RBC Capital Markets

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Middle East: Contagion

Commodity Strategy

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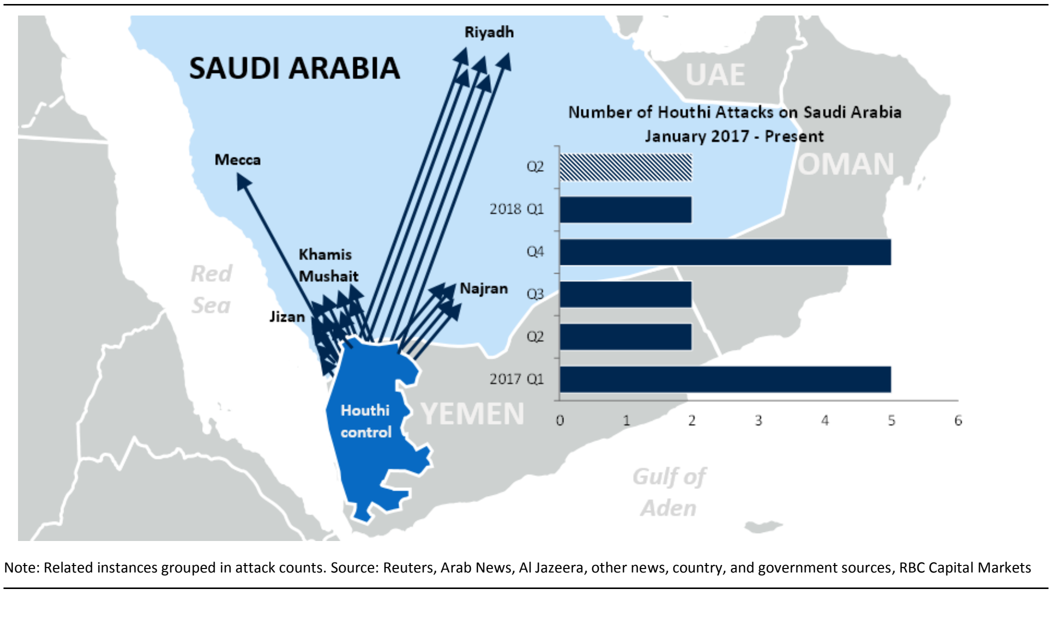
With the White House vowing an imminent response to the latest chemical weapons attack in Syria, a critical concern is whether the war spreads beyond the country's geographic boundaries and ignites a wider regional conflagration, adding a possible 'fear premium' to oil. At the same time, the other proxy war raging in Yemen presents a clear risk to regional energy supplies given the brazen Houthi attacks on Saudi targets. Moreover, in our view the intensification of these proxy fights further dims any hope of the White House remaining in the Iranian nuclear deal when the sanctions waivers once again come up for renewal.

Shock and Awe?

With the White House vowing an imminent response to the latest chemical weapons attack in Syria, a key question is whether the planned US military action will exceed last year's limited missile strikes and bring the US into a direct confrontation with the Russian and Iranian forces that are backing the Assad regime. The potential US action comes against a backdrop of stepped up Israeli airstrikes in Syria aimed at degrading Iranian and Hezbollah military capabilities in the country. While Syria does not pose an immediate threat to oil output, a critical concern is whether the war spreads beyond the country's geographic boundaries and ignites a wider regional conflagration. While such a scenario could send the oil 'fear premium' soaring, it is the other raging proxy war, Yemen, which represents a clear and present danger to actual regional energy supplies. The Iranian backed Houthi rebels have recently escalated their attacks on Saudi targets, launching a drone strike on an Aramco facility, firing multiple ballistic missiles at Riyadh today, and hitting a Saudi oil tanker in the Red Sea last week. At a minimum, both of these proxy conflicts likely doom any hope of the White House remaining in the Iranian nuclear deal next month. The critics of the JCPOA have long argued that the nuclear deal was too narrowly defined and did nothing to address Iran's nefarious regional activities. With John Bolton and Mike Pompeo occupying the top foreign policy jobs, the Trump administration looks set to adopt a more assertive anti-Iranian strategy and the nuclear deal will likely be an early casualty of this more hawkish policy shift. The bigger unknown is the White House's appetite for more extended engagement in the region to alter the facts on the ground.

