

40 YEARS OF FRAUGHT US-IRAN TENSION IN THE PERSIAN GULF

JULY 2019

The geopolitics are coming fast and furious. The Strait of Hormuz, the critical waterway by which the bulk of Middle Eastern oil must travel, is back on the market's mind.

In response to Washington's decision to pressure Iran by ending the waivers it granted a half-dozen nations to continue purchasing its crude oil, the markets received this message from Iranian General Alireza Tangsiri on 22 April:

"According to international law, the Strait of Hormuz is a marine passageway and if we are barred from using it, we will shut it down. In case of any threat, we will have not even an iota of doubt to protect and defend the Iranian waters. We will defend our prestige and embark on reciprocal acts when it comes to defending Iran's right."

And just like that, Hormuz is in the news.

But, surprisingly, not as much as we think it should be.

Given this spring's decline in Brent crude oil -- which was threatening \$75 per barrel in April and was down near \$60 in mid-June -- the cloud hanging over the waterway is not appreciated by the market.

Figure 1 shows three critical Middle Eastern oil chokepoints, the closure of any of which would wreak havoc on oil markets and the global economy.

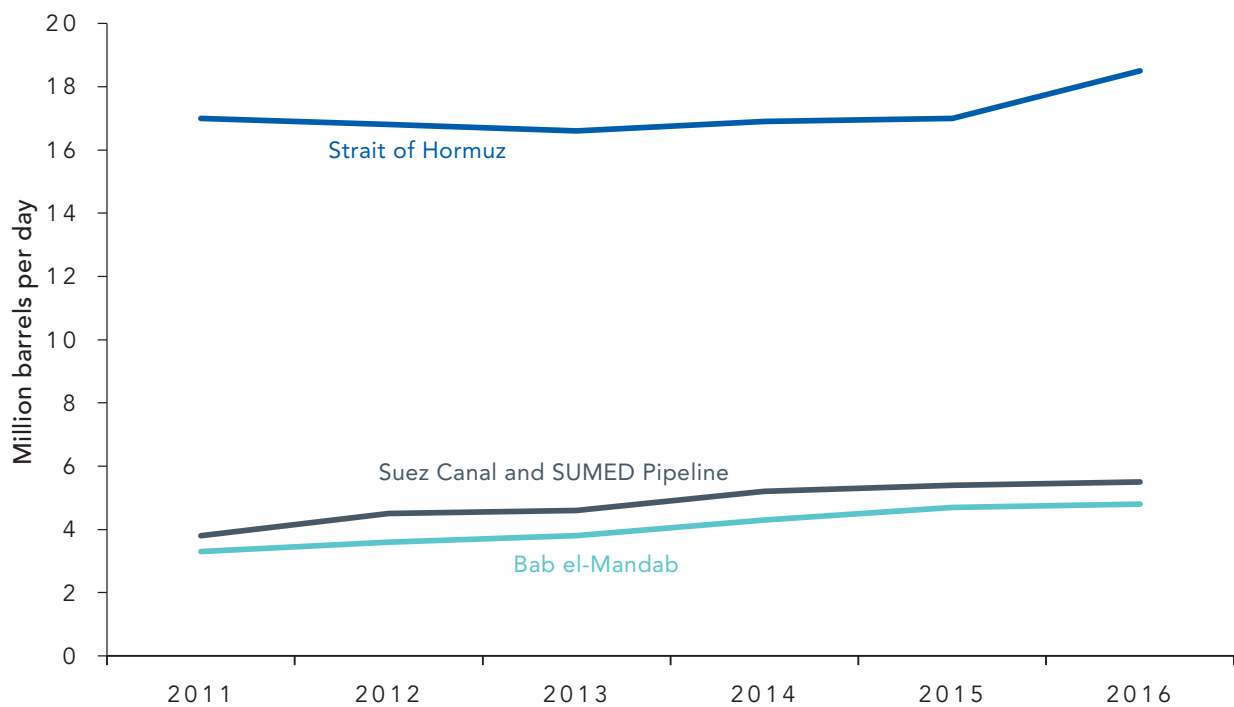
Focus on the topography of the Strait of Hormuz. You can see the tectonic plates breaking apart over millions of years, forming the needle point at the northernmost parts of the UAE and Oman. At its narrowest point, Hormuz's width is 21 miles (33km), though the shipping lane itself is just 2 miles (3km) wide. From Iraq, Kuwait, Bahrain and so on, oil and natural gas destined for the Indian Ocean must go through it.

