DON’T SNOOZE ON HORMUZ

40 Years of Fraught U.S.-Iran Tension in the Persian Gulf

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The geopolitical events are coming fast and furious. The Strait of Hormuz, the critical waterway by which the bulk of Middle Eastern oil must travel, is back on the market’s mind in the wake of the June 13 torpedo attacks on two vessels, one Norwegian, one Japanese. About a month earlier, four Saudi crude oil tankers were also attacked in a series of strikes that many observers believe were ordered by the Iranian government.

Before all this—but after Washington’s decision to pressure Iran by ending the waivers the U.S. granted to a half-dozen nations to continue purchasing Iran’s crude oil—the markets digested this April 22 response from the Islamic Revolutionary Guard’s Navy Rear Admiral Alireza Tangsiri:

> According to international law, the Strait of Hormuz is a marine passageway and if we are barred from using it, we will shut it down. In case of any threat, we will have not even an iota of doubt to protect and defend the Iranian waters. We will defend our prestige and embark on reciprocal acts when it comes to defending Iran's right.

And just like that, Hormuz was in the news.

Given this spring’s decline in the price of Brent Crude oil, which was threatening $75 per barrel in April but now at $65 in July, the cloud hanging over the waterway is not being properly appreciated by the oil market.

For example, spot Brent Crude was trading at $59.97 before news of the June 13 torpedo strikes hit the wire. It rose to $62.64 a few hours later and then settled down around $61 during New York daylight hours the next day. In other words, the market yawned—again. And in the wake of Iran’s shooting down of a U.S. drone just a few days later, all that oil could muster was a couple more points of upside. This surprises us.

Figure 1 shows three critical Middle Eastern oil chokepoints, the closure of any of which would wreak havoc on oil markets and the global economy.

The topography of the Strait of Hormuz is the story of tectonic plates breaking apart over millions of years, forming the needle tip at the northernmost parts of the UAE and Oman. At its narrowest point, Hormuz's width is 21 miles (33 km), but the shipping lane itself is just 2 miles (3 km) wide. From Iraq, Kuwait, Bahrain and so on, oil and natural gas destined for the Indian Ocean must go through it.

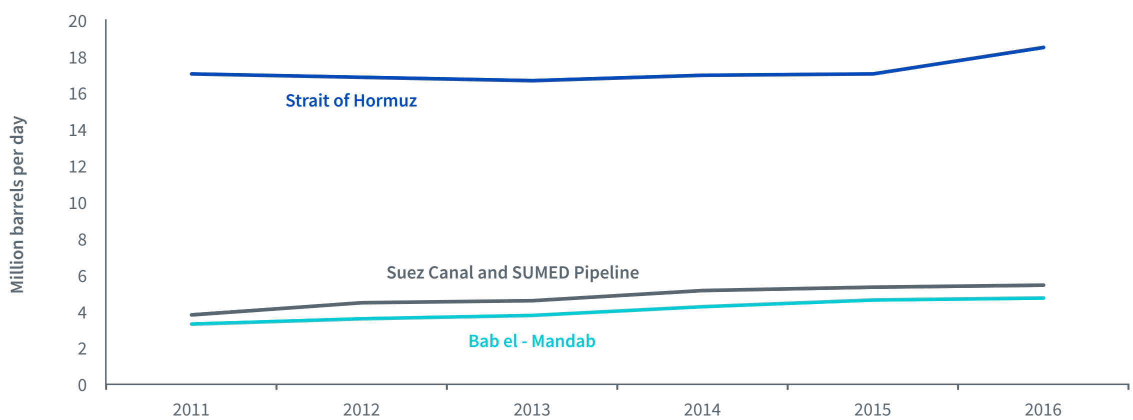
Figure 1: Three Critical Oil Chokepoints, Middle East

Source: EIA.

The U.S. Energy Information Administration (EIA) anticipates that OPEC's total output in 2020 will be 29.8 million barrels per day, of which 18 million barrels will flow through Hormuz. The Strait is also the avenue for all of Qatar's liquefied natural gas (LNG) exports, which make up approximately 30% of the global LNG trade. The area's other two chokepoints pale in comparison (figure 2).

