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MACROCOSM

Oil and the Obama Doctrine

Friday, April 10, 2015
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An Iran nuke deal isn't as simple as Shell's BG deal. Meanwhile, Yemen destabilizes.

Oil prices are getting whipsawed this week by major news events both corporate and geopolitical, with markets having more than the usual difficulties connecting some very indeterminate dots. The most challenging is the still-evolving deal to curb Iran's nuclear weapons program. We'll get to that in a moment, but first some simpler subjects.

- The announcement Wednesday of Royal Dutch Shell's acquisition of BG Group ought to be straightforward enough. Primarily, Shell is betting big on LNG as the hydrocarbon of the future at a time when its own reserves are falling fast in the North Sea.
- But that didn't stop various media accounts from mistakenly treating the deal as heralding the return to dominance of "super-majors." If anything, it represents the last gasp of the traditional big-project model in the face of a new paradigm of smaller, nimbler more innovative energy companies powered by disruptive technologies (see "I Have Seen the Future, and It Fracks" February 24, 2015).
- *If Shell's deal has a larger meaning, it is as evidence of stabilization in the global energy market after the severe disruption of the cascade in crude prices off last June's highs.* We called for a wave of consolidations as a means of relieving the severe stress on the most weakened players (see "Oilmageddon" December 16, 2014). BG is hardly one of those most weakened players, but it is a positive sign that in this disrupted environment Shell would take on such an ambitious deal.
- Separately, this week the Department of Energy's Energy Information Administration updated its influential Short Term Energy Outlook (STEO).
- The EIA revised its 2015 crude oil and condensate forecast for a second time this year, lowering it by another 100,000 barrels/day to 9.2 billion. We maintain our US crude and condensate production forecast at 9.15 million barrels/day for 2015 (see "Saudisfaction Guaranteed" March 13, 2015).
- The EIA also lowered its 2016 forecast to 9.3 million barrels/day -- it had been almost 500,000 barrels/per day higher just three months ago. We maintain our forecast at 9.34 million barrels per day by 2016.

Update to strategic view

OIL: The Shell/BG deal is an encouraging sign that the energy sector is strong enough to mount aggressive consolidations. The EIA made waves by announcing that an Iran deal could lower oil prices by $5 to $15. But we caution that there is no deal yet, and removing sanctions will be a time-extensive challenge in any event. The "Obama Doctrine" that has "engaged" Iran is a dangerous and arbitrary meddling in the region's long-term balance of power, with the escalating proxy war in Yemen posing as probabilistic threat to oil supplies as great as the boon of an elusive Iran nuclear deal. We continue to expect higher global crude prices, in a range of $50 to $65 for the year.

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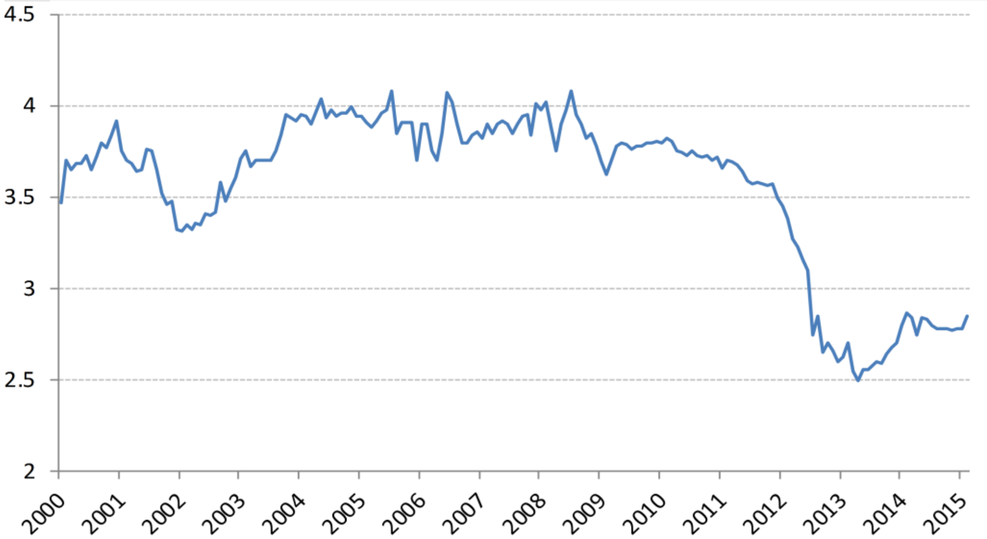
Now, we turn to Iran.