FIGURE 1: THREE CRITICAL OIL CHOKEPOINTS, MID EAST



The EIA anticipates that the Organization of the Petroleum Exporting Countries (OPEC) oil cartel’s total output in 2020 will be 29.8 million barrels per day, of which 18 million barrels will flow through Hormuz. The other two chokepoints pale in comparison (Figure 2). The Strait of Hormuz is the world’s most important choke point, carrying 30% of global seaborne-traded crude oil and other liquids. It is also the avenue for all of Qatar’s liquefied natural gas (LNG) exports, which comprise approximately 30% of the global LNG trade¹.

FIGURE 2: CRUDE OIL AND PETROLEUM PRODUCTS TRANSPORTED THROUGH ARABIAN PENINSULA CHOKEPOINTS



Sources: US Energy Information Administration (EIA) analysis based on Lloyd’s List Intelligence, Panama Canal Authority, Argus FSU, Suez Canal Authority, GTT, BP Statistical Review of World Energy, IHS Waterborne, Oil and Gas Journal, and UNCTAD, using EIA conversion factors. EIA published the analysis in 2017

The last time Hormuz really gave the markets a fright was over seven years ago, when Iranian First Vice President Mohammad Reza Rahimi said this in December 2011: “If [the Western countries] impose sanctions on Iran’s oil exports, then even one drop of oil cannot flow from the Strait of Hormuz.”

THROUGH THE YEARS

We are now 40 years on from the Iranian revolution, and 38 years past the release of the 52 American hostages that were taken in the uprising. It may not be lost on President Donald Trump that they were let go just minutes after US President Ronald Reagan’s inauguration – and the current president would love to have a similar “tough guy” victory in his pocket. But he may be well-served to remember that Reagan had one Iranian headache after another throughout his tenure.

Let’s review the history of US-Iranian conflict in the Strait of Hormuz.

¹Source: Energy Information Administration

Before Iraqi dictator Saddam Hussein was ousted by the western alliance at the turn of the century, he was aided by the US military when warring with Iran in the 1980s. During that era, Iran planted mines in the strait. A US naval ship ran into one in 1988.

That was no isolated incident. The same year included Operation Praying Mantis, a one-day confrontation where Iranian forces were dominated by the US Navy. In the annals of modern-day Mideast conflict, that “taking out” of several Iranian vessels has been largely forgotten with the hands of time. But we shouldn’t forget, because the Persian Gulf had several other scares before the 1990-1991 Gulf War.

Staying with the end of the Reagan years, note too that the year before Praying Mantis – 1987 – witnessed 37 American seamen killed by the Iraqi air force. On edge from frequent engagement at the time, the US made a blunder in summer 1988 -- when a commercial airliner didn’t respond to radio communications, the US concluded it was the Iranian military. The plane was shot down, killing 290.

The events were not forgotten in Tehran.

This is what we find fascinating about the Strait of Hormuz and its potential to influence oil. If you think about critical memorable years for oil, boom or crash, 1987 and 1988 do not typically come to mind. “Big” years for oil usually include the 1973 oil crisis and the repeat shock in 1979 when Iranian oil production went haywire as power transitioned to the Ayatollah. After that, if we are talking about collective memory, even the historically minded among us gravitate to the 1990-1991 Gulf War oil shock when considering the 1980-2000 geopolitical window.

But why 1973, 1979 and 1990-1991? Because all three coincided with – or caused – tough economic periods in oil-consuming nations. Not so with some of the incidents of the late 1980s, which we discuss in greater depth later. Meantime let’s look at more recent years.

WHAT OIL BULL NEEDED HORMUZ WHEN WE HAD THE “COMMODITIES SUPERCYCLE?”

It was a half generation after the Gulf War before oil started heading northward again. Brent crude bottomed at \$9.64 in December 1998 – at less than ¼ its October 1990 peak around \$40. From that low to the peak in 2008 (\$146.08), Brent multiplied 15-fold.

Though Hormuz is always on some radars, we don’t think it was as front and centre in the market’s concern list during these years because the US military was engaged elsewhere – primarily Iraq and Afghanistan. Hormuz was “benign,” if the reader will grant us leniency on that assertion, in the earlier years of president Mahmoud Ahmadinejad (who served from 2005-2013). In those days, many believed Ahmadinejad represented moderation and a shift in Iran’s posture toward the West, though later we learned that was not the case.