Figure 2: Middle East Oil Chokepoints

Crude oil and petroleum products transported through Arabian Peninsula chokepoints



Sources: 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.

The last time the markets had a fright about Hormuz was in December 2011, when Iranian first vice president Mohammad Reza Rahimi said, "If [the Western countries] impose sanctions on Iran's oil exports, then even one drop of oil cannot flow from the Strait of Hormuz."

But Hormuz was an issue long before 2011.

THROUGH THE YEARS

We are now 40 years on from the Iranian revolution, and 38 years past the release of the 52 American hostages that were taken in the uprising. It may not be lost on President Donald Trump that they were let go just minutes after Ronald Reagan's inauguration—the current president would love to have a similar "tough guy" victory in his pocket—but he may be well-served to remember that Reagan had one Iranian headache after another throughout his tenure.

Let's review the history of U.S.-Iranian conflict in the Strait of Hormuz.

Before Iraqi dictator Saddam Hussein was ousted by the Western alliance at the turn of the century, he was aided by the U.S. military when warring with Iran in the 1980s. During that era, Iran planted mines in the Strait. A U.S. naval ship ran into one in 1988.

That was no isolated incident. The same year included Operation Praying Mantis, a one-day confrontation in which Iranian forces were dominated by the U.S. Navy. In the annals of modern-day Mideast conflict, that "taking out" of several Iranian vessels has been largely forgotten. But as investors, we shouldn't forget that the Persian Gulf had several other scares before the 1990–1991 Gulf War.

In 1987, the year before Praying Mantis, 37 American seamen were killed by the Iraqi air force. In the summer of 1988, the U.S., on edge from frequent engagement at the time, made a serious blunder. When a commercial airliner didn't respond to radio communications, the U.S. concluded it was the Iranian military and shot it down, killing 290 civilians.

We suspect only Americans over maybe 40 years old may recall that incident. Consider that an American, aged 47 and managing money for 25 years, was only 15 or 16 years old when all this was happening. Their memory of these events may be hazy, if they recall them at all.

But they are not forgotten in Tehran.

This is what we find fascinating about the Strait of Hormuz and its potential to influence the price of oil. When thinking about critical, memorable years for oil, either boom or crash, 1987 and 1988 do not typically come to mind. "Big" years for oil usually include the 1973 oil crisis and the repeat shock in 1979, when Iranian oil production went haywire as power transitioned to the ayatollah. After that, if we are talking about collective memory, even the historically minded among us gravitate to the Gulf War oil shock when considering the 1980–2000 geopolitical window.

But why 1973, 1979 and 1990–1991? Because all three coincided with—or caused—tough economic periods in oil-consuming nations – the U.S., Germany, Japan, and others – that dominated the global economy. Not so with some of the incidents of the late 1980s, which we discuss in greater depth later. In the meantime, let's look at more recent years.

WHY WOULD AN OIL BULL NEED HORMUZ WHEN THERE'S THE "COMMODITIES SUPERCYCLE?"

It was a half generation after the Gulf War before oil started heading northward again. Brent Crude bottomed at $9.64 in December 1998 at less than a quarter of its October 1990 peak of around $40. From that low to the peak in 2008 ($146.08) it multiplied 15-fold.

Though Hormuz is always on some radars, we don't think it was as front and center in the market's list of concerns during this century's early years because the U.S. military was engaged elsewhere—primarily in Iraq and Afghanistan. Hormuz was relatively quiet in terms of threatening rhetoric from the Iranian state in the earlier years of President Mahmoud Ahmadinejad (who served from 2005–2013). In those days, many believed Ahmadinejad represented moderation and a shift in Iran's posture toward the West, though later we learned that was not the case.

Perhaps more importantly, there was little reason for Shiite Iran to provoke George W. Bush, whose efforts to topple Hussein served Tehran's interests.

