Sanctions will not kill Iranian oil exports but will keep geopolitical premium high

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Oil prices have risen to a to a 3½ -year high on the back of the US announcing the re-introduction of sanctions against Iran. Global oil markets have already become tight as a result of outages from Venezuela and strong compliance from the Organization of Petroleum Export Countries (OPEC) with their accord to curb production. Although sanctions are unlikely to change the global supply-demand balance immediately, the geopolitical premium in oil is unlikely to fade away.

The question is: will oil markets become tighter as a result of new sanctions applied by the US?

Right now, the US does not import any Iranian oil. The US had prohibited US citizens, residents, companies from engaging in any business involving Iran or any Iranian national since 1996 (and many sanctions had been in place since 1979). So, for sanctions to have any effect on reducing global oil supply further, they must be applied in an extraterritorial manner; in other words, rules designed by the US must be able to credibly stop non-US entities from also engaging in business with Iran.

Up until January 2016, such extraterritorial rules were in place. The US used to prohibit foreign companies from doing business in the US if they also did business in Iran. In fact, transactions using the US Dollar were generally prohibited, limiting practicality of integrating Iranian oil supply into the global market at the time.

For the sanctions to hold at the time, it was of crucial importance that other countries also supported the US stance. From 2012 to 2016, the EU upheld an embargo on Iranian oil. Today, some signatories to the Iran Nuclear Accord do not want to follow the US's lead and plan to keep business open with Iran. They don't have any evidence of violations with existing terms. The evidence that Israel released last week, failed to reveal any smoking guns. With China and Russia as major signatories to the accord and their deep oil markets and alternative currencies to facilitate trade, we believe that most of Iran's oil can continue to flow into global markets.

The US has failed to lay the diplomatic groundwork to convince major importers of Iranian oil to reduce their demand.

At the time of writing, Brent oil was trading at US$77/bbl, up from US$73/bbl last week (02/05/2018). Unless the US convinces other countries to join it or tightens extraterritorial restrictions, we expect oil prices to give up some of its recent gains.

However, we don’t think the entire geopolitical premium built up in recent months will fully dissipate. Firstly, the political calendar is just too busy. A potential meeting between Donald Trump and Kim Jong Un is on the radar for the coming month. Secondly, yesterday’s move by the US is a sign that it is re-establishing its diplomatic presence in the Middle East. Whether that will help or hinder stability in the region is yet unknown. If Iran decides to pull out of the agreement itself, we believe the region could transcend into chaos and the proxy-war between Saudi Arabia and Iran will escalate.

In June the OPEC will host its 174th policy meeting and the cartel has already announced that it will keep its curbs in place until 2019. The market is now looking for signals about whether the group and its external partners will taper these curbs thereafter. With Venezuelan production deteriorating so quickly, the rest of OPEC will need to raise production to stop the global supply declining further, despite the US aggressively increasing its production.

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