40 Years of fraught US-Iran tension in the Persian Gulf plays on

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With Iran backed into a corner, increased tension between the regime and the White House has resurrected talk of a closing of the Strait of Hormuz -- the critical waterway by which the bulk of Middle Eastern oil must travel. Unappreciated geopolitical risk may benefit these strategies:

- Long Brent oil
- Long gold
- Short euro against US Dollar

Before moving on, we must point out our cognitive dissonance in identifying an environment that is bullish for oil and gold while at the same time being constructive on USD in a major pair (because commodities tend to move in the opposite direction of the greenback). The reason for our jaundiced view on the euro specifically is the Continent's fragility in the politics of consumer fuel costs. This stems from the risk of France's "yellow vest" movement surprising the market with newfound strength.

What is causing the sabre-rattling?

Though Iran is facing sanctions from the US, many oil consuming nations were offered waivers last November to continue purchasing from the regime. Those waivers expired in May, leaving the regime with a loss of market share for its 1.3mn barrels per day of oil exports.

Now Iran is trying to wriggle out of the its nuclear accord with the European Union (EU), as it doesn't feel like it's getting any upside after the US withdrew from it last May.

The Strait of Hormuz is the world's most important choke point, carrying 30% of global seaborne-traded crude oil and other liquids. It is also the avenue for all of Qatar's liquefied natural gas (LNG) exports, which are roughly 30% of the global LNG trade[1].

Figure 1: Map of Key Straits in the Middle East

Source: US Energy Information Administration (EIA)

The EIA anticipates that the Organization of the Petroleum Exporting Countries (OPEC) oil cartel's total output in 2020 will be 29.8 million barrels per day, of which 18 million barrels will flow through Hormuz. The other two chokepoints pale in comparison (Figure 2).

Figure 2: Crude oil and petroleum products transported through Arabian Peninsula chokepoints

Sources: US Energy Information Administration (EIA) analysis based on Lloyd's List Intelligence, Panama Canal Authority, Argus FSU, Suez Canal Authority, GTT, BP Statistical Review of World Energy, IHS Waterborne, Oil and Gas Journal, and UNCTAD, using EIA conversion factors. EIA published the analysis in 2017.

Asset impacts

It is tempting to look back at history to see what has happened in similar events in the past, but there are limitations, as no two conflicts are the same. Start with oil.

While the Gulf Wars are useful reference points for oil shocks from Middle East conflict, some other periods have a mixed track record. For example, 1987-1988 was a period of elevated tension in the region, yet the era is not known for rising oil prices.

Figure 3: Persian Gulf Conflicts, 1987-1988

Source: WisdomTree

For the bears, there are some parallels to the 1980s – demand for “greener” autos today, Saudi Arabia’s near-10mm barrel daily production and off-the-charts US shale supply come to mind. But much of this is moot if Hormuz’s flow is called into question. For context, consider that Venezuela’s production fell from 2.4 million barrels per day in 2016 to about 800,000 barrels currently, a decline of 1.6mbpd . There is about 11x that much crude and equivalents flowing through Hormuz.

Geopolitical shocks tend to benefit gold prices, as shown in Figure 4.

Figure 4: Geopolitical shocks

Historical performance is not an indication of future performance and any investments may go down in value.

Gold saw some of its best outperformance in the 1970s, but extrapolating those experiences forward is difficult. The demise of the Bretton Woods monetary system fundamentally changed the price of gold in that era. President Ford’s 1974 signing of an act that permitted US citizens to own and deal in it reversed four decades of official state policy that originated with President Roosevelt’s 1933 confiscation decree. With the world’s largest economy able to invest, the mid-1970s saw a structural change for the metal’s demand dynamic. As investors tried to access it for the first time in four decades, its price rose substantially more than we can extrapolate to any current situation.

Nevertheless, the Yom Kippur War and the first Gulf War indicate that gold prices can standout when the Middle East heats up. Additionally, should threats of Hormuz closure become tamer from here, the metal could begin to play off of other geopolitical tensions anyway, with the one at the top of the list being this feeling that we should respect the possibility of a Sino-US cold war.

Short euro against US Dollar

The populist right in Europe could find strength in disgruntlement from rising fuel prices. The gilets jaunes movement in France is an illustration of what could happen when rising fuel prices hit everyday people that were angry to begin with. Although many believe that movement is broadly on the wane, higher diesel costs could bring it back with a vengeance. The US is less sensitive to political shock from high oil prices because it is producing so much oil itself. That is in stark contrast to the US of old. For this reason, the euro looks vulnerable here, a rare exception to the “rule” that oil and gold bullishness tend to go hand-in-hand with USD bearishness.

1 Energy Information Administration

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