Remember, Iraq's straight-line borders were drawn by the British and French after World War I; Hussein was a Sunni dictator in a Shia-majority country beset with intertribal disputes. Iran's logical play was to let the U.S. fight and overthrow their arch enemy. Hormuz wasn't going to get put on the table against that setup.

Besides, in the first decade of this century, who needed the threat of a Hormuz closure to make oil prices rise? The commodity had two broad themes to ride, and both were based on sound reasoning.

The first was the so-called commodities supercycle, in which the bull case for oil and everything else that came out of the ground was predicated on rising demand from rapidly growing emerging markets, namely China.

We can criticize the argument in retrospect, as Brent Crude has flirted with sub-$30 levels on a few occasions in recent years. But at the time, bulls were looking at charts showing Chinese auto adoption rates rising exponentially, calculating that the world was on a trajectory for an upward demand shock.

The other theme was on the supply side. Doomsayers were shouting from the rooftops about scientifically respected "peak oil" theories. The big one, posited mid-century by M. King Hubbert, claimed that the days of gushing, easy-to-extract oil had long since passed. A 25-year chart of U.S. oil production was the embodiment of Hubbert's Peak: 1985 production of 9 million barrels per day was followed by a waterfall decline into the 5 to 6 million barrel per day range by 2002–2005.

Anyone looking at that chart in the pre-shale days would have been hard-pressed to argue against peak oil.

The evidence was everywhere. Think about the panicky Mexican government wondering what was going to happen to its revenues when the supergiant Cantarell field's production rolled over, which started happening in that same 2002–2005 window. Elsewhere, conjecture swirled daily as to whether Saudi Arabia was fudging the numbers to disguise what many thought was imminent peak production there too.

So we didn't hear about Hormuz much during the commodities supercycle, because the bulls didn't need a military conflict to make their case.

But just because eyes weren't on Hormuz for much of the last generation doesn't mean its geostrategic importance ever went away. Why has history largely forgotten the 1987–1988 Persian Gulf conflicts? Because the American middle class, which populates the country that most dominates global media, didn't register pain at the gas station in those years. There was no story because there were no willing readers. The reason? Oil prices collapsed right before those events, so its reactionary rise in response to military conflict didn't raise many eyebrows.

There are a handful of reasons why oil sank through the first half of the 1980s. First, the U.S. dollar index, which was under 100 in 1981, found itself north of 160 at one point in 1985. Dollar strength is no friend of commodities markets.

Also, profound structural changes occurred in the markets at the time. Until the late 1970s, almost 90% of the world's crude oil was sold under long-term contracts at prices set by the major oil companies. OPEC produced just under half of the world's crude oil, allowing the oil cartel to dictate the price and quantity of oil sold. Prices fluctuated when these long-term contracts were revised, but otherwise, they were not particularly responsive to the news cycle.

In the late 1970s and early 1980s, market-based spot and futures trading gained importance as production from non-OPEC countries surpassed that of OPEC members. Owners of the newer oil, from areas such as the North Sea, lacked the typical long-term contracts with buyers, forcing them to find other ways to build market share. They were able to achieve this objective on the spot markets by undercutting OPEC with this newfound supply. By the end of 1982, almost half of all internationally traded oil was on the spot market, not through long-term contracts. With prices now determined on a very short-term basis, daily fluctuations in the price of oil became the norm—and bold moves in price became more common.

Another factor was when Detroit's smaller, more fuel-efficient cars started to roll off the assembly line by the early 1980s, reaching critical mass by the mid-1980s.

But the main driver of oil's collapse in late 1985 was when Saudi Arabia got tired of other OPEC members cheating on their production numbers and ramped up its own production in response. So powerful was the collapse in oil prices from that action that some Kremlinologists hypothesize it accelerated the downfall of the USSR, a petrostate already bankrupted by war with Afghanistan.

In the industrialized West, nothing unusual happened at the gas station, at least not anything that left lasting scars compared to the prior decade's gasoline lines. So, when you ask market watchers what they associate with 1987, most will cite the October stock market crash and not much else. Figure 3 shows West Texas Intermediate (WTI) crude oil, the American benchmark.

