, however, has been implicated in situations inconsistent with this image.*

*Earlier this year, Jean-Christophe Mitterand, son of the late president and head of the Cell from 1986 to 1992, was charged in a case involving the sale of \$550 million of weapons to Angola between 1993 and 1994. A French arms dealer is suspected of having paid commissions to French politicians and intermediaries as part of the deal. Sources indicate that the 'complexity of intrigue' that has always surrounded the Cell will once again 'protect it' – there are too many 'personnes de prominence' involved – Sarkozy 'will back-off'!]*

***Forsyth would have a 'field day' weaving a tale around all of this intrigue – he may well be the only one to understand it all!***

## OPEN SOURCE INTELLIGENCE

### FOLIO – LEVERAGE “STALINGRAD REVISITED”

***“Leverage – the magical power that allows investors to make big investments without putting big money on the table.”***

*Webster’s New World Dictionary* defines ‘leverage’ as the “increased means of accomplishing some purpose”. The definition is imprecise and euphemistic – leverage prevails in many scenarios. When Hitler sent Field Marshall Friedrich von Paulus and the German Sixth Army into Stalingrad it was to extend the rapid invasion of the Soviet Union to even greater territorial gain. The German supply lines were extended, the brutal Russian winter was approaching and the Sixth Army was simply too fatigued from the pace-of-advance. It went down to defeat and brutal captivity. In the world of intelligence an overly extended and leveraged network of spy cells can lead to its demise. In the capital markets it is used to describe the use of debt to finance the aggressive expansion of operations to enhance returns on equity investment.

The Federal Reserve, Securities Exchange Commission and European regulators have spent recent months collecting information to determine the nature of the leverage and collateral arrangements with hedge funds. No one knows how much leverage is in existence! On March 27th, regulators held a conference call with bankers from nine Wall Street firms to brief them on their findings. The regulators informed the investment dealers of the following:

- Collateral arrangements are too weak for the amount of debt outstanding.
- Wall Street firms don’t have enough information from their hedge fund clients to assess risk.
- Contingency plans and arrangements have to be developed to deal with financial losses arising from the collapse of one or several large hedge funds.
- The regulators want to make sure U.S. banks can manage the dislocation emanating from a big hedge fund failure.

When markets turn negative, the bearish impact of leverage will increase exponentially. Bankers and derivatives dealers demand more collateral to cover losses. Investors sell stocks and bonds to raise cash – prices drop, further accelerating losses, and even more vicious selling ensues. Wall Street describes this potential scenario as the “The Great Unwind”.

### **Historical Precedence**

In 1998, the highly leveraged hedge fund giant Long-Term Capital Management threatened to unleash the “Great Unwind” but a group of Wall Street firms under the direction of the Federal Reserve intervened to prevent a massive sell-off. In 2006 when the leveraged energy bets of Amaranth LLC went offside, the hedge fund suffered losses of approximately \$6 billion. The market survived both situations with minimal adverse consequences. Burton Malkiel, a professor of economics at Princeton University and the author of *A Random Walk Down Wall Street* has used the phrase “Irrational Complacency” to describe the current lack of concern over a potential meltdown.

### **Hedge Funds**

Hedge funds are private investment pools for institutions and wealthy individuals. In the 1990s several hedge funds bought shares in affiliates of investment dealers and established joint back office arrangements, which gave them access to higher borrowing facilities – regulators allow securities dealers to take on more debt than other investors. Currently, there are more than 9,000 hedge funds, with an estimated \$1.5 trillion of assets.

Hedge funds now use derivatives to lever their exposure. Investment dealers and banks are offering complex derivatives based on single stocks, baskets of stocks, market indexes, bonds, oil, etc. In many instances the form of the derivative contract used is a "total return swap". In a swap contract an investment bank agrees to pay a counter party, the hedge fund client, the change in the market price of a stipulated security. In a regular margin debt arrangement a client can borrow 50% of the market price of a stock. A total return swap requires only 5% of the market price. If the stock rises the hedge fund's rate of return will be far greater, however, if the value of the underlying security falls the leverage will work in reverse. The hedge fund would have to pay the counter party an amount equal to the decline in share value and transaction fees.

Hedge funds are under no obligation to disclose derivative transactions or borrowing levels. However, Citadel Investment Group, a \$14 billion Chicago based hedge fund, had to disclose such information when it issued bonds last year. The bond offering document indicated its leverage ratio – the value of assets compared to its capital from investors – was 13 to 1. The filing indicated that it had acquired a total-return swap on a \$400 million basket of securities. The swap was arranged last October and entitled the hedge fund to collect payments equal to the gain in all the securities comprising the basket.