Perhaps more importantly, there was little reason for Shia Iran to provoke George W. Bush, whose effort to topple Saddam Hussein served Tehran’s interests.

Remember, Iraq is a nation whose straight-line borders were drawn by the British and French after WWI; Hussein was a Sunni dictator in a Shia-majority country beset with numerous intertribal disputes. Iran’s logical play was to be quiet and let the US weaken the Sunni dictator. Hormuz wasn’t going to get put on the table against that set up.

Besides, in the first decade of this century, who needed the threat of a Hormuz closure to make oil rise? The commodity had two broad themes to ride, and both were based on sound reasoning.

The first was the so-called “commodities supercycle,” where the bull case for oil and everything else that came out of the ground was predicated on rising demand from rapidly growing emerging markets, namely China.

We can criticize the argument in retrospect, as Brent crude has flirted with sub-\$30 levels on a few occasions in recent years. But at the time, bulls were looking at charts of Chinese auto adoption rising asymptotically, calculating that the world was on a trajectory for an upward demand shock.

On the supply side, doomsayers were shouting from the rooftops about scientifically respected “peak oil” theories. The big one, posited mid-century by M. King Hubbert, theorized that the days of gushing, easy-to-extract oil had long since passed.

A 25-year chart of US oil production was the embodiment of “Hubbert’s Peak”: 1985 production of 9 million barrels per day had a waterfall decline into the 5-6 million barrel per day range by 2002-2005. Anyone looking at that chart in the pre-shale days would have been hard-pressed to argue against peak oil. The evidence was everywhere, from the panicky Mexican government wondering what was going to happen to its revenues when the “supergiant” Cantarell field’s production would roll over – which started happening in that same 2002-2005 window. Elsewhere, conjecture swirled on a daily basis as to whether the big one – Saudi Arabia – was fudging the numbers to disguise what many thought was imminent peak production there too.

We didn’t hear about Hormuz much during the “commodities supercycle,” because the bulls didn’t need a military conflict to make the bull case.

But just because eyes were diverted from Hormuz for much of the last generation doesn’t mean its geostrategic importance ever went away. Why has history largely forgotten the 1987-1988 Persian Gulf conflicts? Because the American middle class, which populates the country that most dominates global media, didn’t register pain at the gas station in those years. There was no story because there weren’t willing readers. The reason? Oil prices collapsed right before those events, for several reasons. There were profound structural changes that occurred in oil markets at the time. Until the late 1970s, almost 90% of the world’s crude oil was sold under long-term contracts at prices set by the major oil companies. OPEC produced just under half of the world’s crude oil, allowing it to dominate the price and quantity of oil sold. Prices fluctuated when these long-term contracts were revised, but prices were not otherwise particularly responsive to market conditions.

In the late 1970s and early 1980s, market-based spot and then futures trading gained in importance as production from the non-OPEC countries surpassed OPEC oil production. Owners of the newer oil from areas such as the North Sea lacked the typical long-term contracts with buyers, forcing them to find other ways to build market share. They were able to achieve this objective on the spot markets by undercutting OPEC. By the end of 1982, almost half of all internationally traded oil was traded on the spot market instead of through long-term contracts. With prices now determined on a very short-term basis, daily fluctuations in the price of oil became the norm – and bold moves in the price may have become easier to come by.

Also, Detroit’s smaller, more fuel-efficient cars started to roll off the assembly line by the early 1980s, reaching critical mass by the mid-1980s. And the North Sea oil that we referenced above and now take for granted was still novel back then; it had just started to add to global supply.

But the main driver of oil’s collapse in late 1985 was when Saudi Arabia got tired of other OPEC nations cheating on their production numbers and ramped up its own production. So powerful was the collapse in oil prices from that action that some Kremlinologists hypothesize it accelerated the downfall of the USSR, a petrostate bankrupted by its Afghanistan war to begin with.

In the industrialized west, nothing unusual happened at the gas station, at least not anything that left lasting scars relative to the prior decade’s gasoline lines. So when you ask market watchers what they associate with 1987, most will cite the October stock market crash and not much else. Figure 3 shows West Texas Intermediate crude oil, the benchmark for American eyes.