Figure 3: WTI Crude Oil, 1983–1989

Source: Bloomberg. Data from 12/31/1984 – 12/31/1989.

That background covers the "before," but consider also the "after." Persian Gulf conflicts in 1987 and 1988 may be forgotten because they were so overshadowed by the events of 1989. Perhaps the most significant year of the whole second half of the century, 1989 gave us the Berlin Wall collapse and the Tiananmen Square massacre in Beijing. If asking Americans, Chinese, Germans and many more what global events of the 1980s they remember most, it's the "Tank Man" standing his ground in front of the Chinese People's Liberation Army or Reagan telling Mikhail Gorbachev, leader of the Soviet Union, to "tear down this wall."

Operation Praying Mantis? The downing of Iran Air Flight 655? They get short shrift in 1980's history. But make no mistake, those were the years when Tehran realized it had a potent political weapon in the Hormuz threat.

THIS GENERATION

Aside from the most recent Hormuz fright in 2011, investors have generally been able to bury it down their concern list over the last generation or so. We think the key reason is that this century witnessed the U.S. expending national treasure bringing down Hussein, the nemesis of the Iranian regime. Beyond that military effort, U.S., British and other NATO forces were in Afghanistan, the primary target of the Western alliance in the years after September 11.

But those wars have largely "rolled off," and the new focus of the U.S. military is a sort of trilateral regional alliance between the U.S., Saudi Arabia and the UAE, along with the other Gulf Cooperation Council (GCC) Sunni monarchies—with the exception of Qatar, who is shunned by the rest of the GCC at the moment.

But the U.S. and Trump got into a pickle in 2018 after spending a great deal of political capital sidling up to the House of Saud, only to face the fallout from the hit it ordered on journalist Jamal Khashoggi, who met a brutal death inside the Saudi Consulate in Istanbul.

Saudi Crown Prince Mohammad bin Salman (MBS), de facto monarch, denies knowledge of Khashoggi's torture and murder, and Trump claims to believe him. The U.S. president makes that claim because he backed himself into a corner, thinking that support for the Sunni side in the proxy wars would assure that MBS would keep oil prices in check.

Love him or hate him, few can deny that Trump has an uncanny ability to put a finger on the pulse of Middle America. And that sixth sense for the heartbeat of America knows that high gasoline prices are what makes or breaks presidents. Yes, Nixon was driven out of office because of Watergate, but when people are standing in line for gasoline, they are hard-pressed to look past a scandal like that and give a president a pass. The same goes for Jimmy Carter, walloped in a landslide. Again, gasoline was a pain point.

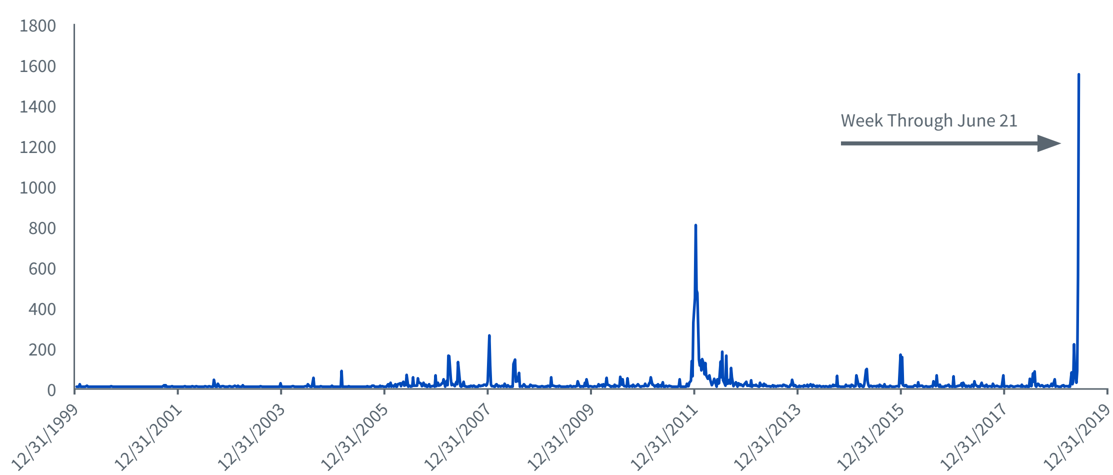
Trump's wager is that if gasoline gets away from him, he's finished—and he's probably right. Meanwhile, with the global community recoiling in collective disgust at Khashoggi's murder and the U.S.'s stay-the-course reaction, Iranian president Hassan Rouhani is looking at his collapsing economy and wondering what it will take to strong-arm the U.S.-Saudi coalition.