Credit Suisse offers total-return swaps through its Delta One prime brokerage operation, while J.P. Morgan Chase offers them through its Master Swap program. Hedge funds "canvass the street" to find the derivative deals that require the least amount of collateral. The collateral used by hedge funds to secure these swaps, however, may be difficult to trade, and in a severe market decline, attempts to unwind these positions may lead to panic selling. The dealers don't disclose the amount of total return swaps on their books.

*[When swap deals go bad hedge funds have to make big payments to the derivatives counter party. Citadel offsets this risk by carrying a pool of easy-to-sell securities – U.S. treasury bonds – and maintains "internal risk and liquidity targets".]*

### **Private-Equity Firms**

Private-Equity firms such as Kohlberg, Kravis, & Roberts ("KKR"), are investment funds that usually buy entire companies. KKR is currently the lead firm in the 'take-out' of Canada's BCE (Bell Telephone). Loans to private-equity firms rose to \$317 billion in 2006 from \$51 billion in 2002. This statistic reflects more and bigger deals but sources indicate that the debt-component has increased relative to the cash generated by the companies being acquired.

<http://www.kkr.com>

*[The Federal Reserve estimates that there is \$21 trillion in corporate stock outstanding versus about \$12 trillion in 2002.]*

### **Investment Dealers**

In 2006, Wall Street's four biggest investment dealers financed \$3.3 trillion of assets with \$129 billion of shareholders' equity – a leverage ratio of 26 to 1. In 2002, those same four firms financed \$1.6 trillion of assets with \$74 billion of equity – a ratio of 22 to 1. In the case of Goldman Sachs its ratio of assets to shareholders' equity increased to 25 to 1 in 2006 from 18 to 1 in 2002. Goldman indicates the increased leverage came as a result of its conversion from a partnership to a public corporation and the need to match its competition. Goldman also indicates it has a pool of liquid assets of approximately \$50 billion that it can sell if market conditions turn negative.

Goldman has a joint venture with the Bank of New York involving "repurchase agreements". Goldman uses stock from its proprietary trading accounts and its hedge fund clients, selling the stock but

agreeing to buy it back later. The cash received is in essence a temporary loan, allowing it to lever the debt secured by those stocks to 2% of their value **(50 to 1)**. The leverage is defended on the basis, "The prime-brokerage lending business provides a stable recurring revenue stream with limited risk."

### **Selected Statistics**

- Margin debt held by individual investors – amount borrowed from brokerage firms to buy stocks – totaled \$293 billion in March versus \$135 billion in 2002. The March margin debt represents the third straight month it exceeded the record set during the high-tech bubble in 2000.
- Prior to the 1929 crash, brokers' customers were allowed to buy stocks with as much as 90% margin debt. The Securities Exchange Commission currently limits margin debt to 50% of a stock's market price.
- Estimates by analysts of leverage at major securities firms, borrowing by hedge funds and margin loans to individuals, totalled \$5.0 trillion in 2006 versus \$1.8 trillion in 2002.
- Hedge fund borrowing amounted to \$1.5 trillion last year compared to \$180 billion in 2002.

### **Stock Market Outlook**

The April 30th issue of the *Wall Street Journal* carried an excellent editorial-opinion entitled *Irrational Complacency?* by Burton G. Malkiel. The writer debated whether the stock market is correctly pricing strong growth and economic stability into its valuation, or, if it is being irrationally complacent in the face of substantial risks.

- Mr. Malkiel estimates long-run annual equity returns by adding today's dividend yield – approximately 2% – to the future growth rate of earnings and dividends – estimated at +5.5%. This would suggest that stocks are priced to produce 7.5% future returns. This is well below the +10.5% annual returns achieved from 1926 through 2006.
- Treasury bond yields at 4.75% are historically low. The spread between high-yield bonds and risk-free U.S. Treasuries is close to all-time lows.
- The prospective equity risk premium (the amount that stock returns exceed bond returns) of about 2.75% is well below the 5% equity risk premium earned since 1926.
- The VIX Index, measuring expected U.S. stock market volatility is historically low.
- Various surveys (polling) done by independent market monitoring firms suggest a high level of complacency – following the almost uninterrupted rise in the stock market since June of 2006.

