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Stratas Series: Global Supply in the Age of Turmoil

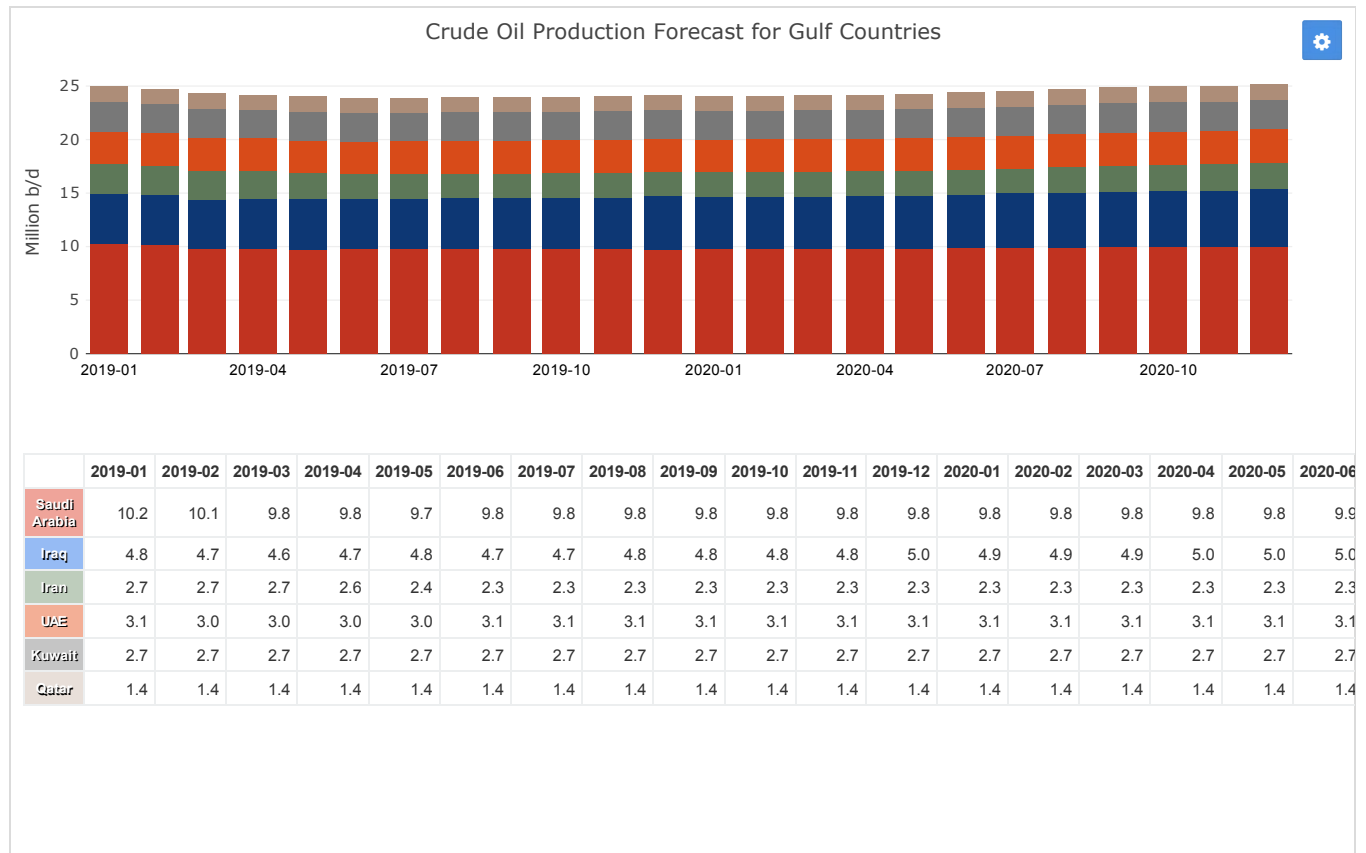
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Part 1. Crisis in the Strait of Hormuz

In recent weeks, tensions in the Arab Gulf, also known as the Persian Gulf, quickly flared against the backdrop of tightened US sanctions on Iranian. The downing of drones and seizure of UK tankers by Iranian forces spiked international concerns over disruptions to crude supply traversing the Strait of Hormuz. Stratas Advisors sees a relatively low possibility of intentional blockage of the Strait from Iran while some risks of mild military conflict remain. The chart below shows our current outlook for regional oil production. As a reminder: our outlook assumes continued adherence to agreed-upon production cuts and no severe military escalations.



Indeed, the Strait of Hormuz remains a vital area for the international oil trade. Nearly one fifth of world crude and oil products consumption and one third of international maritime oil shipments pass through this chokepoint. Major Middle Eastern oil exporters such as Iraq, Kuwait, and Iran are heavily reliant on the strait as an outlet to major international oil customers such as China, India, Japan, and South Korea. For the UAE, an alternative is to bypass the strait and increase crude shipments through the Abu Dhabi oil pipeline to the Fujairah Port, which is located on the Gulf of Oman. However, previous tanker sabotage activities in this area demonstrated Iran's capability to interfere oil shipments in the Fujairah port. While Saudi Arabia is working on capacity expansion on its East-West pipeline to ramp up crude export through the Red Sea, it is worth mentioning that crude shipments through this route still need to pass the Bab al-Mandab Strait, which is easily reachable by Iranian backed Yemen forces. Moreover, the expansion project will take approximately two years. As of now, Saudi still exports over 90% of its crude through the Strait of Hormuz.

During the past decade, the Strait of Hormuz has been constantly under political tension. However, no major military escalations nor material impacts on crude shipments have been recorded. Notably, in January 2012, Iran threatened to block the Strait in retaliation of US and EU sanctions. However, during the subsequent four years, Iran made no material attempts to interfere with oil shipments through the Strait despite that its oil production was squeezed below 3 million Bbl/d during the sanction period. Based on historic patterns, Iran will be more likely to pressure the US and EU to lift sanctions by raising minor conflicts rather than mass blockages.

Nonetheless, some risks associated with military leadership misjudgments still remain. As more naval forces tap into the narrow waterway, tension will quickly build up. The naval forces will be tasked to handle a variety of unexpected incidents and to action swiftly on new information. Misjudgments of information can be possible given the high pressure working environment. The shoot down of an Iranian airliner in 1988 near Iranian water is an example of such risks.

As Iran gradually run out of tanker spaces to store the curbed crude exports due to US sanctions, it will seek to add more pressure to the international community to push the US to lift sanctions. Meanwhile, as the presidential election approaches, President Trump needs to make progress on reaching "great deals" as the trade talks with China dragged on and nuclear talks with North Korea and Iran stalled. Secretary of State Mike Pompeo recently offered to visit Tehran and address the Iranian people, gesturing to resume dialogues. We will closely monitor the developments in the Persian Gulf. Stay tuned for our refreshed supply outlook.