But still, the actual volume of news flowing from Hormuz was calm until April. Last year, financial media was littered with coverage of the economic malaise in Venezuela, Argentina and Turkey, because each nation taps international capital in size. But Iran flies under the radar, with little international ownership of Iranian bonds or equity ventures. Yet the pain has been palpable; the IMF calculates Iranian GDP contracted 3.9% in 2018, with hyperinflation to boot.

The catalyst for an acceleration of Iran's economic woes was when the Trump administration ripped up the nuclear accord reached in 2015 by the Obama administration. Against the background of late-inning, hard-line trade negotiations with China, Trump and U.S. trade representative Robert Lighthizer ended the waivers it had given half a dozen nations that allowed them to continue purchasing Iranian oil. One of the countries with a waiver? China.

With the oxygen that much more limited, June witnessed the largest news story count for "Hormuz" this century (figure 4).

Figure 4: Story Count, "Hormuz"



Source: Bloomberg, 12/31/1999–06/21/2019.

Let's assess the spikes in news coverage of the Strait.

In the exhibit, we see big news activity for Hormuz in 2006–2008, with the apex of that scare occurring when some small Iranian boats approached the U.S. Navy and threatened to set off explosives. The boats then dropped packages into the water that an observer could reasonably believe were those bombs.

But things calmed down, partly because Tehran may have shared the fear of many frontier and emerging markets autocracies in 2008—social unrest stemming from runaway food prices. While many of us in this industry remember 2008 as the year Lehman went under, it's worth recalling the fears of the developing world at the time. Food riots erupted in Egypt that year. So bad was the problem—it was the commodities supercycle, after all—that a handful of countries banned food exports on national security grounds. Rice prices nearly tripled that year, and there was discussion about potential unrest in places like Cambodia and Laos, where affordable rice was a matter of social stability.

Wars happen all too easily in such environments. So, Tehran eased up on the Hormuz rhetoric and the issue went back into hibernation until the next chapter, when Barack Obama laid down sanctions on the regime. On December 27, 2011, Reza Rahimi responded with that quote we mentioned earlier: "If (the Western countries) impose sanctions on Iran's oil exports, then even one drop of oil cannot flow from the Strait of Hormuz."

That threat led to the biggest news story word count for Hormuz this century, at least until recently. Then, summer 2012 brought another closure threat from an Iranian general, followed by a few years of calm, then some ballistic missile tests in late-2015. Then the last spike on the chart, a rolling series of headlines in 2019.

In May, Hormuz witnessed actual conflict, with a handful of Saudi Arabian oil tankers attacked. Details are hazy. In mid-June, the torpedo attacks on the ships owned by Norwegian and Japanese entities occurred too, perhaps raising eyebrows in broader circles than was the case in May. Then the issue caught a third headline from the shooting down of the U.S. drone, and Iran became a primary focus of the Trump administration.

Think about it this way: Iran-Saudi military fighting has been, by design, in the form of proxy wars. Both regimes are constantly looking over their shoulders at the potential for overthrow by their own citizens, so the actual theater of conflict has been primarily in Yemen and and Syria, not in their own countries.