FIGURE 3: WTI CRUDE OIL, 1983-1989



Source: Bloomberg, 1983-1989

That background covers the “before,” but also consider the “after.” Persian Gulf conflicts in 1987 and 1988 may be somewhat forgotten because they are so overshadowed by the events of 1989. Perhaps the most significant year of the whole second half of the century, 1989 gave us the Berlin Wall collapse and the Tiananmen Square massacre in Beijing. If asking Americans, Chinese, Germans and many more what global events of the 1980s they remember most, it’s the “Tank Man” standing his ground in front of the Chinese People’s Liberation Army. Others may see Reagan telling Mikhail Gorbachev, leader of the Soviet Union, to “tear down this wall.”

Operation Praying Mantis? The downing of Iran Air Flight 655? They get short shrift in 1980s history. But make no mistake: These are the years when Tehran realized it has a potent political weapon in the Hormuz threat.

THIS GENERATION

Aside from the most recent Hormuz fright in 2011, investors have generally been able to bury it down their concern list over the last generation or so. We think the key reason is that this century witnessed the US expending national treasure bringing down Saddam Hussein, a Sunni autocrat that was the nemesis of the Iranian regime. Beyond that military effort, US and British forces were in Afghanistan, the primary target of the western alliance in the years after September 11.

But those wars have largely “rolled off,” and the new focus of the US military is a sort of trilateral regional alliance between the US, Saudi Arabia and the UAE, along with the other Gulf Cooperation Council (GCC) Sunni monarchies -- with the exception of Qatar, who is shunned by the rest of the GCC at the moment.

But the US and Trump got into a pickle in 2018 after so much political capital was spent sidling up to the House of Saud, only to observe in shock the fallout from the hit it ordered on journalist Jamal Khashoggi, who met brutal death inside the Saudi Consulate in Istanbul.

Saudi Crown Prince Muhammad bin Salman (MBS), de facto monarch, denies knowledge of Khashoggi’s torture and murder, and Trump claims to believe him. The US president makes that claim because he backed himself into a corner, thinking that support for the Sunni side in the proxy wars would assure that MBS would keep oil prices in check.

Love him or hate him, few can deny that Trump has an uncanny ability to put a finger on the pulse of Middle America. And that sixth sense for the “heartbeat of America” knows that high gasoline prices are what makes or breaks presidents. Yes, Nixon was driven out of office because of Watergate, but when people are standing in line for gasoline, it is hard to find a bedfellow in the average voter. The same goes for Jimmy Carter, walloped in a landslide. Again, gasoline was a pain point.

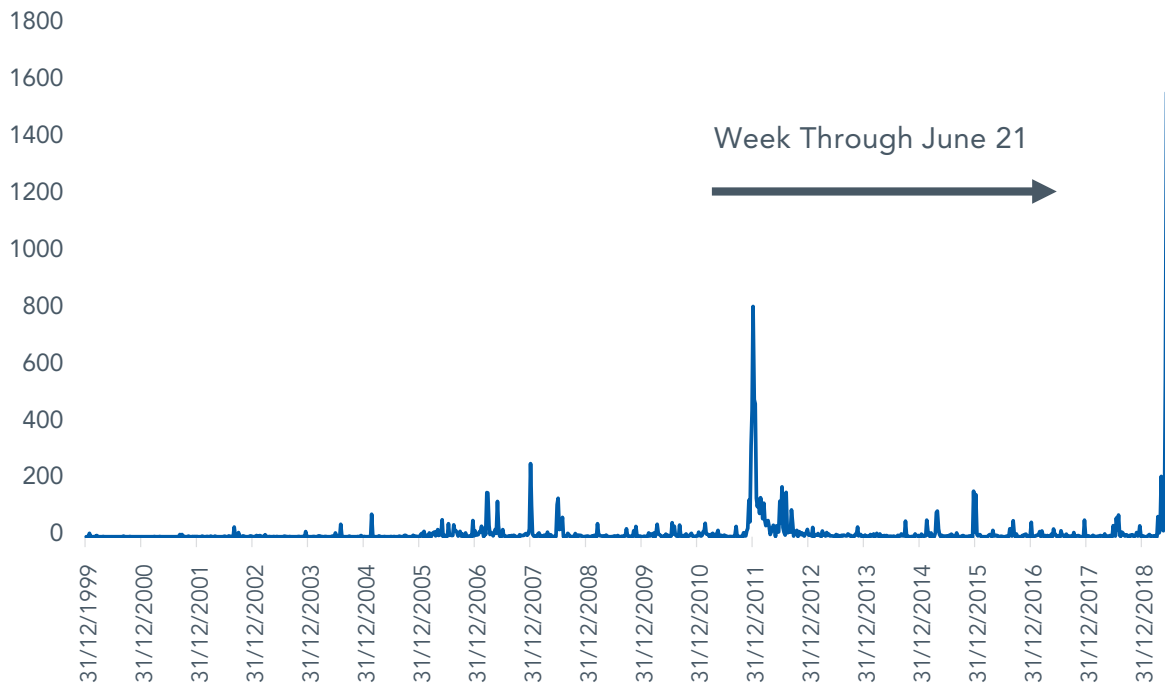
Trump’s wager is that if gasoline gets away from him, he’s finished -- and he’s right. Meanwhile, with the global community in collective disgust at the brutality of Khashoggi’s demise and the US’s stay-the-course reaction, Iranian president Hassan Rouhani is looking at his collapsing economy and wondering what it will take to strongarm the US-Saudi coalition.

