Current Market News

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Iran sanctions: The other geopolitical flashpoint

What's happened

Each day brings a new series of headlines and editorials related to prospective changes in the global trade landscape. This, of course, is with good reason. As we have discussed before, a significant escalation in protectionism would threaten economic growth and cause companies to rethink future capital investment plans. But tariff threats are not the only geopolitical game in town. We are inching closer to the imposition of renewed U.S. sanctions on Iran, which may also have significant implications for global growth in 2019.

With the resumption of sanctions nearly upon us, Middle East tensions are set to escalate once again. Despite recent comments suggesting he would be willing to meet with Iran, President Trump has generally emphasized a zero tolerance for sanction exceptions, as the they are meant to provide "unprecedented financial pressure" on the regime. This maximum pressure approach is a replay of the 2017 North Korea strategy, which ended in a successful de-escalation with little market impact. It is far from clear, however, that a similar, minimally disruptive outcome can be reached in this case. Why? In addition to the oil price impact of lost Iranian production, Iran has once again threatened to close the Strait of Hormuz in response to efforts aimed at stopping exports.

The Strait of Hormuz links the Persian Gulf to the Indian Ocean, and is one of the world's most important trade routes. As shown in ***Exhibit #1***, over 18 million barrels of crude

Exhibit 1: Oil & Gas traffic, January – June 2018

Number of vessels transiting the Strait of Hormuz	
VLCC	2,601
Suezmax	663
LNG	564
Other Tankers	2,192

Oil & Gas exports from the region	
Crude/Condensate	18.29 million bpd
Fuel Oil	787,700 bpd
CPP	407,000 MT/day
LNG	506,355 m^3/day

Source: Thomson Reuters Oil Research

Strait of Hormuz

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alone have passed through the strait each day in 2018. At the narrowest point, it is just over 20 nautical miles wide with traffic lanes running approximately two nautical miles in each direction. Given the heavy concentration of traffic and narrow passageway, it represents one of the major chokepoints of the global oil industry. It is no wonder that Iran has focused on the strait, as a successful closure would send global oil markets into disarray.

So could Iran really close the waterway? It is possible they may attempt to disable traffic by military means, but this would be a violation of international law and surely met with a swift, aggressive response by the U.S. and other nations. Strait closure would also damage the Iranian economy, which is heavily dependent on shipments through the waters. For these reasons we assign a very low probability to such an event, but do acknowledge that increased rhetoric may have an impact on sentiment. To date, Brent crude prices have been hovering nearly 10% below the highs reached earlier this year, but escalating regional tension coupled with low inventory levels is likely to cause increased volatility over the next several months. Should prices spike to materially higher levels, economic growth prospects will be negatively impacted. While this is not our base case, it is an area we will be watching closely.

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