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GULF TANKER WAR AND OIL SHOCK

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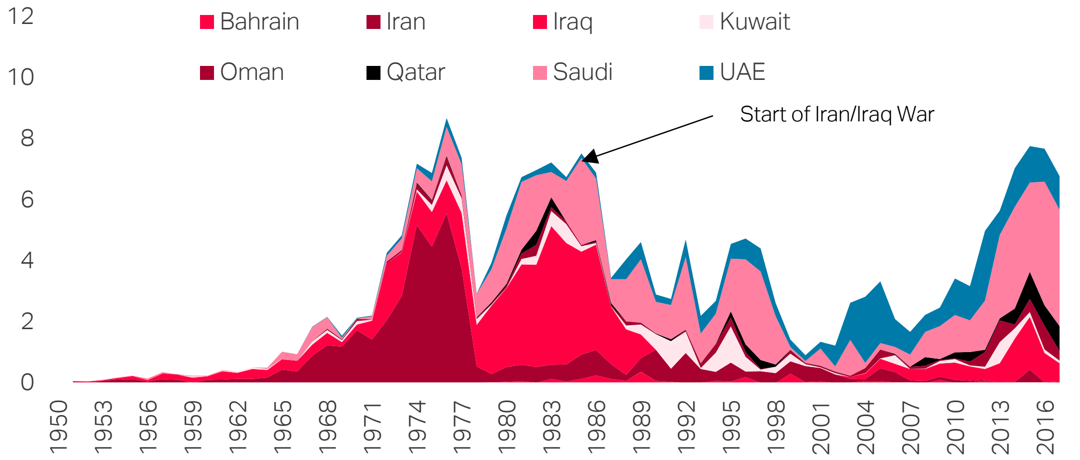
- **The incentives of the belligerents in the new Gulf stand-off ensure continued provocations; and escalation from here would take the form of a much more serious tanker war than its 1980s predecessor.**
- **The effects of this situation will not be limited to fleeting oil price spikes: the threat of such a war will inject a premium into the oil curve.**
- **Even were Iran to balk at escalation in response to any air strikes by the US or its allies, the pattern of deniable provocations would resume.**
- **This spells an upward oil price spiral which, in the event of an all-out tanker war, would spike well above $100/bbl for a few weeks before retreating to still elevated levels, driving up inflation and yields.**