Figure 1: Map of Saudi Arabia and Yemen with Houthi Attacks



Note: Related instances grouped in attack counts. Source: Reuters, Arab News, Al Jazeera, other news, country, and government sources, RBC Capital Markets

All values in USD unless otherwise noted.

Priced as of prior trading day's market close, ET (unless otherwise stated).

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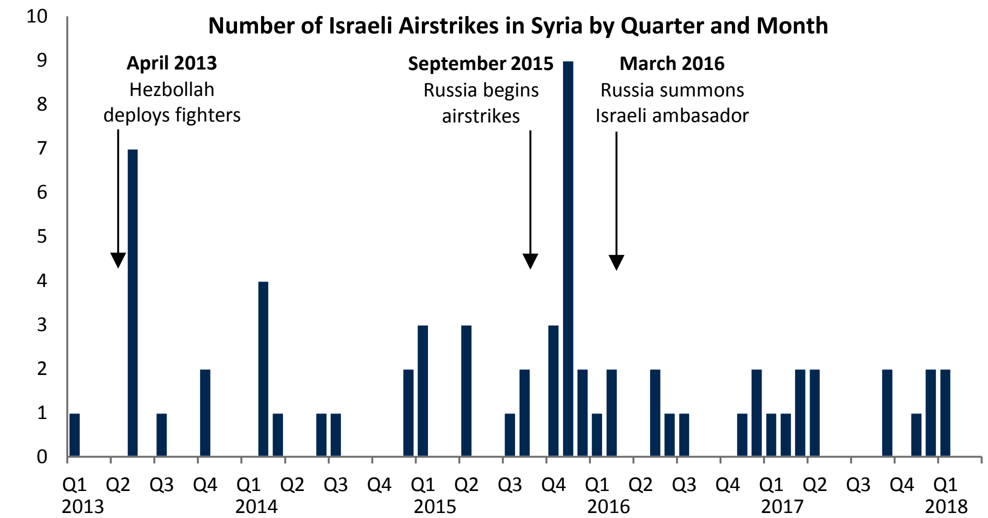
Figure 2: Airstrikes in Syria



Source: International Crisis Group, RBC Capital Markets

Thin Red Line

The White House has signaled an imminent response to the chemical attack in Syria.

Just one week ago, President Trump pledged to withdraw the remaining 2,000 US troops from Syria. However, another chemical weapons attack is set to scuttle those exit plans and at least temporarily draw the US more deeply into the eight-year conflict that has left nearly 500,000 people dead and 12 million displaced from their homes. At the time of writing, President Trump had brushed off Russian threats to shoot down US missiles fired at Syria and warned Moscow to get ready for “nice, new and smart” ordinances. In addition, Syrian forces had reportedly started moving heavy equipment from major airports and military bases in anticipation of US action.

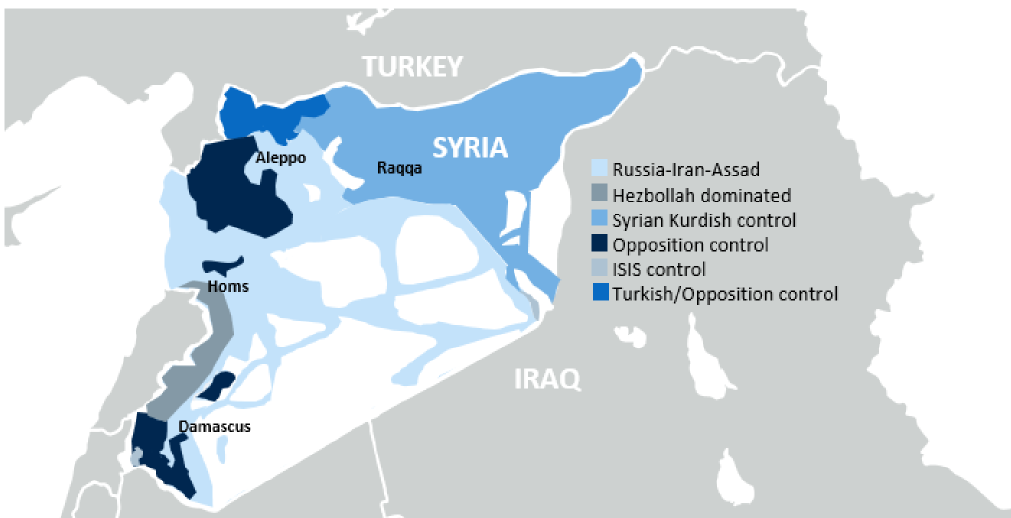
A year ago, the US launched a limited strike…