Mr. Malkiel concludes, "These measures imply that financial markets are very relaxed about risk and that the world is a very stable place." In recent years recessions have been mild, earnings variability has moderated and inflation has been contained. Price-earnings multiples in the mid to high teens are clustered close to their long run average values. A shock to the system, however, may come from the geo-political environment where risk levels are judged to be extremely high.

- "The conflict between Sunnis and Shiites as well as the violence of Hezbollah and Hamas threaten to destabilize the Middle East region."
- Iran is engaging in virtually 'unchecked' nuclear belligerency and repeatedly targets Israel with confrontational rhetoric. Israel, however, has both nuclear weapons and 'deliverability'.
- "The energy-vulnerable European nations have large Muslim populations that are experiencing limited social integration, high unemployment and radical Islamist influence."
- There are also a number of macro-economic factors underlying the United States economy, which cause Mr. Malkiel concern. "Inflation and quality adjusted home prices are still more than 50% above

their averages throughout most of the 20th century.” Measured savings rates in the United States are essentially zero, and the trade deficit is running at 7% of GDP. The share of after-tax corporate profits relative to GDP is almost 9% versus 5% during the 1970s – whereas, wages and salaries have fallen from 53% to under 46% since 1970 – the Dobbsian “Assault On The Middle Class!” (Lou Dobbs – CNN)

- The political agenda will become increasingly adverse towards the Bush administration as it enters the 2008 presidential year. There is a growing realization the “insurgents” do not want the United States to withdraw from Iraq. Democrat controlled ‘Capital Hill’ has yet to dwell in earnest into the financial cost of the war and the apparent lack of accounting for the huge amounts of money spent.

Mr. Malkiel, however, does include several arguments to rationalize today’s market valuations. He states, “I believe that markets are high and risk spreads compressed because of a massive increase in world liquidity. A world awash in dollar-based purchasing power has helped to keep our interest rates low and the spreads on risk assets tight”. Flows of money continue into private equity and hedge funds available for public investors. Malkiel concludes, however, “In our highly leveraged, narrow-spread markets, shocks to the system can have large destabilizing effects.”

*[The Diary’s editors have chosen a ‘bullet-summary’ format to add additional commentary.]*

- *Over the past several years the Diary has profiled the Putin orchestrated moves by which the Kremlin (KGB) has regained political and economic control over Russian society. Putin has essentially captured the Russian energy platform and has undertaken strategic moves into many other key industries. The United States is not a factor in the development (and control) of Russia’s energy reserves.*

- *China and India’s economies are growing at phenomenal rates – and are dealing with commensurate energy demands by securing foreign resources – at ever increasing premium prices. Western-based economic concerns are losing-out on these markets.*

- *The status of the United States as a world super-power capable of influencing an event with ‘gun boat diplomacy’ is being denigrated daily by the insurgent activity in Iraq. The apparent indifference (or implicit geo-political intention) of Russia and China to contain the nuclear ambitions of North Korea and Iran has left the United States to go it alone. The United Nations has been shown to be a meaningless entity unable to prevent suffering and political dislocation of the world’s innocent civilians.*

- *The United States huge trade deficits are being financed offshore. The Bank of China is now one of the largest holders of United States treasury debt. This is where leverage has even reached the national state level. The Bank of China can be described as ‘America’s banker’. It has a ‘call’ on the United States – it can simply decide to start to sell its U.S. dollar denominated holdings – which could precipitate an even greater crescendo of selling in a “wind down” scenario.*

- *And finally... .. the United States Army is understandably fatigued and ‘war-weary’. The “coalition of the willing” has left a lot to be desired. Its traditional allies (Great Britain, Canada – in Afghanistan) have stood behind America – however, other key and important nations have not. The United States is now facing the eventuality of withdrawing from Iraq – simply because it has become too great a drain on its military and economic resources. There is actually fear in some circles that the Iraqi insurgents may attempt an unexpected but coordinated offensive similar to the surprise “Tet Offensive” of the Viet Nam War, with U.S. military ground forces pinned down and only limited means of extrication. This is a worst-case scenario and an example of a severe adverse geo-political event that would trigger a melt down.*