Arms Imports by Gulf States

Thousands of SIPRI total import volume (TIV) units

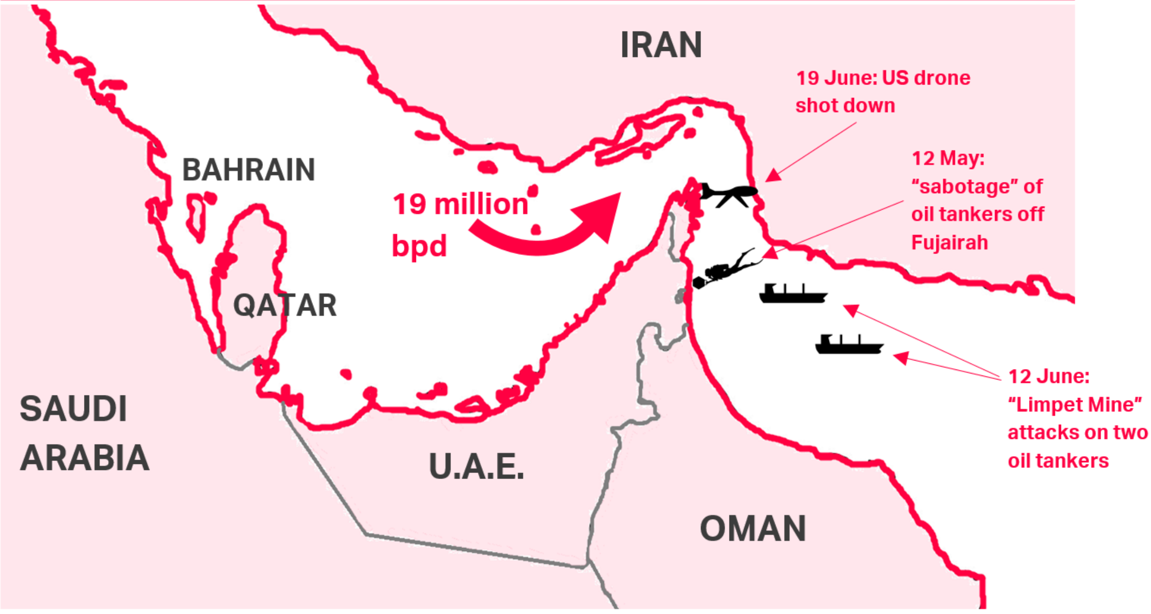


Source: SIPRI

Reasons to fear another tanker war

Each new – and louder – rumour of war between the US and Iran muffles its predecessor. Yesterday's drama – when Donald Trump pulled back from the brink of full-blown armed conflict following the Iranian shoot-down of an American advanced surveillance drone – is a good example. The previous episode on 12 June, now pushed out of the news headlines, is the one that deserves investor attention. That incident, consisting of attacks on two oil tankers off the Iranian coast, followed a "disabling" attack on four tankers anchored off the UAE port of Fujairah that took place exactly a month before (see map below).

Escalation around the Straits of Hormuz



Source: TS Lombard

The makings here of a tanker war are all the clearer, and more ominous, as this has been seen in the Gulf before. Between March 1984 and July 1988, Iran, Iraq and the US fought a maritime conflict that may soon have to be re-labelled as the "*First* Gulf Tanker War". The cause of the conflict was the same back then as it is today: faced with an adversary bent on stopping its oil exports, Iran responds in kind – i.e. by assailing its adversary's oil trade.

This Iranian motive is the key, transcending the (for now unknowable) truth about particular incidents. It is not certain that the recent harbingers of a new tanker war were, in fact, Iranian actions as the Trump administration claims. But even if those attacks on 12 May and 12 June were the work of a third party (such as Saudi Arabia) aiming to foment conflict between the US and Iran, the effectiveness of such a provocation stems precisely from Iran having such a clear motive. Tehran has not sought to disguise this motive. It was set out in unambiguous public remarks last October by Ali Akbar Velayati, a long-serving top official of the Islamic Republic dealing with foreign and security policy, on the subject of the US project of throttling the Iranian economy by sanctioning its oil trade. As Velayati put it: *If Iran cannot export oil through the Persian Gulf, no one will do this. Everyone will export, or no one.*

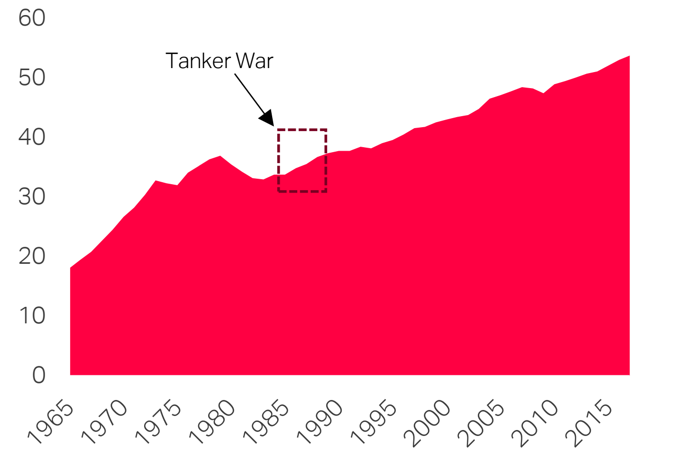
This was exactly the dynamic that played out in the 1980s tanker war. By early 1984, the Iran/Iraq War was going badly for Saddam Hussein. After the Battle of Faw, Iraq had been left landlocked, forced to beg its Arab neighbours for use of their oil export terminal facilities. In an attempt to expand the war and encourage US intervention on his side, Hussein launched an air attack on Iran's major oil terminal on Kharg Island – the idea being that Iran would be provoked into closing the straits of Hormuz. Iraqi planes, armed with Exocet missiles, attacked Kharg in several waves, hitting two tankers in dock and starting huge fires across the facility. Iran did not take the bait. It left Hormuz open to shipping, and instead launched a campaign of attacks on ships carrying Iraqi oil, regardless of what flag they flew. Iraq responded in turn against Iranian shipping, and the tanker war began.