One year ago, US destroyers launched 59 Tomahawk missiles at Syria’s Shayrat Airbase that was used for the sarin nerve agent attack on the town of Khan Shaykhun. While there was a pause in poison gas attacks for a limited period, the US response did little to degrade Assad’s military advantage. Saturday’s chemical attack on Douma, the largest town in the Damascus suburb of Eastern Ghouta, which claimed at least 49 lives, capped a brutal six-week campaign by the government to vanquish the last rebel held stronghold near the capital. The Syrian army released a statement hailing the fall of Eastern Ghouta as restoring security to Damascus and to the roads connecting the capital to the central, northern and eastern parts of the country. The government now controls all of Syria’s urban centers and over 60% of the country’s territory. This marks a major reversal from when Assad was clearly on the defensive. It was the Russian military intervention in July 2015 that fundamentally altered the dynamics of the war and decisively turned the tide in Assad’s favor. Russia’s entry coincided with a ramp up in assistance from Iran and Hezbollah and the commitment of significant military assets from their side to help shore up the regime. Hence, a larger military response from the US runs the risk of putting the US in direct confrontation with an array of Russian, Iranian and Hezbollah forces that are allied with Assad. Even if the US once again opts for a very limited response on the site directly linked to the latest chemical attack, there remains the real risk of an unintended escalation through miscalculation.

… but this time, the participants and level of response could differ.

This time around, the US may not be acting alone. French President Macron has previously indicated that chemical weapons use represents a red line for his government and one that would warrant a military response. Similarly, Saudi Crown Prince Mohammad bin Salman, who is in France this week, also signaled that he would be willing to join an international coalition to confront Assad. At a joint press conference with Macron, he stated, "If an alliance with our international partners requires it, we will be present." Meanwhile, the Israelis have already been escalating their airstrikes on Syria since the start of the year. The ever-expanding Hezbollah and Iranian military presence in Syria is seen as posing an increasingly serious threat to Israeli security interests. On Sunday an Iranian colonel, who served as a senior officer in Iran's drone program, was amongst the 14 killed in a reported Israeli F-15 airstrike on the T4 military base near Homs. The T4 airbase is one of the key sites where the Iranian revolutionary Guards Quds force is deployed in Syria. That same base was targeted by the Israel in February after an Iranian drone reportedly entered its airspace and Syrian air defenses shot down one of the Israeli F-16 fighters involved in that operation. Israeli news outlets are reporting that the country's northern border is currently on high alert amid concerns of a revenge attack by Iran or Hezbollah following Sunday's airstrikes (*Haaretz*, April 20, 2018).

Figure 3: Syria Control Map



Note: As of April 2, 2018. Source: Institute for the Study of War, RBC Capital Markets