But still, the actual volume of news flow from Hormuz had been calm until April. Think about last year, where the news was littered with coverage of the economic malaise in Venezuela, Argentina, and Turkey, because each nation taps international capital in size. But Iran flies under the radar, with little international ownership of Iranian bonds or equity ventures. Yet the pain has been palpable: The IMF calculates Iranian GDP contracted 3.9% in 2018, with hyperinflation to boot.

The catalyst for an acceleration of Iran’s economic woes was when the Trump administration ripped up the nuclear accord agreed during the Obama administration in 2015. Meantime, against the background of late-inning hardline trade negotiations with China, Trump and US Trade Representative Robert Lighthizer ended the waivers it had given half a dozen nations that allowed them to continue purchasing Iranian oil. One of the countries with a waiver was China.

With the oxygen cut off that much more, Iran’s April Strait of Hormuz saber-rattling witnessed the third largest news story count for “Hormuz” this century (Figure 4).

FIGURE 4: STORY COUNT, “HORMUZ”



Source: Bloomberg, 31 December 1999 to 30 May 2019

Let’s assess the spikes in news coverage of the strait.

In the exhibit, we see big news activity for Hormuz in 2006-2008, with the apex of that scare occurring when some small Iranian boats approached the US Navy and threatened to set off explosives. The boats then dropped packages into the water that an observer could reasonably believe were explosives.

But things calmed down, partly because Tehran may have feared the fear of many frontier and emerging market autocracies in 2008 – social unrest from runaway food prices. Again, while many of us in this industry remember 2008 as the year Lehman went under and so many banks were bailed out, it's worth remembering what the fears were in the developing world at the time. For example, food riots erupted in Egypt that year. So bad was the problem – it was the commodities supercycle, after all – that a handful of countries even banned food exports on national security grounds. Meanwhile, rice prices nearly tripled that year, and there was discussion about potential unrest in places like Cambodia and Laos, where affordable rice was a matter of social stability.

Wars happen all too easily in such environments. Tehran backed down on the Hormuz rhetoric and the issue went back into hibernation until the next chapter in the saga, when president Barack Obama laid down sanctions on the regime. On 27 December 2011, Iranian First Vice President Mohammad Reza Rahimi responded:

“If (the Western countries) impose sanctions on Iran’s oil exports, then even one drop of oil cannot flow from the Strait of Hormuz.”

That threat marked the biggest news story word count for “Hormuz” this century. Then, in summer 2012, another closure threat from an Iranian general. Then calm for a few years, and then some ballistic missile tests in late 2015. Then the last spike on the chart, in April 2019.

The news count has subsided from that April peak, which surprises us. In May, Hormuz witnessed actual conflict, with a handful of Saudi Arabian oil tankers attacked. Details are hazy. It may be best, in the interest of regional peace, that we never find out who exactly attacked those ships.

Think about this: Iran-Saudi military fighting has been by design in the form of proxy wars. Both regimes are constantly looking over their shoulders at the potential for overthrow by their own citizens, so the actual theatre of conflict has been primarily in Yemen and Syria.