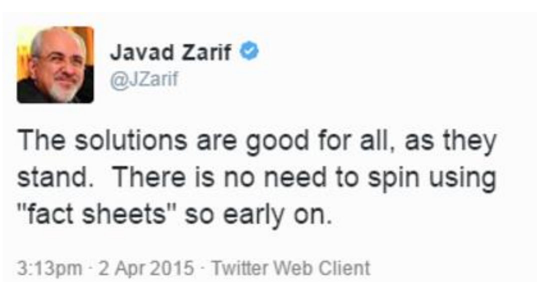
- The EIA's STEO focused the market's attention on the elephant in the room, projecting that if Iranian sanctions were lifted in response to a nuclear weapons deal, crude prices would need to be revised downward between $5 and $15 for 2016, as significant latent capacity would be unleashed. The EIA noted, "Iran is believed to hold at least 30 million barrels in storage, and… has the technical capability to ramp up crude oil production by at least 700,000 bbl/day…by the end of 2016."

Iran crude oil production Millions of barrels/day



Source: Bloomberg, TrendMacro calculations

- To be sure, Iran has a great deal of latent capacity (please see the chart below).
- But there is no actual nuclear weapons deal and no actual sanctions deal. All that was announced last week from the so-called P5+1 negotiations in Lausanne was a "Joint Comprehensive Plan of Action" that commits the participants only to further negotiations. "Important implementation details are still subject to negotiation, and nothing is agreed until everything is agreed."
- Nevertheless the US announced "parameters" of this deal-to-make-a-deal. Within minutes, Iranian Foreign Minister Javad Zarif tweeted not-so-subtle objections to the US announcement.



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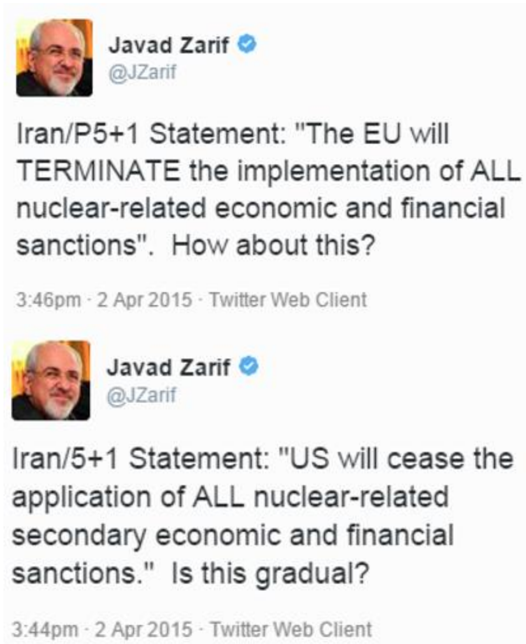
- Minutes later, Zarif poked at the most divisive element in the next round of negotiations -- and the piece the oil market is most immediately concerned about -- the extent and pace of the removal of Western sanctions.


Javad Zarif
@JZarif

Iran/P5+1 Statement: "The EU will TERMINATE the implementation of ALL nuclear-related economic and financial sanctions". How about this?

3:46pm · 2 Apr 2015 · Twitter Web Client

Javad Zarif
@JZarif

Iran/5+1 Statement: "US will cease the application of ALL nuclear-related secondary economic and financial sanctions." Is this gradual?

3:44pm · 2 Apr 2015 · Twitter Web Client

- Yesterday, Iranian President Hassan Rouhani said "We will not sign any agreement, unless all economic sanctions are totally lifted on the first day of the implementation of the deal."
- That's a big ask, a polarizing position that could scuttle a final deal. The White House has already said sanctions will only be lifted in phases. Besides, President Obama cannot unilaterally lift Iran sanctions that were imposed by the US Congress. Moreover, there is a spider web of sanctions imposed by multiple foreign governments, multinational organizations and several US states that will take a significant amount of time to unravel.
- For the moment, the key concept is that nothing has actually happened here. In fact on Wednesday Europe officially re-imposed its existing sanctions impacting Iranian shipping and banking, which are crucial to delivering oil cargos.
- *There are more unknowns than knowns. So for now, we are not revising our outlook for crude prices, still expecting the global benchmark to trade between $50 and $65 over the year.*

A final deal with Iran will or will not happen, and sanctions will or will not be lifted, and if they are, it will be all at once or gradually. But it's not as simple as regarding each of these contingencies as a binary outcome about which certainty will accrue as the facts come in. Surrounding these outcomes is an environment of heightened systemic uncertainty in the global geopolitics of energy, beyond the normally considerable level of uncertainty that energy markets always have to live with. We think it is the result of what is emerging as "The Obama Doctrine."

- In an interview last week after the Plan of Action was announced, President Barack Obama told the *New York Times'* Thomas Friedman, "You asked about an Obama doctrine. The doctrine is: We will engage, but we preserve all our capabilities."
- By "engage," Obama means opening avenues of diplomacy and commerce, even with regimes that would seem to openly oppose American interests. He sees instances of engagement as "tests" exploring experimentally for better outcomes, with very little downside for America -- free options, as it were. He told Friedman, "We are powerful enough to be able to test these propositions without putting ourselves at risk. And that's the thing...people don't seem to understand."
- *Perhaps some people don't understand, and perhaps some people just don't agree. Both possibilities are at work here, and will contribute to ongoing volatility in world energy markets.*

The Obama Doctrine is difficult to understand because there isn't a clear disclosed framework for when it is to be applied and when it isn't.