A War on Two Fronts

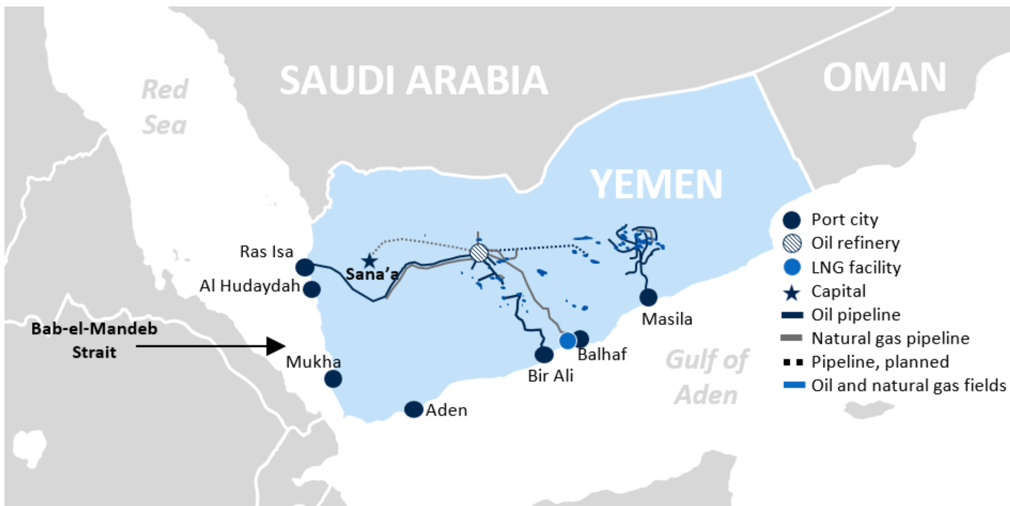
Meanwhile, Yemen represents an increasingly dangerous conflict in the region…

While Syria will likely dominate the headlines over the coming days because of the likely imminent American action, we continue to contend that Yemen is the most dangerous conflict for oil and the potential tripwire for a head on battle between Saudi Arabia and Iran. Iranian-backed Houthi rebels have recently stepped up their attacks on Saudi sites, firing multiple ballistic missiles at Riyadh and the Saudi Aramco facility at Jizan today. Saudi air defenses reportedly intercepted all the incoming missiles. Last week, the Houthis targeted a Saudi oil tanker reportedly carrying around 2 million barrels of crude. While the tanker only sustained minor damage, it marked the first direct attack by the Houthi forces on a vessel in international waters near the critical chokepoint between the Arabian Peninsula and the Horn of Africa. Around 5 mb/d of crude and refined products pass through the Bab-el-Mandeb Strait on route to Europe, the US and elsewhere. The prior week, the Houthis marked the third anniversary of the Saudi intervention into the Yemen conflict by launching seven ballistic missiles at Riyadh and elsewhere, with falling debris killing one civilian in the Saudi capital. The Saudi leadership wasted little time blaming the Iranians for the attack, with the Foreign Minister warning that "The Kingdom has the right to respond to this hostile Iranian act in an appropriate way at the right time and place." The Houthis, for their part, have vowed to continue firing missiles into Saudi Arabia until Riyadh halts its bombing raids in Yemen. Thus far, the Saudi response to these provocations has been relatively restrained,

… and places barrels at risk.

but with MBS soon heading home from his extended foreign tour, the gloves may be set to come off and we believe the market should brace for further escalation. Moreover, with John Bolton and Mike Pompeo now directing US foreign policy, Washington may also take a much tougher stance on Iranian support for the Houthis and could at a minimum step up efforts to interdict weapons shipments. The US may also end up having to help ensure the security of navigational routes. Last week's maritime attack raises the ominous specter of a potential return to a tanker war scenario. During the Iran-Iraq War (1980 to 1988), hundreds of international vessels and oil installations were targeted by the warring sides in an effort to deprive their rivals of trade revenue and ultimately the US Navy was forced to intervene to protect Kuwaiti ships in what was at the time the largest US naval convoy operation since WWII.

Figure 4: Yemen Map with Infrastructure



Source: EIA, RBC Capital Markets

Final Blow to the JCPOA?