There are so many groups engaged in conflict in Syria that it gets hard to keep track of it all. Generally, one side has Iran, Russia and Hezbollah, plus any other willing Shia from the region fighting on the side of the Assad regime. Assad is Alawite, and that sect of Islam is particularly shunned by the Wahhabis that control Saudi Arabia. The Saudi-aligned forces include the rest of the Sunni Gulf monarchies and the US

This means a show of force – the targeting of Saudi tankers – raises alarms.

Riyadh, having miscalculated that it had carte blanche to assassinate Khashoggi, is out there right now trying to pitch investment bankers in London and New York to put a value on a Saudi Aramco IPO in some range north of \$1 trillion dollars. Fire and brimstone in the Persian Gulf isn't going to help that cause.

POSITIONING

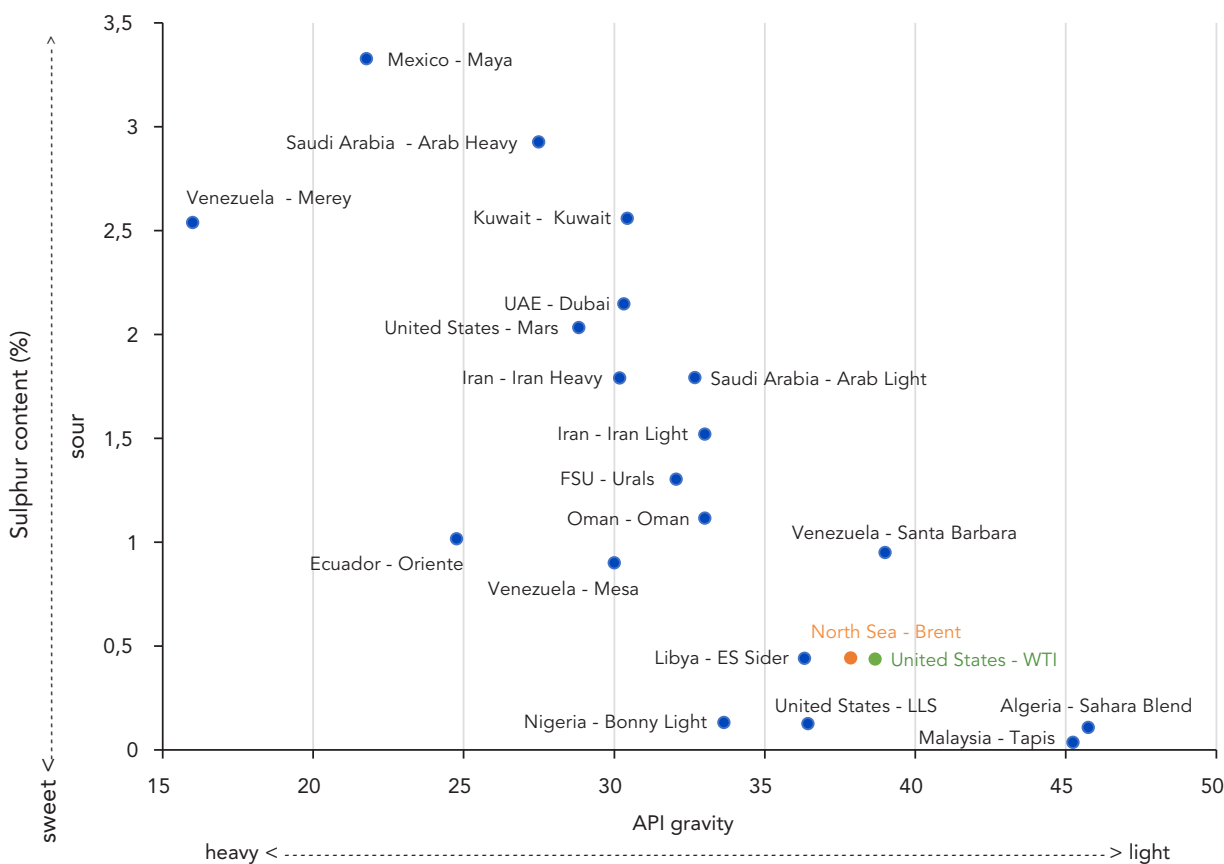
A supply-based bull case for crude oil is of course on our mind, but which varieties are opportune?

We keep coming back to IMO 2020, the UN's maritime fuel cleanliness regulation by the International Maritime Organization that may soon drastically reduce the legally allowed sulphur content of cargo ships' bunker fuel.