Over four years, this struggle would eventually damage or destroy more than 450 ships. The conflict eventually drew in the US, though not perhaps in the way that Saddam had hoped. President Reagan decided to secure the shipping of the Arab states (other than Iraq) using naval convoys and by attacking Revolutionary Guards' bases on Iranian oil platforms. Interestingly, more shipping was destroyed during the year of US protection, 1987, than during any other year – 179 ships were attacked, around 5-7% of all shipping in the Gulf. That track record does not bode well for the US ability to protect shipping today – especially given Iran's much enhanced military capabilities, on which more below.

The last tanker war proved irrelevant to the oil market

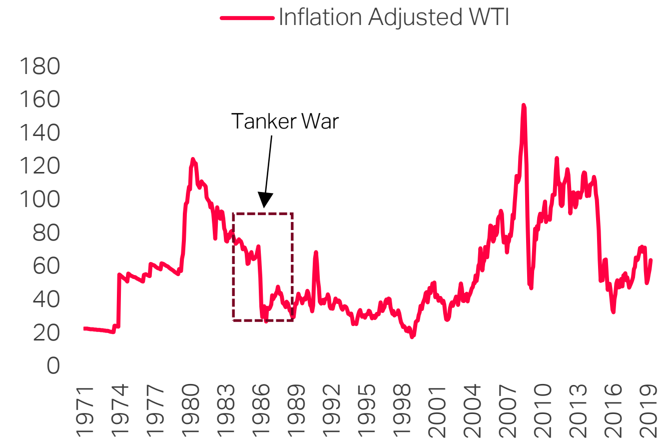
Oil markets barely responded. In fact oil prices nearly halved over the duration of the tanker war, with not even a fleeting supply concern being registered. In what was then a happy coincidence for the world economy, the 'tanker' phase of the Iran-Iraq War coincided with the slump in global oil demand after the second oil shock – reinforced in 1986 by Saudi Arabia's decision to discipline its OPEC partners which had been cheating on their output quotas by ramping up its own crude production. The economic effect of the 1980s tanker war was therefore limited to driving up the cost of shipping, who at the time required 100% bonuses to sail through Hormuz.

Chart 1: Global crude oil consumption
Thousands of terawatt hours



Source: Our World in Data

Chart 2: Inflation adjusted oil price/bbl
WTI in 2018 dollars



Source: FRED

A new tanker war would be far more serious

We see five reasons for supposing that the outbreak of a similarly serious tanker now would pose much more serious risks for the world economy:

