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MACROCOSM

After Soleimani, What If Peace Breaks Out All Over?

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Michael Warren and **Donald Luskin**

#WWIII is one thing – but taking out Middle East oil capacity is a way to support prices.

It's too early to have any real grasp on the likely course of events in Iran and Iraq in the aftermath of the US killing of Iran's Qasem Soleimani. Insight is difficult because this is more than the mere fog of war (is there even a war?) – it's the fog of politics in the Age of President Donald J. Trump. Reporting is completely unreliable. The media has widely reported that the Iraqi parliament voted Sunday "to expel US troops" from Iraq. Follow our "Ninth Paragraph Rule" – and you'll discover that the non-binding vote was to expel all foreign troops, including Iran's. Front-page stories reporting that Iran is abandoning restrictions on nuclear fuel enrichment don't mention at all, even in the seventh paragraph, that the same news outlets had previously reported last year that those restrictions were being violated.

All that said, here are some thoughts. ***We'll make some quick general observations, and then visit the possible consequences for oil prices, markets and the global economy***.

- Nobody can possibly know whether the world is a safer place or a more dangerous place without General Qasem Soleimani in it. There is a strong cognitive bias that doing nothing is always the less-risky course, but one never actually knows. If Iran takes some hostile action now it will be framed as revenge for the killing, and that bias will cause us to think we brought it upon ourselves – but that ignores that there may well have been some hostile action that Soleimani would have taken anyway, had he lived.
- In the aftermath of the killing of Soleimani, the US and Iran are in a war of trash-talk, and we understand that it is very upsetting. But it's not unlike the "fire and fury" episode between Trump and North Korea's Kim Jong-Un in May, 2018. The public uproar then was very similar to today's, and the market reaction was worse. We said at the time that such moments appear to bring nations to the brink of war, yet that is exactly what it takes to create the mutual motivation to make peace (see "Iran Deal: More Fire, More Fury, Pure Trump" May 9, 2018). Matters between the US and North Korea are far from resolved, but we think it is indisputable that the lines of friendly communication that, ironically, were made possible by all that trash-talk have made the world safer.
- While it may seem that killing Soleimani makes peace impossible,

Update to strategic view

OIL, US MACRO: Panic is in the air after the death of Soleimani. But just as with the 2017 "fire and fury" episode with North Korea, such events are more likely indicative of coming peace, not coming war. In terms of oil prices and their effect on the global economy, the risk of a military event in the Middle East leading to an oil price spike is obvious. Yet an equally important risk is that of a price collapse if Soleimani's death leads to a peace that brings Iranian production back online. Attacks on US oil interests in Iraq would reduce production, and create disruptions, but they would clear a path for increased market share for US Permian production, without risking a deflationary collapse in oil prices. We are leaving our price target for WTI as a range of $50 to $60.

[Strategy dashboard]

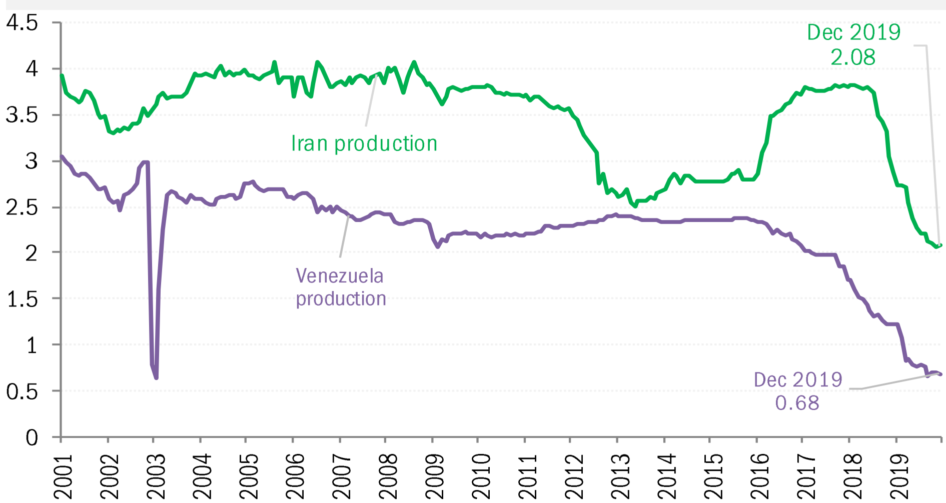
perhaps it's just the opposite. *Perhaps peace is now possible for the first time*, simply because it was he who was making it impossible all along, and now he's gone.

