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Iran Deal: More Fire, More Fury, Pure Trump

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Michael Warren and **Donald Luskin**

Don't panic. Still 180 days till sanctions take to 2 million barrels/day out of the oil market.

As we anticipated (see "Oil's Bullish Bottlenecks" April 24, 2018), President Donald J. Trump announced the withdrawal by the United States from the Iran nuclear deal – the Joint Comprehensive Plan of Action with China, the European Union, the United Kingdom, Germany, France and Russia. Like Trump's campaign to denuclearize North Korea (see "Thoughts on North Korea, Fire And Fury Edition" August 11, 2017), *this very belligerently creates an enormous threat*. And like Trump's global trade reform initiatives (see, most recently, "On the March Jobs Report, and New China Tariffs" April 6, 2018), *the threat is costly to both sides if it is actually carried out, and it is held in suspense for a long period to permit negotiations in which Trump holds the whip hand. It is a very aggressive strategy.*

- Withdrawal from the deal means the cancellation of waivers on various sanctions, all based on laws signed over decades by Presidents Clinton, Bush and Obama – and all still in force, but waived since the deal went into effect.
- Many of the sanctions under these laws are simply prohibitions against Americans from doing business with Iran. The waivers for most of these will lapse in 90 days.
- *The most consequential sanctions are those under Section 1245 of the National Defense Authorization Act of 2011* (NDAA), *which punish non-US banks who carry out transactions for purchases of Iranian oil, for any company, in any country, everywhere in the world. For non-US banks, the penalty is effectively being shut out of US financial markets. For US banks or foreign banks operating as US banks, enormous fines can be imposed* – like the $9.3 billion penalty assessed on BNP Paribas in 2015. *The idea, quite overtly, is to destroy the global market for Iran's oil.*
- These highly complex sanctions seem designed intentionally to be impossible to observe – as though to give the US maximum discretion in selectively enforcing them. And they cost the US relatively little, because the US is not an importer of Iranian oil. But for Iran's large customers – in order: China, India, South Korea, Turkey, Italy, Japan, Spain and France – *losing Iran's oil is a real problem: there is no spare capacity to make up for it anywhere except in Saudi Arabia*.

Update to strategic view

OIL, US STOCKS: Withdrawing from the Iran deal means cancelling waivers of pre-existing sanctions, which will impose penalties on banks worldwide in order to shut down Iran's oil exports. This potentially takes as much as 2 million barrels per day out of a global oil market in which there is little spare capacity anywhere except Saudi Arabia, which has already indicated it may help. US shale producers can't help until port capacity bottlenecks are solved. The sanctions won't come into effect for 180 days, during which the door is open to renegotiate the Iran deal, and for countries to get exceptions and extensions as they did with the steel and aluminum tariffs. We reiterate our call for a higher trading range for oil, and likely overshoots. Like North Korea denuclearization and China trade reform, this is another high-return and high-risk Trump negotiation. Markets seem to be getting used to that. But the low-vol days of 2017 are long gone.

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- This likely explains why the Saudi seems to have favored the US pulling out of the deal. Already the Kingdom has announced it may raise output as necessary, regardless of the OPEC production quotas. But if, at the extreme, it has to make up for as much as two million barrels per day of lost Iranian output, well, it just doesn't have the capacity.
- US shale producers have the capacity to produce much more – but for the foreseeable future, their ability to export it where it's needed globally is tightly constrained by lack of port facilities (see "Oil's Bullish Bottlenecks").
- *Much of this has already been discounted, but we stand by our call for a higher trading range for oil, with the possibility of overshoots.*

Discounted yes, but still: why haven't markets acted more panicked about this? There are several safety valves.

- *Waivers for the NDAA sanctions won't lapse for 180 days – a long period during which the Iran deal could potentially be renegotiated. In the aftermath of Trump's announcement, Iran has left the door open to this by playing the victim of US perfidy and reaching out to Western nations, rather than itself repudiating the deal.*
- At the same time, various nations can work with the US to get their own waivers or delays – as most nations did to get out from under the new tariffs on steel and aluminum (see "Getting Away With an Act of Tariffism" March 9, 2018). Already, major European companies that do business with Iran are saying they will seek exemptions, but also that ultimately they will comply if they must.
- Some nations – say, Turkey – may simply not comply, and dare the US to try to do anything about it. Nations may also opt to enact "blocking regulations" that would make it unlawful for their banks to comply with the US sanctions – creating a Gordian knot of conflicting international laws that would take the World Trade Organization years to adjudicate.
- *The US's ability to enforce these sanctions hasn't really been tested.* Shortly after NDAA was enacted, Europe self-imposed its own total embargo on Iranian oil.
- China reduced is imports from Iran in a minor way, under US pressure. But it largely evaded US sanctions with a loophole. NDAA targets "crude" oil, but as a technical matter does not include condensate. A natural gas by-product, Iran produces about 500,000 barrels per day in its Pars Field, in partnership with France's Total. Most of it ships to China, many of whose refineries are optimized for it. Theoretically Trump could close that loophole – which would both be a jab at China, and a boon to Permian and Eagle Ford condensate producers whose global market would surely tighten.
- So here we go again. North Korea. China. Now Iran. All negotiations, the successful resolution of which would make the global economy a vastly more profitable place – and all taking place under a deadly Sword of Damocles.

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Bottom line

Withdrawing from the Iran deal means cancelling waivers of pre-existing sanctions, which will impose penalties on banks worldwide in order to shut down Iran's oil exports. This potentially takes as much as 2 million barrels per day out of a global oil market in which there is little spare capacity anywhere except Saudi Arabia, which has already indicated it may help. US shale producers can't help until port capacity bottlenecks are solved. The sanctions won't come into effect for 180 days, during which the door is open to renegotiate the Iran deal, and for countries to get exceptions and extensions as they did with the steel and aluminum tariffs. We reiterate our call for a higher trading range for oil, and likely overshoots. Like North Korea denuclearization and China trade reform, this is another high-return and high-risk Trump negotiation. Markets seem to be getting used to that. But the low-vol days of 2017 are long gone.