1. **Today's Gulf is a different place.** In 1984, 7.4 million barrels per day (mbpd) were exported from the straits of Hormuz, which was 12% of the world oil demand at that time: today's number is 19mbpd, over a fifth of global crude oil output.
2. **Iran is now up against not just a single country as in the 1980s, but most of the GCC.** The 1984-88 conflict was fought between Iran, then producing 2.2mbpd, and Iraq, producing 1.0 million bpd. Today's conflict would be fought between Iran, now producing 2.5 million bpd and Saudi Arabia, Bahrain and the UAE, together producing 13 million bpd. A lot more oil is directly involved.
3. **The sophistication of the weaponry involved is vastly greater.** Not only are the potential belligerents in this conflict much larger oil producers than during the 1980s, but they are also much better armed. In the 1980s Iran and Iraq were operating well-funded, but run-down armies suffering from four years of wartime attrition. The tanker war was for them a sideshow, something on which not too many resources could be expended. This time both sides would be entering the conflict fresh and fully focussed, with arsenals built up for decades. To compare the effectiveness of weaponry between now and then, back in the 1980s, Iran was often reduced to machine-gunning the crew quarters of tankers, lacking any other means of attack. Today Iran has very large stocks of cruise missiles. While the weapons used would be much more powerful, a tanker remains as easy to sink now as it was then.
4. **The US would not be a bystander this time, but a belligerent from the very start.** During the long Gulf War, which from a Middle Eastern perspective lasted from 1981 to 1991, America consistently played a role of being pro-GCC and anti-Iran. However it played this role reluctantly and only in favour of the status quo: the US attempted no regime change in Iran or Iraq, no change of regional power balance and no territorial change. This time, senior US government officials, namely National Security Adviser John Bolton and his allies, seem to be actively beating the drum for war. Their goal is to shift regional power dynamics by reducing Iran to regional minor-power status.
5. **Iran has little to lose.** Throughout the Iran/Iraq War, Iran continued to be a major oil exporter, indeed prosecution of the war would have been impossible without the US$17 million a day that the government was receiving from exports out of Kharg Island. With every step towards escalation that the Iranian government took, it always had one eye on its own shipping. It did not want the Persian Gulf to be closed for business, only hazardous for Iraqi oil. Today, thanks to Trump's policy of isolation, Iran has very little shipping to be threatened, it would not have that much to lose by closing Hormuz.

Conflict incentives and precursors

These much higher risks from a present-day tanker war call for a thorough assessment of the likelihood of such a conflict. This assessment must begin by looking at the potential belligerents' incentives – which are too numerous and powerful for comfort.

Today, everyone has a lot less to lose. Conflict has not happened in the Gulf since 2003 because for the most of that period regional leaders, and those in the US, have seen much to lose and little to gain. In the past two years, this balance has been reversed. Thanks to shale technology, the US has now come close to achieving energy independence, and this would cushion the economic blow of an oil price shock stemming from supply disruption in the Gulf.

That was absolutely not the case in the 1980s. The UAE, traditionally a pacific regional power, also has less to lose today: its non-oil trade with Iran, which made up 35% of non-oil goods exports as recently as 2007, has shrunk by more than half in recent years (see Chart 3 below) and now represents less than 20% of trade. As for Iran, its interest in free and open shipping in the Persian Gulf has been ended by Trump's sanctions.

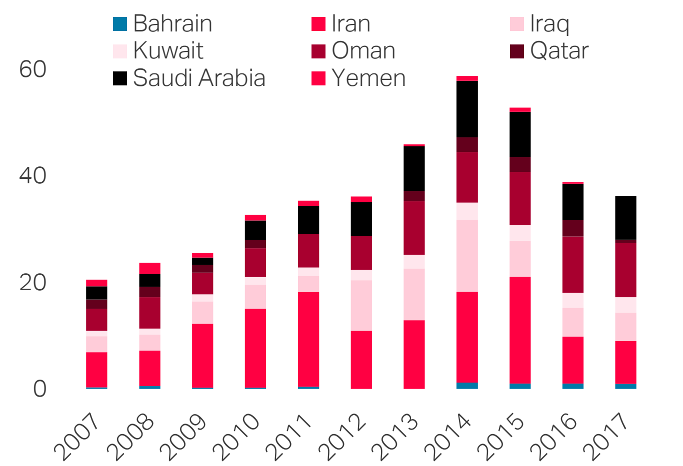
Alongside a loss of historic barriers to conflict, there are also so strong push factors. From the perspective of Iran hawks in Washington, the current period of energy independence in the US and bellicose leadership in the GCC represents a once-in-a-generation chance to confront Iran militarily and change the balance of power in the region, removing what they see as the principal threat to US interests and allies.

From the Iranian perspective, the Trump administration is completely irrational and impossible to negotiate with. Trump's withdrawal from the nuclear accord, and re-imposition of "maximum pressure" to comply with demands amounting to a capitulation ultimatum, gives Iranian leaders no incentive to seek an accommodation. They may calculate instead that a brief conflict may at least bring America back to the negotiating table, and could even bring in powerful mediators who could extract Iran from its current predicament.

