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A Kashmir Sweater

Since coming to power in 2014, Indian Prime Minister Narendra Modi has shown a penchant for using surprise to launch new policies. In 2016, for example, his government announced a sudden replacement of large-denomination bank notes to fight crime and curtail the shadow economy. Modi's latest shocker came early last month, when his [government suddenly announced that the northern state of Jammu and Kashmir would no longer have the special autonomy](#) it has enjoyed since India's independence from Britain in 1947. Like the cash reform, officials couched the Kashmir initiative as economic policy – as a way to encourage more development in the region. However, its main impact is likely to be political and strategic. Indeed, it even has the potential to eventually prompt a military confrontation between India and Pakistan, pitting two nuclear powers against each other. That complication makes the situation a real “sweater.” Thus, it makes sense to examine the move in greater detail and discuss what it says about the evolving geopolitical environment. As always, we will also discuss the investment implications of the move.

Himalayan Tug-of-War

Lying high in the Himalayan mountains and constituting the northern tip of India, [Kashmir is a region of thickly forested peaks, deep, narrow valleys and barren plateaus](#) (see Figure 1). Over the last two millennia, it has been an important center of Buddhism, then Hinduism, and finally

Islam. The region was under Muslim rule from 1346 until it was annexed into the Sikh kingdom of the Punjab in 1819. It was later annexed again in 1846 by the Dogra kingdom of Jammu, making it part of an important Hindu-dominated buffer state that Britain used to protect its Indian colony from the Russian and Chinese empires to the north. Following the Indian Rebellion of 1857, Britain took direct control of Kashmir.

Figure 1.



City of Srinagar, Kashmir, with Himalaya mountains beyond. (Source: TripSavvy.com)

In the aftermath of World War II, as the British were dismantling their global empire, they divided their Indian territory into Hindu-dominated India and Muslim-dominated Pakistan. In the process, princely states such as Kashmir were allowed to decide which country they wanted to join. With some restrictions, they could even opt to become independent. [The Hindu “maharaja” of Kashmir initially delayed making a decision with the hope of leading an independent country](#), but his plan was thwarted by the complex social and religious tensions resulting from the history described above. As his Muslim subjects revolted and tried to seize territory, the maharaja turned

to New Delhi for help. India agreed to intervene on one important condition: that Kashmir would become part of India.

The maharaja of Kashmir signed an Instrument of Accession to the Indian Union in October 1947, leading to an all-out civil war in which Pakistan supported Kashmir’s Muslims and India backed its Buddhists, Hindus and Sikhs. When a ceasefire was finally achieved in 1949, the territory lay divided along the front lines at the time. Kashmir today remains divided along that same “line of control.” The sparsely populated, economically under-developed northern portion is occupied and administered by Pakistan (see Figure 2). The more populous and vibrant southern portion is controlled by India and makes up the country’s only Muslim-majority state (as discussed below, part of India-controlled Kashmir was later seized by China). To help appease the Muslims in Kashmir, the Indian constitution was amended in 1950 to give the region temporary autonomy. The amendment, known as Article 370, states that Kashmir’s autonomy can only be removed with the approval of a special commission, and since that commission is now defunct, the Indian Supreme Court ruled last year that Article 370 cannot be abrogated. Indian law has also prohibited outsiders from purchasing land in Kashmir.

Figure 2.



Map of Kashmir region. (Source: BBC)

To this day, India and Pakistan have each claimed the right to control Kashmir, sparking military conflict between the two countries in 1965, 1971 and 1999. To keep control over the restive Muslim majority in the territory, India has maintained a military presence there since the 1980s. After the growth of a separatist Muslim insurgency in the 1990s, the military presence has become oppressive and often violent (see Figure 3). India and Pakistan have continued to sporadically fire on each other over the line of control. In fact, after a militant separatist group killed 40 Indian policemen in a suicide bombing last February, India responded by conducting airstrikes against purported militant training camps on Pakistan’s side of the line. The following day, Pakistan shot down two Indian fighter jets in its airspace and captured an Indian pilot, who was later released.