Both of these conflicts have read-throughs for the Iranian nuclear deal…

Finally, with the US poised to intervene in Syria and the Yemen conflict intensifying, it is very difficult to see President Trump extending sanctions waivers next month and remaining in the Iranian nuclear deal. Both Bolton and Pompeo are ardent critics of the JCPOA and insist that it has done nothing to reign in Iran's regional aggression. Bolton for his part has publicly called for regime change in Iran on multiple occasions. The incoming Secretary of State and new National Security Advisor are by no means minority voices in the administration. The US' UN Ambassador Nikki Haley stated "it is hard to find a terrorist group in the Middle East that does not have Iran's fingerprints all over it" and asserted that "the nuclear deal has done nothing to moderate the regime's conduct in other areas." While it is unlikely that Trump will be able to reconstruct the international coalition of the willing that came together to sanction Iran in 2012, we think that a snapback of the US sanctions would curb the enthusiasm of European and some Asian corporates to follow through with plans to invest in the Iranian upstream sector. Moreover, it could force foreign refineries to source less crude from Iran, especially if the threat of being locked out of US capital markets were revived. We contend that it is now credible that Iranian exports could be curtailed by 200 – 300 kb/d by Q4 2018 in the likely event that Trump exits the nuclear agreement next month.

We further contend that for Iran, energy is not the only key sector that would be impacted by a sanctions snapback. From the Iranian standpoint, one of the most important benefits of the JCPOA sanctions relief was the ability to purchase spare parts and new planes for its

… which we think is on life support.

aging airline fleet; 1700 passengers and crew of Iranian aircraft have been killed in air accidents since 1995. In February 2016, Iran Air – which had been delisted from US sanctions on implementation day – announced that it would purchase 118 Airbus commercial aircraft with an estimated value of $27bln. In December 2016, Boeing and Iran finalized the sale of aircraft to Iran, with a total estimated value of $17bln. Given Iran's documented role in supplying both Assad, Hezbollah and the Houthis with advanced weaponry, it is increasingly likely that Iran Air will once again be designated a SDN and a "blocked person" by Treasury's Office of Foreign Asset Control (OFAC). As aircraft companies required an OFAC license for their sales to Iran Air, such a designation could upend plans to sell additional aircraft with substantial US-origin content. Senior Iranian officials have said that any effort to block the aircraft sale would constitute a material violation of the JCPOA and represent clear grounds for an Iranian exit. Altogether, with multiple participants articulating exit strategies, the JCPOA stands in mortal peril, in our view.

Conclusion

With Syria tensions escalating, the critical concern is that the conflict could ignite a regional conflagration. Meanwhile, the proxy war raging in Yemen presents a clear risk to regional energy supplies given attempted attacks on Saudi targets. Both situations present clear risks and may add a 'fear premium' or even put physical barrels at risk in the case of Yemen. At a minimum, with the US poised to intervene in Syria and Yemen intensifying, it is difficult to see President Trump extending sanctions waivers leaving the JCPOA on life support.

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Figure 5: OPEC Watch List

	Oil production (mb/d)		Geopolitical risk		
Country	2017 avg	Last month	Past year	This year	Comment
Saudi Arabia	9.97	9.87	6	7	Hawkish foreign policy raises confrontation risks
Iraq	4.44	4.43	9	9	Upcoming elections represent a potential destabilizing factor
Iran	3.79	3.81	6	7	The lightning rod for regional grievances
UAE	2.91	2.86	2	3	Best in class in OPEC but high military expenditures
Kuwait	2.71	2.70	3	3	Financially flush but the population does not want austerity
Venezuela	1.94	1.51	10	10	With few economic options left, oil production is at risk and falling
Nigeria	1.71	1.85	10	9	Does face a number of challenges including political ones
Angola	1.66	1.57	6	6	Angola is facing strong economic headwinds amid a transition
Algeria	1.04	1.00	8	7	While Algeria's risk rating is lower y/y, it remains elevated
Libya	0.83	0.99	9	9	Being the IS fallback option could push it back up on our watch list
Qatar	0.61	0.61	2	7	Faces a current crisis and a longer term LNG challenge
Ecuador	0.53	0.52	5	5	Amid a political transition but middle of our risk spectrum
Gabon	0.20	0.19	6	6	Low production but rising political risk over the course of the year
Scale:			*High -> Low*	*High -> Low*	

Source: Bloomberg (production date), RBC Capital Markets

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