*[It is doubtful that the Pentagon has war-gamed anything like this!]*

**Selected Quotations**

- "It's easy to put on leverage, but not as easy to take it off." ...Warren Buffet
- "Total-return swaps make a mockery of margin requirements". – The widespread use of swaps makes the leverage that preceded the 1929 crash – "Look like a Sunday-school picnic." ...Warren Buffet
- With hedge fund managers now collecting management fees of 1% to 2% – or even higher – on billions of dollars, "they are extraordinarily well compensated". "I used to say that I should not make a dime unless my investors made a dime and the 1% management fee was supposed to be enough just to pay expenses" ...Michael Steinhardt
- What's his take on today's stock market? "The bell is beginning to ring. We are not too far from the end of the bull market." ...Michael Steinhardt
- A trillion dollars here! ...A trillion dollars there! Suddenly we are talking "serious money" ...Anonymous
- Twenty-five and fifty to one ratio – nothing compared to my ex-wife – she ran 100 to nothing ratios with my credit card! ...Anonymous

*[The OSINT **Law of Stalingrad Syndrome** – "The finality of an outcome is certain – only the entrapped are ignorant of the finality." ... .. Does it apply to today's situation?*

*The Editors have purposely chosen to highlight with underlined, bold, italic text the various leverage ratios in play in today's capital markets. The aforementioned ratios are awesome! The Editors include one money-manager who does not engage in leverage at all in his clients' traditional portfolios – in fact he is only approximately 40% in the stock market on a non-borrowed basis. He does run a private financial derivatives fund, however, the fund has never surpassed a 5 to 1 leverage ratio – and in many instances over the four-year history the positions have been 'short the market'. A 25 to 1 long position would cause this portfolio manager cardiac arrest – not to mention a terminal case of 'strangled sphincter muscles'!]*

*The Editors do not want to see any severe adverse situation develop in the capital markets – however, prudent investors should be aware of the risk in the market place and how increasingly the probability is growing that geo-political risk may converge to ignite the melt down. We hope our concerns are unfounded – however, we are hedging our bets – and we are sleeping well at night – very soundly actually!]*

***The Editors used three articles to prepare this précis. We would like to reference them in full recognition of copyright requirements. All three articles are outstanding! Burton Malkiel and Michael Steinhardt are legends in the investment business. The Diary's editors consider it an honor to even reference these men through our précis summaries. Not only do we fully acknowledge copyright authority we also compliment them for their outstanding contributions to the world of finance.***

***Barron's – Talking With Michael Steinhardt – A legend Lashes Out, April 30th, 2007***

***Wall Street Journal – Irrational Complacency, April 30th, 2007***

***Wall Street Journal – As Funds Leverage Up, Fears of Reckoning Rise, April 30th, 2007***

## **CONTEMPORARY WARFARE**

### **A Failure of Generalship**

Lieutenant Colonel Paul Yingling recently published an article in Armed Forces Journal entitled "a failure of generalship," available at <http://www.armedforcesjournal.com/2007/05/2635198/>. This piece is critical of the Generalship exhibited by senior military leaders with respect to the conduct of Operation Iraqi Freedom and has been extensively reported in the press and debated. Yingling's commentary draws parallels between the failure of the leadership of the Prussian Army to adapt to Napoleonic warfare and the potential for catastrophic failure of American forces in Iraq if current military commanders do not immediately prepare for the challenges of the "Long War."

See also "Army Officer Accuses Generals of 'Intellectual and Moral Failures'" in The Washington Post, April 27, 2007 at

<http://www.washingtonpost.com/wp-dyn/content/article/2007/04/26/AR2007042602230.html>

### **Global Incident Map**

<http://www.globalincidentmap.com/home.php> provides a link to a Global Incident Map which automatically updates every 420 seconds. Each incident can be accessed to provide a description and satellite imagery of the location where it took place.

### **Special Operations Command: A Twenty Year History**

([http://www.fas.org/blog/secretcy/2007/04/special\\_operations\\_command\\_a\\_t.html](http://www.fas.org/blog/secretcy/2007/04/special_operations_command_a_t.html))

Tuesday, April 17, 2007, 2:28:55 PM Steven Aftergood

As the missions and budgets for U.S. Special Operations Command steadily expand, a new official history (large pdf) looks back at the origins and development of SOCOM.

"Since its creation in 1987, USSOCOM has supported conventional forces and conducted independent special operations throughout the world, participating in all major combat operations," writes SOCOM Commander General Bryan D. Brown.

The new account, prepared by the SOCOM history office and obtained by Secrecy News, describes in new detail the major SOCOM operations of the past two decades up through the present.

"After 9/11, the first SOF [special operations forces] counterterrorism operations were not conducted in Afghanistan or even in the Middle East, but in Europe," the SOCOM history notes.