Finally, from the perspective of the rulers of the GCC, Muhammad bin Salman in Saudi Arabia and Muhammad bin Zaid in the UAE, Iran is an ever expanding threat better checked sooner rather than later. Furthermore, a war with Iran would not only be an opportunity to test immensely expensive armies (see chart 4 below) but also to assert greater control over these armies, pushing out many of the older generation of officers who represent the principal threat to the power of these young rulers. A war would also help to bind together the new "nationalist compact" that these rulers hope will keep the monarchist system together, in an age when the old "welfare compact" is under increasing pressure from sustained low oil prices and, for reasons we set out in a note published earlier this week, GCC economies are caught in a self-inflicted growth stop.

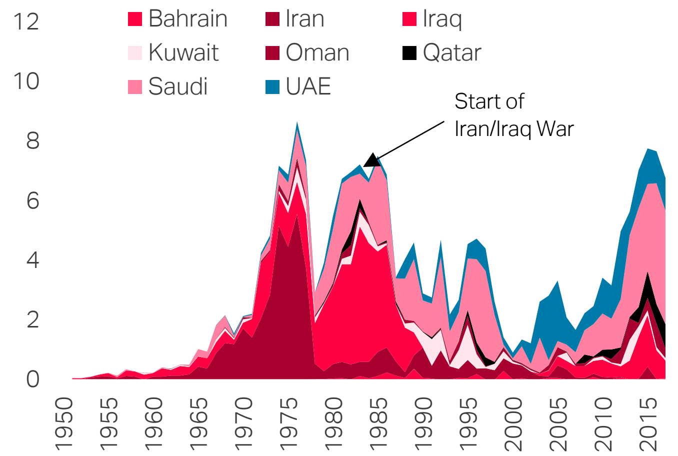
Perhaps the most critical ingredient is the parties' respective leadership flaws. Both the Iranian and the US/Saudi Arabia/UAE sides are poorly led. In Iran, Trump's sanctions policy has undermined the reformist government to the point that they no longer enjoy much sway over the

Chart 3: UAE intra-regional goods exports (US$ billion)



Source: OEC, Comtrade, TS Lombard

Chart 4: Arms imports by Gulf states (000s SIPRI TIV import volume units)



Source: SIPRI

military and foreign intelligence services of the Islamic Republic. The Ayatollah meanwhile is old, and seems to delegate much authority to General Qassem Soleimani, who himself lacks complete control over the military organs of the state. If the recent tanker attacks were indeed carried out by Iran, it is not clear who would have ordered them, and by what authority.

Meanwhile, the Trump administration is allied to, but not in control of, the Emiratis and Saudis, who often seem to be able to ask for forgiveness rather than permission. In relation to its Gulf allies, the US has laid itself open to the familiar 'tail-wags-dog' problem of big power proxies. Even inside the administration, there is no clear division of responsibility towards the region. Although in the lead on wider MENA policy, including Israel-Palestine, Jared Kushner is distracted by other, more domestic concerns. John Bolton meanwhile seems unable to convince the president to use military force against Iran – but will presumably continue trying.

Some risk mitigation stems from other international actors resisting the march to war. The main factor here is China, which is easily the largest consumer of oil shipped through Hormuz. The EU likewise favours peace with Iran. President Trump himself has clearly demonstrated that he has no appetite for new wars.

China is a particularly interesting actor. It accounts for almost all of the oil export growth through Hormuz since the last tanker war, and Saudi Arabia is its largest single largest foreign source of energy. China sees the GCC as an important arena for offshore RMB development as well as for the roll-out of its "One Belt, One Road" initiative. China is also one of Iran's principal protectors in the Security Council and a key international ally of Tehran. For China, Iran is a good place to resist US hegemony and a useful regional friend. That said, China has notably failed to provide Iran with any effective support or relief through its current economic crisis, and this will limit Beijing's diplomatic sway over Tehran.

