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An update on U.S. – Iran tensions

A rise in tensions between the U.S. and Iran have made headlines worldwide over the past few weeks. Below are details on the geopolitical environment and potential economic implications of these events.

Backdrop

- The relationship between the U.S. and Iran has been a source of geopolitical risk for decades, given Iran's substantial share of the world's oil supply, the country's nuclear ambitions and its ability to pinch the Strait of Hormuz – the main pathway through which oil leaves the Middle East and travels to importing nations.
- This risk has increased over the past year after the U.S. re-imposed sanctions on Iran. Indeed, we continue to identify the U.S.-Iran relationship as the most important near-term geopolitical risk for the world.
- Following an autumn in which Iran sniped at U.S. assets and allies, including Saudi oil infrastructure, a recent attack on the U.S. embassy in Baghdad led to a further deterioration of relations between the two nations, with the U.S. opting to hit back by killing a prominent Iranian military figure, General Soleimani.
- On Wednesday morning, Iran retaliated with missiles that struck Iraqi air bases housing factions of the U.S. military. While there are no reported casualties and damage appears minimal, tensions between the two nations are clearly quite high.
- While the risk of a significant further confrontation is material, both countries have indicated that they do not want these tensions to escalate further. Iran clearly indicated that it viewed its missile attack as a proportionate retaliation to the U.S. actions, suggesting no further near-term provocations. Meanwhile, the U.S. has stated that additional economic sanctions will be applied, but it has notably not opted to strike back at this point in time.
- Our base-case remains that the situation does not deteriorate too drastically from this point.
- From the U.S. perspective, Trump is fundamentally an isolationist, Iran would be a formidable opponent, high oil prices would hurt American consumers, and war-fatigued American voters probably wouldn't reward a bellicose president to the extent they have in the past.
- For its part, Iranian leadership would ultimately lose a war and possibly their control over the country.
- Thus, the stalemate will likely persist, and the risk of U.S. retaliation to the latest missiles is arguably declining as time passes. Both Iran and the U.S. have stated their desire to avoid future escalation.

Market reaction

- Markets initially reacted negatively to both the news of Soleimani's killing and the Iranian retaliation, with the most notable reaction to escalating tensions reflected in the price of oil. Brent crude prices jumped about $5 or 7% in the immediate aftermath, though they have since settled slightly. The risk premium now embedded in the price of oil is considerable, such that an absence of actual actions impeding the flow of oil should theoretically lead to a slight retreat in oil prices.
- From an economic perspective, higher oil prices are usually negative for global growth. As consumers face higher prices at the pump, they're required to cut back in other areas. However, the relationship is murky. It takes a sustained increase in prices before we'll see any great impact on consumer spending. Furthermore, as oil production has ramped up in the all-important U.S. market, it is no longer clear that the U.S. economy suffers a net hit from higher oil prices. The Canadian economy, for its part, usually does slightly better in a higher oil price environment.
- What's more, the spike in oil prices following geopolitical events is typically short-lived, mitigating its economic effects. For instance, in September, oil prices spiked nearly 15% following a drone attack on key components of Saudi Arabia's oil infrastructure. Prices returned to pre-attack levels in less than two weeks.

- More generally, geopolitical events rarely have a lasting effect on markets. Indeed, U.S. equity markets have largely brushed off these events, and investors remain focused on the positive aspects of firming global growth, decreasing trade tensions, and continued support from central banks.
- The U.S. dollar was noticeably absent from a rally in safe haven currencies following the U.S. actions, which signaled that markets were swayed more by positive economic data than the escalating tensions. For their part, currency markets have shown the same resilience as equities in light of the recent events.

Key takeaways

With tensions in the Middle East elevated, headlines may continue to draw attention to these risks. This in turn, may stir up concerns about the impact these events could have on investment portfolios. While the market impact outside of oil prices has so far been muted and our base-case scenario is that large-scale conflict is avoided, it is not impossible that the situation could escalate further, spilling over onto a broader range of risk assets. During these periods of time, it is important to remember that short-term fluctuations, particularly those related to geopolitical events, are likely to have little impact on your long-term investment objectives – or the strategy designed to get you there. As always, avoiding knee-jerk reactions and maintaining a well-structured plan is the key to long-term investment success.

Publication date: January 8, 2020