Figure 3.



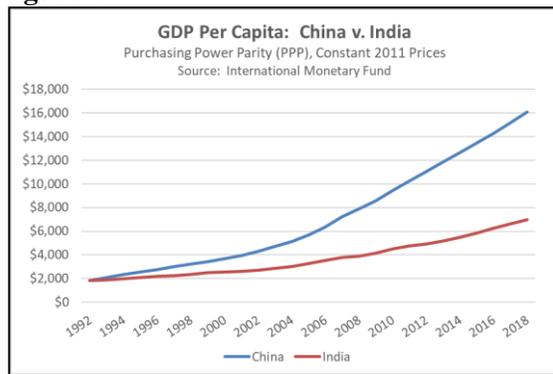
Indian soldiers subduing Kashmiri protestors in 2017. (Source: NewsClick.in)

Enter Narendra Modi

For nearly seven decades after India won its independence in 1947, the country was dominated by the broad-based, center-left Congress Party. The party took its inspiration from modern India’s founding father, Jawaharlal Nehru, whose family happened to come from Kashmir. The great challenge for Nehru, a British-educated atheist and socialist, was to lead a newly independent India that was intensely religious, poorly educated and economically

underdeveloped. The approach adopted by Nehru and the Congress Party leaders after him was to build a socialist economy with elements of central planning, a secular state that celebrated all of India’s religions equally and a system of world-class educational and research institutions that could propel the economy forward. The result was a country whose economy was growing but lagged the explosive growth in post-reform China (see Figure 4), while its ethnic and religious tensions were only partially contained. An integral element of Nehru’s program was autonomy for his family’s homeland of Kashmir.

Figure 4.

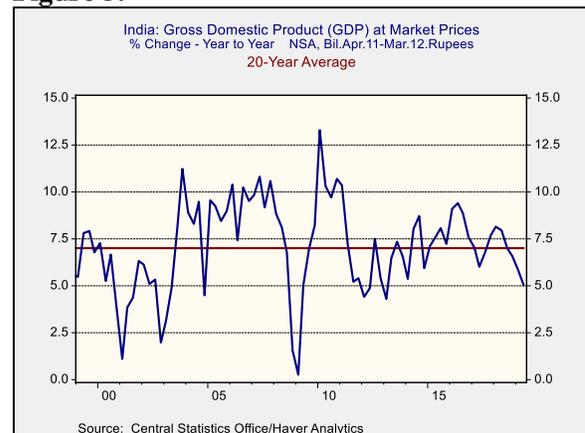


[However, the 2014 election of Narendra Modi as prime minister has ushered in a sea change in Indian politics.](#) Modi, the leader of the Hindu-nationalist Bharatiya Janata Party, rejects the Nehru program as far too Western for India. He sees Nehru-style policies as a font of political and administrative chaos, while viewing Nehru’s autonomy for Kashmir as appeasement. He and his party have long complained that Kashmir’s autonomy amounts to favoritism for the region’s Muslims and encourages separatist sentiment. They also claim autonomy has left Kashmir insufficiently integrated with the rest of the country and economically underdeveloped (although, by some measures, its economy is stronger than the rest of the country). Modi therefore has pursued an aggressive program of

centralizing power, liberalizing the economy and favoring the Hindu majority. He has often used surprise tactics to push through new initiatives, like when he suddenly implemented his currency reform in 2016.