There are so many groups engaged in conflict in Syria that it gets hard to keep track of it all. Generally, one side has Iran, Russia and Hezbollah, plus any other willing Shia from the region, fighting on the side of the Assad regime. Assad is Alawite, and that sect of Islam is particularly shunned by the Wahhabis who control Saudi Arabia. The Saudi-aligned forces include the rest of the Sunni Gulf monarchies and the U.S.

This means a show of force, such as the targeting of Saudi tankers, raises alarms because the fight is on new turf – Persian Gulf or Gulf of Oman waters.

The timing is horrible for Riyadh. Having miscalculated that it had carte blanche to assassinate Khashoggi, the kingdom is out there right now trying to pitch a Saudi Aramco IPO to investment bankers in London and New York, and they are targeting a value north of $1 trillion. Fire and brimstone around Hormuz isn't going to help that cause.

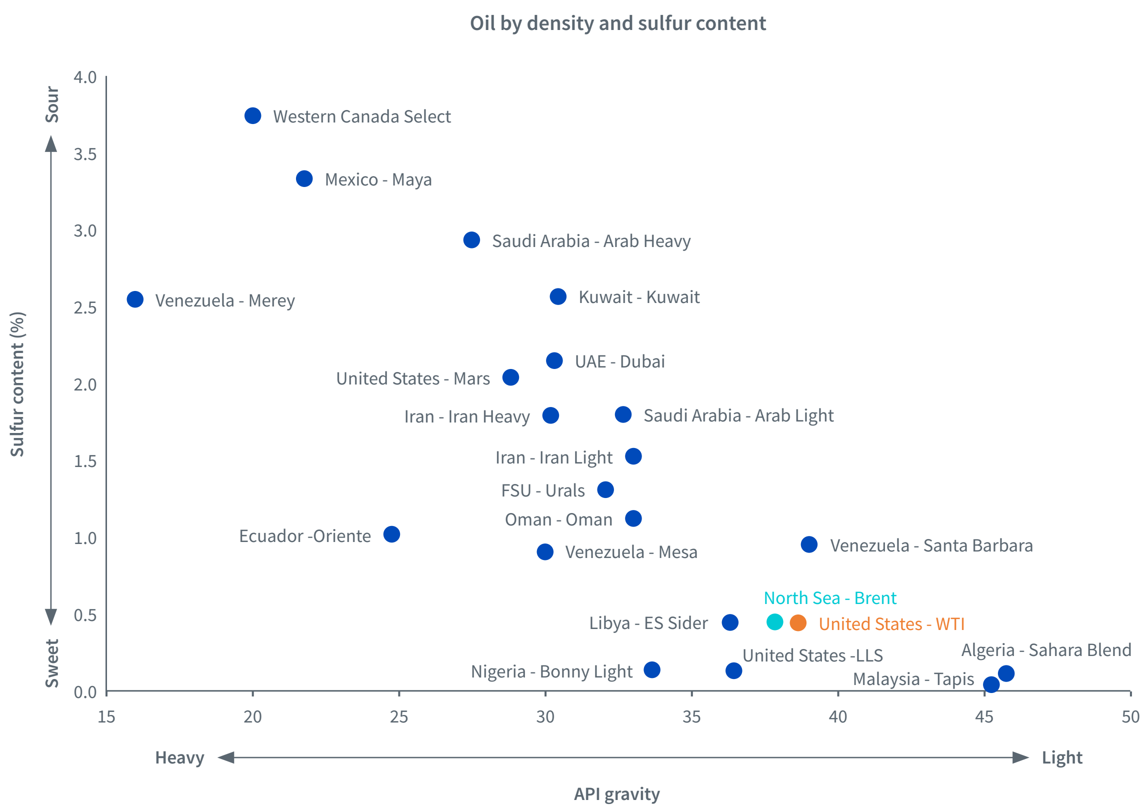
POSITIONING

Of course, a supply-based bull case for crude oil is on our mind, but which varieties are opportune?

We keep coming back to IMO 2020, the UN's maritime fuel cleanliness regulation that may soon drastically reduce the legally allowed sulfur content of cargo ships' bunker fuel.

