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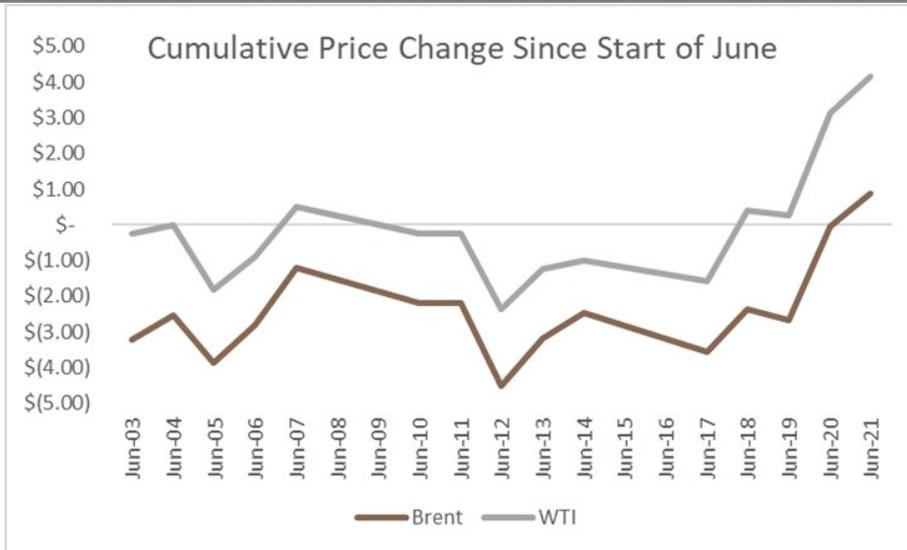
Tension in the Strait of Hormuz has Taken a Military Turn

Stratas Advisors

Tensions in the Gulf of Oman have been rising since May 12 when four ships were sabotaged in the port of Fujairah. On May 14, drones launched by Iranian-backed Houthi rebels bombed a 1,200 km Saudi pipeline carrying crude oil from the main oil fields in the east of the country to the port city of Yanbu in the Red Sea. The pipeline, which has a capacity of at least five million barrels a day, is designed as an alternative route for crude oil exports if the strategic Strait of Hormuz were to be closed.

These drone attacks clearly show the level of sophistication of the Houthis in drone technology is constantly improving. For this last action, the drone traveled 800 km on the Saudi territory to reach its target. Notably, the drone must have been guided by satellite technology, because beyond a certain distance, unmanned aircraft need a satellite data link so that information can be returned to the pilot.

A month after the back-to-back attacks, two tankers were attacked in the Arabian Sea. The damage was so severe that the crews had to be evacuated and the ships towed into nearby ports. Initial reports placed the blame on Iran. One of the affected tankers was a Japanese-owned oil tanker. Japan's Prime Minister, Shinzo Abe, was in Iran that day to deliver a message from US President Donald Trump to Iran's Supreme Leader Ayatollah Khameni. Oil markets reacted swiftly to news of the attacks but the price strength was short-lived. The attacks happened on Thursday June 13. Prices ended the day up 2.2% from their Wednesday close and ended Friday up 3.4% from the Wednesday (pre-attack) close. However, by Monday June 17, prices were only 1.6% above the Wednesday close and were below Thursday and Friday figures. As can be seen in the chart below it wasn't until the most recent drone attack that prices charted into positive territory



Five days later, the White House announced an additional 1,000 troops would be sent to the Middle East. Even still, prices posted a small decline with Brent opening the day at \$62.07/bbl and closing at \$60.94/bbl. Iran, for its part, denies any involvement in these incidents. Meanwhile, Tehran has decided to raise pressure on the United States by announcing that as of June 27 its enriched uranium reserves would pass above the limits outlined in the Joint Comprehensive Plan of Action. "The countdown to pass above 300 kilograms for enriched uranium reserves has begun and in ten days, that is, June 27, we will exceed this limit," said Behrouz Kamalvandi, door of the Iranian Atomic Energy Organization.

On June 20, Iran shot down a US military drone, claiming it had crossed into Iranian airspace. The Iranian Islamic Revolutionary Guard reported that the drone took off from an American base on "the southern shore of the Persian Gulf", "extinguished all its reconnaissance devices", flew past the Strait of Hormuz and headed east towards the Iranian port of Chabahar, they said. According to the Revolutionary Guard, the aircraft was shot down after returning from its mission in the coastal area near Bandar-e Jask (South). The United States said the drone flew 34 km from the Iranian coast and was therefore in international waters.

According to multiple reports, including President Trump's own tweets, the President did approve retaliatory strikes against Iranian military positions. The strikes were scheduled for Friday morning to minimize loss of life. However, the President withdrew his approval for the strikes at the last minute, claiming the loss of life from such retaliation would have been disproportionate to the shooting of an unmanned drone. Since then, President Trump has also said that while Iran made a "huge mistake" in shooting down a US drone, he also believes operational and human error may have been to blame and that the strike might not have been intentional. These statements are a surprising turn of events, especially given that two of President Trump's closest advisors (National Security Advisor John Bolton and Secretary of State Mike Pompeo) have long been advocates of a hawkish, uncompromising stance on Iran.



Is there a risk of direct confrontation?

President Trump and senior government officials have repeatedly warned Iran against a direct confrontation. Moreover, after each escalation, officials from both countries declare they do not want war, showing at least some level of a will to stop the escalation of tension witnessed in the Gulf for a month. Importantly, a high concentration of military personnel from both countries in the region raises the risk of an accident or misinterpretation that could lead to military confrontation. Indeed, three years ago, while the United States was participating in the Joint Comprehensive Plan of Action, American sailors were apprehended by the Iranian Army. The incident was settled in less than 48 hours with a phone call from John Kerry to Iranian Foreign Minister Mohammad Javad Zarif. But today, because of the lack of direct communication between Washington and Tehran, the smallest of incidents could quickly escalate.

Despite recent escalations and the risk of accidents, it is highly unlikely there will be direct confrontation as the consequences, for now, would be too costly for the region. In addition to the ~21 mmb/d of oil that would be at risk, significant oil infrastructure is located immediately adjacent to the Gulf. Multiple countries have a vested interest in preserving the delicate peace that currently exists.

The strategic doctrine of the Revolutionary Guard is clear, if Iran is attacked the country will retaliate without distinction between American military bases and the countries that host them. The cost of a war would therefore be devastating and was likely factored into President Trump's decision to cancel the airstrikes.

Consequences for Oil Prices

If the Strait of Hormuz were to close or be significantly impacted prices could spike worldwide. Absent that, prices will likely struggle to maintain strong risk premiums as markets remain overwhelmingly bearish about future demand expectations. Throughout the month, prices have fallen swiftly after each event despite a lack of resolution and the ongoing war of words between leaders. Looking ahead, prices will likely begin to drift slowly down until the next geopolitical event.

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