This development has the potential to hamper demand for "heavy" crudes, which are typically loaded with sulphur (Figure 5). Sulphur-heavy barrels require more refining, which is expensive, for the liquids to be compliant with IMO 2020. The beneficiaries of an oil spike would seemingly be the southeast corner of the exhibit.

FIGURE 5: LOW SULPHUR, THE BENEFICIARY OF IMO 2020

Oil by density and sulphur content



Source: Energy Information Administration, McKinsey&Company, WisdomTree, data available as of close 14 February 2019

GOLD

We would be remiss if we discussed Hormuz without mentioning gold, as foreboding Hormuz forecasting has always been the purview of goldbugs. We think part of this stems from the creation of gold permabulls during the metal's legendary 1970s run. Having rallied from \$35 to \$850 inside of a decade – a decade that ended with the Iranian revolution, many gold watchers are extrapolating 1979's politics to the present.

But doing so is fraught with difficulty. Firstly, the demise of the Bretton Woods monetary system fundamentally changed the price of gold in this period. Secondly, in 1974 President Ford signed an act of Congress permitting US citizens to own and deal in gold, reversing Executive Order 6102 signed by President Roosevelt in 1933 (when investor gold was confiscated). With the world's largest economy now able to invest in gold, there was a structural change in the metal in the mid-1970s. As investors tried to access the metal for the first time in four decades, its price rose substantially more than we can extrapolate to current times.

Although gold rose in the final week of May 2019, it failed to make significant headway at the time of the initial attacks on Saudi Arabian vessels and operating facilities earlier in the month. Either the Saudi-led emergency security meetings (which were announced in the final week of May) provided gold the upside pressure or the worsening trade outlook did the trick. Though gold made headway in June, the lack of initial conviction may draw doubts on gold's ability to react to this isolated risk. Even more so if we note that Kim Jong Un, North Korea's dictator, fired a couple missiles while this was all going on – and gold yawned. If gold is to rally, it will need an agreeably weak USD, which could be a problem given vulnerability in EUR, which we outline below.

HORMUZ TENSION: BEARISH FOR EUR

The US has no current social movement whose primary grievance is high auto fuel prices. Neither does Switzerland, Australia, Japan, and on.

But France does.

The gilets jaunes, or yellow vest movement, started in 2018 when French president Emmanuel Macron miscalculated the anger of the everyday working class when he placed taxes on diesel. That caused a weekly motorist protest, though the number of demonstrators has fallen since the peak.

Nevertheless, with the French embodiment of the protest vote taking the form of Marine Le Pen's National Assembly Party, the European Parliamentary elections witnessed her cohort take 23% of the vote, ahead of all other parties. Le Pen's supporters are known for hostility to open borders, free movement of people and Islam. Britain's Nigel Farage, founder of the new Brexit party, embarrassed both Labour and the Tories with his group's success in the elections. In Italy, Matteo Salvini, of the League Party that is cut from a similar cloth, is now the most powerful politician. Nationalism, Euroscepticism, rejection of Brussels – these concepts have never been as strong as they are at this moment.

Now picture the series of events that could play out.

Trump needs to strong-arm Kim Jong Un or Hassan Rouhani, or the German auto industry, or whoever. He plays a strong hand with Iran. Iran gives the market another empty quote for the New York Times or maybe something a little bolder, such as action in the form of some speedboats breezing the US Fifth Fleet. Hormuz takes the mantle of top market story.

Meanwhile, the global shipping industry is rotating from high-sulphur bunker fuel to low-sulphur varieties, a demand shock that sends diesel prices higher, aggravating French drivers who thought they got a message to president Emmanuel Macron that they don't want to pay up for fuel.

The yellow vest movement, which the press currently thinks is on the wane, comes back with the snap of a finger, with a vengeance. Though EUR relative to GBP may be a large question mark because of great Brexit unknowns, we are hard pressed to see how EUR can hold up relative to the greenback in the event this is a gilet jaunes summer.

IGNORE RISKS IN THE STRAIT AT YOUR PERIL

Should we see disruption to oil flowing through the Strait of Hormuz - the world's most important oil transit chokepoint - it will likely drive oil prices substantially higher in already-tight conditions. Gold could also rise on the back of higher geopolitical risks, but it is hard isolating the impact on gold from issues in the Strait amid the market's focus on trade and a more dovish Fed. Rising fuel prices could aggravate already fragile politics in Europe, an unappreciated portent that we think could trouble EUR bulls.

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