With his reelection in May 2019, it appears that Modi has been emboldened to continue his Hindu nationalist program. Softening economic growth may have also prompted Modi to look for a distraction that would shore up his support (see Figure 5). The Modi government prepared the groundwork for its Kashmir initiative in the first days of August, when it quietly ordered tourists and pilgrims visiting religious sites to leave the state. It also detained many local political leaders, banned public gatherings, closed schools and cut off telephone and internet service. It then announced in parliament that it would revoke the constitutional provision that provided for Kashmir’s autonomy and divide the state into two new “union” territories. The move has [generated substantial anger among Kashmir’s Muslim population](#), including threats of violence against Indian forces, but the government has so far been able to avoid any major demonstrations by keeping tight restrictions on communications and movement within the territory. Still, we think there is the potential for a stronger reaction when those controls are removed.

Figure 5.



The revocation of autonomy, territorial dismemberment and legal changes have angered not only Kashmiris, but also Muslims throughout India and beyond. Muslims in Kashmir suspect the moves were mostly aimed at allowing Hindus from outside Kashmir to buy up property in the territory and gradually displace them. Given the recent Supreme Court ruling that Kashmir's autonomy can't be revoked, the abrogation of Article 370 is bound to be challenged in court, but Modi's supporters argue that the way it was pushed through parliament makes it valid. [Modi's initiative has international political implications as well](#). Most directly, the revocation of Kashmir's autonomy is being seen in Pakistan as an assault on fellow Muslims. The Pakistani government has publicly protested the revocation and this month plans to ask the United Nations to take action against it. More ominously, the head of Pakistan's army, General Qamar Javed Bajwa, said shortly after the revocation was announced that, "The Pakistan Army firmly stands by the Kashmiris in their just struggle . . . We are prepared and shall go to any extent to fulfill our obligations in this regard." That statement could mean that the Pakistanis will now ramp up their support for Kashmir's Muslim separatists, which could eventually spark a military confrontation with India.

Although growing tensions between India and Pakistan are the more obvious and immediate concern, Modi's move in Kashmir could also lead to increased friction with China. As an ally of Pakistan, China would naturally push back against India, but Beijing also has its own independent interests in Kashmir. In 1962, after the countries failed to resolve a border dispute centered on the northeastern portion of the region, China launched a war against India and seized an area of Kashmir known as Aksai Chin. It still holds that area today.

The dispute continues to simmer, and Chinese and Indian forces have periodically exchanged fire in the region. The Chinese government would naturally worry about any effort by New Delhi to strengthen its control in an area facing Chinese troops. It therefore criticized the initiative against Kashmir and demanded that India not make any moves that could threaten stability in the border region.

Ramifications

The Indian government's solid planning and tight execution of its Kashmir initiative have helped limit the political, economic and financial market fallout so far. Cutting telecommunications links and restricting the Kashmiris' movement have minimized protests, and whenever the calibrated lifting of those measures allowed protests to begin, [the government has reversed course and kept the protests from growing](#). If the government can continue to execute its initiative well, there will probably be little, if any, financial market implications in the near term.

However, the Kashmir move does increase the risk of intensified terrorism or a renewed insurgency in Kashmir itself or elsewhere in India. If India suspects that Pakistan is providing support for Kashmir's Muslim separatists, it is highly likely that at some point India will take military action against Pakistan, which in turn would almost certainly fight back. Such a confrontation between two nuclear-armed adversaries would be highly risky because it could escalate to all-out war, potentially drawing in China and other major powers. Accordingly, we see Modi's move against Kashmir as a longer term risk for Indian, Pakistani and other Asian equities. Investors have become enamored with Indian equities in recent years, seeing the country as one of the world's next great growth opportunities after China.

Worsening tensions in Kashmir would probably relegate India back to second-tier status among the emerging markets.

Growing tensions between nuclear-armed India and Pakistan would likely be positive for gold and other precious metals. If tensions escalate toward war, traders may also instinctively bid up oil prices initially. However, since both India and Pakistan are primarily importers of commodities, rather than producers or exporters, we believe escalating tensions between the countries

could actually be slightly negative for most other commodities. At the same time, any potential souring of relations or rise in military tensions would likely encourage safe-haven buying in the bond market, driving government bond prices higher and yields lower.

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