This development has the potential to hamper demand for heavy crudes, which are typically loaded with sulfur (figure 5). Such dirtier varieties require more refining, which is expensive, if the liquids are to be compliant with IMO 2020. The beneficiaries from this regulation would seemingly be the southeast corner of the exhibit.

Figure 5: Low-Sulfur, the Beneficiary of IMO 2020



Sources: Energy Information Administration, McKinsey & Company, WisdomTree, 2/14/19. Canadian data from CrudeMonitor, October 2016.

GOLD

We would be remiss if we discussed Hormuz without mentioning gold, as foreboding Middle East forecasting has always been the purview of goldbugs. We think this stems partly from the creation of gold permabulls during the metal's legendary run in the 1970s. Having rallied from $35 to $850 within a decade—a decade that ended with the Iranian revolution—many gold watchers are extrapolating 1979's politics to the present.

But doing so is fraught with difficulty. Firstly, the demise of the Bretton Woods monetary system fundamentally changed the price of gold in that period. Secondly, in 1974, Gerald Ford signed an act of Congress permitting U.S. citizens to own and deal in the metal, reversing Executive Order 6102, which was signed by President Roosevelt in 1933 (when investor gold was confiscated). With the world's largest economy able to invest in gold again, there was a structural change in the market. As investors tried to access the metal for the first time in four decades, its price rose substantially more than we can extrapolate to current times.

Gold initially struggled to gain traction but recently made a new attack on $1,400. Interestingly, gold is getting attention despite the still strong U.S. dollar. If gold is to keep running from here, it will need the U.S. dollar to comply. That could be a problem given vulnerability in the euro, which we outline below.

HORMUZ TENSION: BEARISH FOR EURUSD

At present, the U.S. has no social movement whose primary grievance is high auto fuel prices. Neither does Switzerland, Australia or Japan.

But France does.

The *gilets jaunes,* or the yellow vest movement, started in 2018 when French president Emmanuel Macron miscalculated the anger of the working class and raised taxes on diesel. That caused a weekly motorist protest, though the number of demonstrators has fallen since the peak.

The protest took on the form of votes for Marine Le Pen's National Assembly Party in the European Parliamentary elections, where her cohort won 23% of the vote, ahead of all other parties. Le Pen's supporters are known for hostility to open borders, free movement of people and Islam. Britain's Nigel Farage, founder of the new Brexit party, embarrassed both Labour and the Tories with his group's success in the elections. Italy's most powerful politician is now Matteo Salvini of the League Party, which is cut from a similar cloth. Nationalism, euroskepticism, rejection of Brussels—these concepts have never been as strongly supported as they are at this moment.

Now picture the series of events that could play out.

Trump needs to strong-arm Kim Jong Un or Hassan Rouhani, or the German auto industry, or whoever. He plays a strong hand with Iran. Iran gives the market another empty quote for the New York Times or maybe something a little bolder, such as action in the form of some speedboats breezing the U.S. Fifth Fleet. Hormuz takes the mantle of top market story.

Meanwhile, the global shipping industry is rotating from high-sulfur bunker fuel to low-sulfur varieties, a demand shock that sends diesel prices higher, aggravating French drivers who thought they got a message to Emmanuel Macron that they don't want to pay more for fuel.

The yellow vest movement, which the press currently thinks is on the wane, comes back with the snap of a finger and with a vengeance. Though the euro relative to the pound may be a large question mark because of great Brexit unknowns, we are hard-pressed to see how the euro can hold up relative to the greenback in the event that this is a *gilets jaunes* summer.

IGNORE RISKS IN THE STRAIT AT YOUR PERIL

Should we see disruption to oil flowing through the Strait of Hormuz, the world's most important oil transit chokepoint, it will likely drive oil prices higher in conditions that are already tight. Gold could also keep rising on the back of higher geopolitical risks, but it is hard to isolate the impact on gold from issues in the Strait amid the market's focus on trade and a dovish Fed. Rising fuel prices could aggravate already fragile politics in Europe, an unappreciated portent that we think could trouble euro bulls.