"In late September 2001, U.S. SOF learned that Islamic extremists with connections to Usama bin Laden were in Bosnia. SOCEUR forces quickly put together Operation RESOLUTE EAGLE to capture them. U.S. SOF surveilled the terrorists, detained one of the groups, and facilitated the capture of another group by coalition forces. These raids resulted in the capture of all the suspected terrorists and incriminating evidence for prosecution and intelligence exploitation."

Other operations, like the battle of Tora Bora, were admittedly less successful.

"The fact that SOF came as close to capturing or killing UBL [Usama bin Laden] as U.S. forces have to date makes Tora Bora a controversial fight. Given the commitment of fewer than 100 American personnel, U.S. forces proved unable to block egress routes from Tora Bora south into Pakistan, the route that UBL most likely took."

See "United States Special Operations Command, 1987-2007,"

(<http://www.fas.org/irp/agency/dod/socom/2007history.pdf>) SOCOM History and Research Office, MacDill Air Force Base, April 2007 (143 pages in a very large 32 MB PDF file).

The Government Accountability Office prepared a detailed critical profile of SOCOM (<http://www.fas.org/irp/gao/gao-06-812.pdf>) in 2006.

"The Special Operations Command is comprised of special operations forces from each of the military services. In fiscal year 2005, personnel authorizations for Army special operations forces military

personnel totaled more than 30,000, the Air Force 11,501, the Navy 6,255, and the Marine Corps 79," the GAO reported.

"From fiscal year 2001 through fiscal year 2005, funding for the Command increased from more than \$3.8 billion to more than \$6.4 billion," GAO said, and it is only projected to rise through 2011.

But recruiting and training special operations forces to meet expanding mission requirements will be a challenge, the GAO concluded.

See "Special Operations Forces: Several Human Capital Challenges Must Be Addressed to Meet Expanded Role" [GAO-06-812] (<http://www.fas.org/irp/gao/gao-06-812.pdf>), July 2006.

See also "Army Special Operations Forces" (<http://www.fas.org/irp/doddir/army/fm3-05.pdf>) U.S. Army Field Manual 3-05, September 2006, obtained by Secrecy News.

### **Chatham House – "Accepting Realities in Iraq"**

An extremely pragmatic assessment of the current situation in Iraq "Accepting Realities in Iraq" promulgated by Chatham House (The Royal Institute of International Affairs [www.chathamhouse.org.uk](http://www.chathamhouse.org.uk)) is available at <http://www.chathamhouse.org.uk/pdf/research/mep/BPIraq0507.pdf>. The summary of this report suggests:

- Iraq has fractured into regional power bases. Political, security and economic power has devolved to local sectarian, ethnic or tribal political groupings. The Iraqi government is only one of several 'state-like' actors. The regionalization of Iraqi political life needs to be recognized as a defining feature of Iraq's political structure.
- There is not 'a' civil war in Iraq, but many civil wars and insurgencies involving a number of communities and organizations struggling for power. The surge is not curbing the high level of violence, and improvements in security cannot happen in a matter of months.
- The conflicts have become internalized between Iraqis as the polarization of sectarian and ethnic identities reaches ever deeper into Iraqi society and causes the breakdown of social cohesion.
- Critical destabilizing issues will come to the fore in 2007-8. Federalism, the control of oil and control of disputed territories need to be resolved.
- Each of Iraq's three major neighbouring states, Iran, Saudi Arabia and Turkey, has different reasons for seeing the instability there continue, and each uses different methods to influence developments.
- These current harsh realities need to be accepted if new strategies are to have any chance of preventing the failure and collapse of Iraq. A political solution will require engagement with organizations possessing popular legitimacy and needs to be an Iraqi accommodation, rather than a regional or US-imposed approach.

### **Winograd Commission Interim Report**

The Winograd Commission, investigating the Israeli conduct of the 2006 war in Lebanon, issued its interim report on 30 April. A précis of the "Main Issues" contained in this report is available in English at <http://www.idi.org.il/english/article.asp?id=07052007123937> and the original text in Hebrew can be accessed at <http://www.vaadatwino.org.il/reports.html#null>. The main conclusions pertain to the lack of coherent strategic thought, failures of decision making, problematic interpersonal and organizational relationships amongst key appointments, issues of professional competency, and the scope of the Commission's mandate.

Background information on the Winograd Commission is available at <http://www.idi.org.il/english/article.asp?id=26042007090945>.

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