- *It's worth considering such possibilities as a counterbalance to the whiff of panic in the air*. It should tell you something that, over the weekend, #WWIII, #WorldWarThree and #WorldWarThreeDraft became trending hashtags on Twitter, and supposedly drove so much fear of a new US military draft that the Selective Service Administration's website went down from too much traffic.

As we think about the market and economic implications of all this, we can't help but be very much of two minds.

- On the one hand, we are respectful of the conventional view that a sufficiently disorderly series of events in the Middle East could lead to catastrophically higher oil prices. That possibility is so well-understood and so obvious we're not going to spend any time exploring it in detail.
- We're more interested in the view that the global oil market is in a glut, facing stagnant demand growth and an explosion of new production in the US. The central risk is that this glut, if not managed, could lead to *catastrophically low oil prices* that would lead to the kind of "reverse oil shock" the world experienced in 2015 and 2016 – with the obvious "consumer tax cut" more than offset by CAPEX contraction, deflation, rising real interest rates, and widening credit spreads (see "The Recession Caused by Low Oil Prices" January 8, 2016).
- *One way we have managed the oil glut is with OPEC production quotas. But a second and more important way has been the use of sanctions to effectively zero out the oil export capacity of Iran and Venezuela* (please see the chart below, and "The Perfect Moment to Take Out Iran" April 23, 2019).
- *We have joked with clients about this for months. With something*

Crude oil production, millions of barrels per day



Source: Bloomberg, TrendMacro calculations

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like two million more barrels per day to come from the Permian in 2020, what are we going to do next to support oil prices: take out Iraq? At 4.65 million barrels a day, it's OPEC's second largest producer. Maybe…

- *…Maybe Iran does that work for us, by attacking some Iraqi pipelines out of Basra, or Exxon-Mobil's West Qurna fields, all near Iran and Iraq's shared border. Revenge, and all that. In the Permian, they'll call it market share.*
- That's a reprehensible ethical proposition. But just like Iran's attack on Saudi facilities last year, it is a backdoor way to impose production quotas in the grisly *realpolitik* sense that "war is merely the continuation of politics by other means" (see "The Oil Glut Even Drones Couldn't Fix" September 16, 2019).
- And we should be realistic, when the consensus fears war, that *economically there is in fact also a great deal to fear from peace*.
- *Let's say, with Soleimani out of the way, that the US and Iran make peace – Iran reliably gives up its nuclear ambitions, it recognizes Israel, renounces terrorism, and so on. Some scary arithmetic then happens.* We lift the sanctions, and Iranian crude production rises back from the present 2.08 million bbl, back to the 2017 peak at 3.83. At the same time, Permian production rises by another 2 million. Let's say there's a robust China trade deal, which would enable global oil consumption to grow by, say, 1.25 million. *Sounds like there's about 2.5 million barrels per day with nowhere to go if peace breaks out all over.*
- *With all the panic in the air, it's tempting to upwardly adjust our price target for oil – we've left it as a range of $50 to $60 in WTI terms for over a year. As of this writing, it's already above the range, and obviously a military shock in the Middle East could drive it higher, for at least a period.*
- *Unless Iran takes out a lot of Saudi Arabia's capacity, the "Saudi call" still exists. And there is now something of a "Russia call." Brazil is producing more. Guyana has had first production after years of exploration. Some African nations are slowly increasing production. Several offshore projects that were held back, like Norway's Johan Sverdrup field, should be producing hundreds of thousands of barrels in 2020. And then there's the mighty Permian.*
- *So for now, we are leaving our price target intact.*

Bottom line

Panic is in the air after the death of Soleimani. But just as with the 2017 "fire and fury" episode with North Korea, such events are more likely indicative of coming peace, not coming war. In terms of oil prices and their effect on the global economy, the risk of a military event in the Middle East leading to an oil price spike is obvious. Yet an equally important risk is that of a price collapse if Soleimani's death leads to a peace that brings Iranian production back online. Attacks on US oil interests in Iraq would reduce production, and create disruptions, but they would clear a path for increased market share for US Permian production, without risking a deflationary collapse in oil prices. We are leaving our price target for WTI as a range of $50 to $60.