

October 21, 2024

### Israel's Pager Caper and Supply Chain Security

Can you trust your refrigerator? What if it could be weaponized against you, perhaps by being booby-trapped to explode, release poisonous gas, or just stop working on the command of some foreign enemy communicating with its computer chip? Just as important, if everyday products connected to the internet or communication networks could become that dangerous, what would you want your government to do to protect you? What *could* your government do to protect you?

These questions may sound strange, but they demand attention after hundreds of Hezbollah militants in Lebanon were maimed by simultaneously exploding pagers and walkie-talkies on September 17 and 18. Dozens of militants died in the attacks, which have been attributed to Israel. In this report, we explore how this groundbreaking attack has probably transformed national security requirements and will likely lead to big, costly changes in global supply chains in the coming years. We will also delve into the underlying philosophies that help explain why this could impact globalization. As always, we wrap up with a discussion of the implications for investors.

#### Background

On October 7, 2023, the Hamas government in the Gaza Strip attacked Israel, killing more than a thousand Israelis and taking hundreds hostage. In response, Israel has been waging war on Hamas in Gaza with the

goal of destroying the group. Meanwhile, Hezbollah militants in Lebanon have continuously launched rocket, artillery, and drone strikes against Israel to express their sympathy with Hamas and force the Israeli military to divert resources away from Gaza. The incessant Hezbollah attacks have forced Israel to evacuate some 50,000 civilians from the area along its northern border with Lebanon, creating mounting political problems for Israeli Prime Minister Netanyahu. In recent months, Netanyahu and the Israeli military have therefore become increasingly anxious to stop Hezbollah's attacks.

The Israeli government has not admitted responsibility for the September pager and walkie-talkie attacks, but they have all the hallmarks of an operation carried out by Israel's aggressive, sophisticated intelligence agency, known as Mossad. Below, we lay out all the key elements of the operation as best we can piece it together from press reports.

**Nasrallah Urges Pagers.** After Israel successfully killed several top Hezbollah and Hamas officials in airstrikes earlier this year, Hezbollah leader Hassan Nasrallah reportedly became concerned that Mossad had compromised the militants' smartphones. Therefore, in April, he publicly urged his fighters to ditch their phones in favor of low-tech pagers. In all likelihood, this initiative had been percolating in the Hezbollah bureaucracy for some time, and the organization was probably already planning to buy pagers for its fighters. It may have already ordered them. Indeed, the idea may have even been

planted by the Israelis themselves via compromised Hezbollah officials controlled by Mossad. In any case, the Israelis apparently got wind of the initiative and launched an effort to take advantage of it.

***Israel Seizes the Supply Chain.*** Debris from the explosions suggested the pagers had been made by a Taiwanese company called Gold Apollo. [However, that firm quickly announced that it had licensed their production to a Hungarian manufacturer called BAC Consulting.](#) Reporters swiftly discovered that BAC Consulting was no longer in business, suggesting the Israelis had simply taken over its identity and made it a front company. Officials in Budapest insist there are no records of the pagers ever being shipped from Hungary. It therefore appears that the Israelis acquired them and rigged them to explode elsewhere. At any rate, the Israelis were able to see the Hezbollah order, insert themselves into the supply chain using a front company, and manipulate the product without Hezbollah discovering it.

***Israel Rigs the Pagers.*** Based on press reports, it seems there were two key changes that weaponized the pagers. First, the Israelis apparently identified and inserted an explosive that was able to kill or maim with as little as 1-2 ounces and yet was so chemically similar to a pager battery that it wouldn't be detected when Hezbollah conducted its security screening. Second, the Israelis would have had to compromise the software in the pagers and/or the pagers' communication system to detonate the explosive at a certain signal.

***Israel Detonates the Devices.*** It appears that Israel detonated the pagers by sending some kind of signal to them. Some reports suggest Israel had originally planned to detonate them as the opening round of a large-scale

ground attack on southern Lebanon but decided to detonate them early as a standalone attack out of fear that the project would be discovered. In any case, reports say the pagers received a signal that made them start beeping and then exploded within seconds. Many of the Hezbollah fighters who heard the beeping were looking at the pager's screen when it exploded and were blinded. Others had their hands blown off or received lacerations to their torsos. Of course, some civilians were also killed or injured by the explosions.

