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Rising Geopolitical Risk Bears Watching in Oil Market

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Key Takeaways

- Two attacks on oil tankers in the Gulf of Oman, bringing the total to six in the last several weeks widely believed to be a result of escalating regional tensions after the U.S. pullout from the JCPOA - commonly known as the Iran nuclear deal - are raising the geopolitical risk premium for crude oil.
- Tensions with Iran are likely to escalate further as the leadership there seeks to build a position of strength from which to engage with the U.S.
- Unless further attacks result in a meaningful disruption to global crude flows, the latest indications of weak global demand growth will continue to restrain crude prices.

Latest Attacks on Oil Tankers Could Threaten Global Crude Flows

Geopolitical tensions are being ratcheted up in the Middle East with another attack on two tankers this week in the Gulf of Oman near the Strait of Hormuz, a vital trading route through which about 20% of global crude oil passes daily. The latest attacks make for six tankers targeted by what is widely believed to be Iranian forces over the last several weeks.

With tensions rising, it is reasonable to see some geopolitical risk premium priced into oil after the pullback over the past month. However, we are not seeing a major disruption in global crude flows, yet. The supply-demand differential is not very tight and the impact on prices is likely to be muted by the ongoing weakness in demand and rising inventories. If tensions escalate to the point of meaningful disruption of physical flows of crude from the Middle East, then the impact on oil prices and energy share prices would be significant.

On June 13, OPEC revised its 2019 demand growth forecast down by 70,000 barrels per day (BPD) to 1.14 million BPD. The International Energy Agency is still modeling 1.3 million BPD growth for 2019, but we would not be surprised to see a downward revision to this forecast considering that demand growth slowed to 0.7 million BPD in 4Q18 and 1Q19, requiring a substantial ramp up for the balance of the year to get to the current forecast. To highlight this, copper prices – an indicator of industrial activity in China which accounts for about one-third of demand growth in a typical environment - have slumped near 52-week lows. At the same time, U.S. crude, distillate and gasoline inventories have loosened, with the potential for U.S. shale supply to step up following a slow start to the year.

The situation with Iran needs to be watched as tensions could continue to escalate considering that the failure of the Joint Comprehensive Plan of Action (JCPOA), commonly known as the Iran nuclear deal, and the resulting pressure on the economy, with inflation as high as 50% likely giving more voice to the hardliners. Gradual ratcheting up of actions would not be surprising especially if Iran and its partners do not see a path to increasing crude exports in avoidance of U.S. sanctions. The concern around this strategy is that it lends itself to miscalculation on the part of Iran or the U.S., which in turn can have a more meaningful impact on the oil markets.

About the Author

Dimitry Dayen, CFA
Director, Senior Research Analyst for Energy

- 14 Years of investment industry experience
- Joined ClearBridge Investments in 2014
- BA from New York University's Leonard N. Stern School of Business
- Member of the CFA Institute

ClearBridge Investments
620 Eighth Avenue, New York, NY 10018 | 800 691 6960 | **ClearBridge.com**