- Obama's outreach to Myanmar and Cuba would seem to be wildly experimental, with only the slenderest evidence that either nation is making any progress at all toward democracy or the embrace of human rights.
- Why engage with Iran and seek to lift sanctions, while at the same time imposing new sanctions on Russia -- another major energy exporter -- with whom we are already substantially engaged?

And the Obama Doctrine is hardly a free option -- we can only wish geopolitical decisions could be as riskless as Obama claims these are.

- A deal with Iran, by altering the balance of power, implicates the ongoing cold war between Saudi-backed Sunnis and Iranian-backed Shias with unknown and potentially vast impact on regional stability.
- It all began innocently enough. Substantive back-channel diplomacy between the US and Iran has been reportedly going on since early 2013. Communication increased as the Islamic State emerged as a regional threat. And then with the election of a more moderate Hassan Rohani as Iran's President in June 2013, talks progressed to the point where negotiations on Iran's nuclear program could begin in March 2014.
- Insurgencies like the Islamic State are a critical threat to regional stability (see "The Stench of CrISIS" June 25, 2014), and for the moment it's all to the good that the US and the fractious region have come together to fight it. But to the extent that the US and Iran have been brought together in this common cause, the longer-term question is what unintended consequences that will have.
- The two heavyweights in the region are the Sunni-led Saudis -- traditionally a US ally -- and the Shia-led Iranians -- who have had an adversarial relationship with the US ever since the Islamic revolution that overthrew of the Peacock Monarchy.

- There has been a cold war brewing between the Saudis and the Iranians for decades. And our Sunni ally is potentially wearying of the growing cooperation between Iran and the US. It's one thing to help confront the Islamic State threat, and quite another to lift sanctions in the name of a deal that only slows down -- unverifiably, and without eliminating -- Iran's nuclear weapons capability.
- The Saudis are sending a message to Iran and the region with their military action in Yemen, aimed at curbing Iran's disruptive influence. The large-scale bombing campaign to destroy the military and political ability of the Iranian-backed Shia Houthis has been backed by the ten Sunni-controlled regimes of the Gulf Cooperation Council. Several of the ten countries have already committed forces and expressed a willingness to put boots on the ground if required. The proxy war in Yemen means that the cold war is heating up -- on the ground, and on Twitter, with Iran's Supreme Leader yesterday trash-talking both the new Saudi regime and the US.

Khamenei.ir
@khamenei_ir

Despite disputes,#Saudis used to display composure w us but now inexperienced #youngsters have come to power& replaced composure w barbarism

8:46am · 9 Apr 2015 · Twitter Web Client

Khamenei.ir
@khamenei_ir

I warn that they should refrain from any criminal move in #Yemen. The US will also fail & face loss in this issue. pic.twitter.com/ittzr6JcOf

9:00am · 9 Apr 2015 · Twitter Web Client

- While not much of an oil producer itself, Yemen is of some importance to world oil markets. If the Houthis prevail, and are aligned with Iran, the rebel group could gain control of the Bab Al-Mandab Strait in the Gulf of Aden, utilizing aircraft and anti-aircraft missiles. The straits are the choke-point for oil getting to Europe in Suezmax tankers. Iran itself has already repeatedly threatened to close the Strait of Hormuz in retaliation for sanctions imposed against the regime as late as 2012. Although the likelihood of closure is remote given the US's massive naval presence in the region, the mere attempt would immediately impact markets.

In the meantime, while the regional balance of power is destabilized in the name of "engagement" under the Obama Doctrine, the energy industry has to be left wondering why the US can't "engage" with Canada and greenlight the Keystone pipeline -- the delay of which, all these years, is the logical equivalent of an economic sanction.

- Keystone would dramatically cut costs for both Canadian and US producers (see "Keystone is Key to Low Oil Prices" February 2, 2015). We think some producers could save as much as $5 to $15/barrel with Keystone, versus their present costs of railing. Those numbers should sound familiar -- that's how much the EIA estimated this week that the global oil price might fall if Iran returned to full production.
- Obama vetoed a bipartisan bill to greenlight the Keystone in the name of protecting the environment against greenhouse gas emissions-- even though the fossil fuels that would be carried by the pipeline are already being produced and transported and consumed anyway. Why are similar concerns not on the table with respect to 700,000 barrels/day of Iranian oil that *not* presently even being produced?

Bottom line

The Shell/BG deal is an encouraging sign that the energy sector is strong enough to mount aggressive consolidations. The EIA made waves by announcing that an Iran deal could lower oil prices by $5 to $15. But we caution that there is no deal yet, and removing sanctions will be a time-extensive challenge in any event. The "Obama Doctrine" that has "engaged" Iran is a dangerous and arbitrary meddling in the region's long-term balance of power, with the escalating proxy war in Yemen posing as probabilistic threat to oil supplies as great as the boon of an elusive Iran nuclear deal. We continue to expect higher global crude prices, in a range of $50 to $65 for the year.