### **The Impact on Globalization**

Stepping back from the tactical execution of the pager attack, we think there are potentially much broader implications for the global economy. As noted in the introduction, the "pager caper" reveals the vulnerability of extended supply chains. So, how did we get here?

***The Philosophy of Human Relations.*** There are some basic philosophical queries that act as a sort of [Rorschach test](#) for how people think. One of the classic questions is, "If a tree falls in a forest, and no one is around to hear it, does it make a sound?" This question gets at how an individual perceives external reality. If one thinks there is a world outside of their perception, then, of course, a falling tree makes a sound. Most Westerners think this is the case. However, if no one hears it, can you prove reality is external? If we take the opposite argument, your assumption is that no reality exists if you personally don't perceive it.

A similar test exists for political philosophy. Thomas Hobbes held that people in the state of nature are at war with each other. To prevent constant war and fear, humans band together and form governments. Nations exist to protect their citizens; these citizens give their governments a monopoly on

violence and give up some of their freedoms for protection.

Jacques Rousseau took the opposite position. He held that humans in the state of nature are essentially good, and that it is government that corrupts them. Thus, it follows from Rousseau that government is, at best, a necessary evil and, at worst, a force to be restrained.

So, the question that is derived from these two positions is, “Are humans essentially good or not?” Our casual observation is that most people tend to agree with Rousseau when it comes to those close to them but adopt Hobbes’s theory for the broader world. Simply put, most of us lock our cars and homes at night but show kindness to strangers.

***The Philosophy of Free Trade.*** In terms of economic and political theory, it isn’t easy to follow a middle path. One area where this issue is evident is in trade economics and policy.

Adam Smith, the father of economics, made an important observation that specialization improved production. He noted that 10 workers could produce 48k pins per day if each specialized in one or two aspects of production. However, if each worker had to make the entire product, they may not be able to produce but a few. In terms of international trade, he took that idea and suggested that nations should focus on producing what they do best (“absolute advantage”) and import what other nations do best.

*If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it off them with some part of the produce of our own industry employed in a way in which we have some advantage.*

*The general industry of the country, being always in proportion to the capital which employs it, will not thereby be diminished [...] but only left to find out the way in which it can be employed with the greatest advantage.*<sup>1</sup>

David Ricardo took this idea even further, arguing that even if a nation holds absolute advantage over another nation in the production of different products, it still makes sense for the superior nation to specialize in what it does best internally and import the other products from abroad. This idea, known as “[comparative advantage](#),” has become the basis of international trade theory.

However, we believe there is an unspoken assumption built into the trade theories of both Smith and Ricardo, which is that they are both in the Rousseau camp and they extend that position to nation states. In fact, they seem to view a nation in the same way most college professors view their universities — as platforms for their individual goals. The classical economists, of which Ricardo and Smith belong, viewed consumption as the primary goal of economies. This assumes national goals are secondary to meeting aggregate demand.

***The Philosophy of Trade Protectionism.*** In my graduate economic program, one of my concentration areas was the History of Economic Thought. In the coursework, we read original (translated) versions of *The Wealth of Nations*, *Das Kapital*, *The General Theory*, and key excerpts from various other works. However, we never encountered the German heterodox economist Friedrich List.

---

<sup>1</sup> Smith, Adam. (1937). *The Wealth of Nations*. New York, NY: The Modern Library, p. 424.

[List formalized](#) some of the [writings of Alexander Hamilton](#), who crafted the idea of protecting “infant industries” with tariff barriers. List argued that national interests at times are more important than individual interests. In other words, supporting the nation by various economic policies may be more important than seeing the economy’s primary goal as meeting consumption desires.

In our view, List and Hamilton may have believed Rousseau to be correct and relevant to relations *between citizens* but Hobbes as more relevant in relations *between states*. In Smith and Ricardo’s view, national specialization will likely lead to the best outcome for consumers. However, what if that specialization leads one state to underinvest in a dual-use product that may be essential to that nation’s defense?

Since the end of communism, we have lived through a unique period where the world was mostly a single economy. Obviously, there were a few “holdouts,” e.g., Cuba, North Korea, etc., but globalization spread rapidly, supported by technology, the widespread acceptance of the dollar as the reserve currency and the Treasury note as the reserve asset, and the willingness of US policymakers to tolerate persistent current account deficits.