Escalation mechanism

The prospect of continued escalation is all the stronger as both sides so clearly aim to provoke each other. The prospective belligerents' shared idea is to balance on the cusp of war. This entails provocations designed to achieve one of two things:

- Convince the opponent that escalation is too risky: for the US-led side, this would mean a loss of prestige and jeopardizing strategic aims, while Iranian passivity would entail accepting economic strangulation.
- Lure the opponent over the edge in a way that legitimizes the successful provocateur's role in the ensuing blow-up as clearly justified self-defence.

The US version of this technique starts with the blunderbuss of "maximum pressure", goading Iran into rash action. For the purpose of this analysis, it matters little whether the recent tanker attacks were 'false flag' provocations carried out by the US-led camp or Iranian actions, it is perfectly possible that the incidents of 12 May and 12 June had different perpetrators. US-released pictures of Iranians removing a limpet mine are not the same as pictures of Iranians installing a limpet mine and eye-witness accounts of the 12 June attacks make clear that the method was flying projectiles rather than mines. As discussed above, however, there is a clear motive on the Iranian side. Tehran has made no move to release radar data, invite investigators or present contrary evidence.

The likelihood is that the IRGC acted on its own account, for its own reasons, without central government permission. Given the continued weakness of the central government, we should expect further attacks. For his part, Trump, who displayed some enthusiasm when launching a missile strike against Syria in April 2018, may need only some casualties to persuade him to turn his missiles on Iran. An air strike on Iran would probably suit all sides, helping the Iranian government and Trump to appear strong at home, and helping Saudi Arabia and the UAE to further draw the US into a conflict with their arch-rival. Any such air strike, even if presented by the US and/or its regional allies as a limited retaliation, would tip this situation from the 'cusp' of conflict into actual conflict.

Oil price conclusion

For the purpose of gauging investment risks via the oil price channel of the present stand-off between Iran and the US (plus regional allies), we see three levels of risk.

Level One: Cusp

The situation in the Gulf is almost certain to remain in a high-tension pattern of provocative feints and sallies. Each successive incident will trigger short-lived oil price spikes, as seen during the past week. This effect may wilt as markets become inured to repetitive news flow. On the other hand, this pattern will encourage hedging by buyers to lock in forward prices, producing sustained support for the average oil price. At the very least, this would inject a premium into the oil curve and keep the front end in pronounced backwardation (especially for Brent).

Level Two: Open fire

As and when the US and/or its allies launch air strikes on Iran, Tehran will face a fraught choice. The cautious option would be to refrain from retaliatory escalation. This would not mean passivity – but rather continuing with the 'conflict cusp' tactics of deniable provocations. The oil price effect would remain broadly similar to the Level One situation, at least insofar as spot price volatility would remain fleeting. Yet the underlying momentum for a rising price on the back of precautionary stockpiling would strengthen – perhaps to the extent of complicating the monetary policy easing path on which the world's leading central banks are embarked.

Level Three: Tanker war

Alternatively, and most likely depending on the circumstances and intensity of the US attack, Iran could choose to escalate. For the reasons that will be clear from the analysis in this note, we have little doubt about the form which that escalation will take – that is, a new tanker war. This would require consensus in the Iranian political establishment that war had become the only remaining option to reshuffle the geopolitical deck in the country's favour. In contrast to limited, deniable, attacks by ambitious junior actors, full-scale tanker war would entail the use of missiles, torpedoes and mines – a 'whole-of-government' undertaking.

A tanker war would probably push the oil price above US$100/bbl for several weeks – but not for many months, let alone years. The shock would have a limited timescale either because both sides would seek to a prompt end to the pain, or because the US would quickly destroy much of Iran's maritime capability. In any case, it would not be a four year affair as happened during the 1980s, but rather a fiercer, briefer, conflagration. However, the price spike would be very dramatic – more akin to what happened during the Gulf war in 1990 than the slack response to the Iran/Iraq war. Depending on the extent of war damage, the oil price – even post-spike – could still prove persistently high, driving up global inflation expectations and bond yields. From a global macro standpoint, this could be a game changer.

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