But one mostly overlooked theme was that, unlike the Cold War, there was no obvious competing ideology. By default, the trade theories of Smith and Ricardo became preeminent. In effect, there appeared to be little risk in creating far-flung, complicated supply chains that took advantage of low-cost specialization. This system was the essence of what Smith and Ricardo outlined.

However, this system assumed that there was no geopolitical risk in creating such

supply chains. Hamilton argued against such a system, postulating that if the emerging US specialized in agriculture, in which it would have an absolute advantage over Britain, the emerging nation would not have the manufacturing base to build a military. Without this base, it would be as subservient to Britain as it was under the colonial system.

*How the Pager Caper Will Further Undermine Globalization.* When studying history, it is common to select a certain historical event as a watershed moment that “changed everything.” Historians will then examine the period before the watershed and [point out events that were a precursor to the change](#), but at the inflection point, “common knowledge” is forever changed. What was seen as normal suddenly becomes passe.

Globalization as practiced from 1990 to 2008 had been under threat for some time. Unconventional presidents, such as Barack Obama and Donald Trump, generally have been elected when an inflection point in US history is being reached. [When Edward Snowden revealed that the NSA had been collecting data from all the major social media and tech platforms](#), it suggested that ordinary citizens were being surveilled through their use of technology. [When the Transatlantic Trade and Investment Partnership \(TTIP\) and the Trans-Pacific Partnership \(TPP\) failed](#) to be enacted in 2014, it signaled that political support for free trade was lost in the US. President Trump’s implementation of tariffs and the further expansion of trade impediments by the Biden administration suggest continued erosion of support for trade.

However, Israel’s weaponization of the supply chain is a whole other matter. At the most basic level, it raises the concern that the smartphones most of us carry may not

just surveille us, they could maim us. Our cars could be taken control by a nefarious actor. Even our appliances or our children's toys could become weaponized.

Granted, some of these threats are unlikely, but what Israel proved is that it's possible to take ordinary items and weaponize them. It isn't a far stretch to see medical or food supply chains become compromised. An organic farm I visited recently had a sign that read "DO YOU KNOW WHERE YOUR FOOD COMES FROM?"

Increasingly, that might become an important question.

What this discussion has attempted to show is that the underlying theory of trade that dominated the world economy during 1990-2008 was predicated on the assumption that the world was mostly secure. In our opinion, we no longer have that luxury.

### **Investment Implications**

At the risk of redundancy, our investment implications often return to the same theme — the low inflation of the past period between 1990 and the pandemic were mostly driven by globalization, with aid from deregulation. Although it has been one of our core tenets that the inability to craft a domestic policy to allow the US to maintain its hegemonic role would undermine this "golden age" of globalization, we concede that, up until now, globalization has continued at a reduced rate. But now, the security element could become the condition that accelerates the unwinding.

The end of globalization and the resulting fracturing into blocs (which we have discussed in numerous earlier reports) will almost certainly be inflationary. This fracturing undermines the specialization at the heart of Ricardo and Smith's trade theories. Inflation poses significant risks for fixed income investors. It does also pose

risks to equity investors, although we suspect that equity markets will probably provide decent protection against the scourge. Commodities and precious metals should perform well.

The hardening of supply chains will likely have company and sector-specific risks and opportunities. Small and mid-cap stocks could benefit if their supply chains are less expansive. Small, mid-cap, and large firms providing logistic security services could also benefit, much as cybersecurity firms have benefitted from the growth in computer hacking. Nearby nations, such as Mexico and Canada, could benefit as well.

Western consumers have been living in a remarkable period of abundance; the last time we saw such a period was pre-WWI, as described by Keynes in his book *The Economic Consequences of the Peace*:

*The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep...But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable.*

Sounds much like what most Americans experience today. Those days may be unwinding. The products may become harder to acquire, and may cost more, but they will likely be safer.

Bill O'Grady  
Patrick Fearon-Hernandez, CFA  
October 21, 2024

*This report was prepared by Bill O'Grady and Patrick Fearon-Hernandez of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

### **Confluence Investment Management LLC**

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics, and geopolitical analysis with a value-driven, company-specific approach. The firm's portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.