Oil soars on Middle East escalation

Oil prices rallied more than 7% this morning after Israeli airstrikes against Iran. This has elevated geopolitical uncertainty significantly and requires the oil market to price in a larger risk premium for any potential supply disruptions

Israel strikes Iran

Israel has started conducting strikes against both Iranian nuclear facilities and military targets.

These attacks come at a time when the US and Iran are holding ongoing nuclear talks. Admittedly, there appeared to be little progress in these discussions recently, with both sides far apart. However, talks were set to continue this weekend. After these latest developments, it's not clear if they will still go ahead. It is also worth mentioning that the US has stated that it has had no involvement in the strikes against Iran.

This is a significant escalation and differs from the strikes we saw last year, which spared Iranian nuclear sites. This will certainly lead to some form of retaliation from Iran against Israel. It will only lead to further uncertainty and increase the risk that regional energy supplies are disrupted due to the escalation.

While there are no reports of disruptions to oil supply, the market needs to start pricing in a larger risk premium.

How much oil supply is at risk?

Iran is a meaningful oil producer, pumping 3.3m b/d of crude oil and exporting in the neighbourhood of 1.7m b/d. In a scenario where we see further escalation, it's not too difficult to envisage a situation where Iranian oil supplies are disrupted.

What impact this would have on the oil market depends on whether downstream assets are affected or if midstream and upstream assets are targeted. The latter would have more of an impact on the global market, putting as much as 1.7m b/d of export supply at risk. This would be enough to push the oil market from a surplus over the second half of this year into a deficit. It would prompt some fairly aggressive price revisions higher. This scenario could see Brent spiking to $80/bbl, although we believe prices will likely settle around $75/bbl. Much will depend on the supply response we see from other producers.

The Strait of Hormuz risk

In a scenario where we see continued escalation, there's the potential for disruptions to shipping through the Strait of Hormuz. This would impact oil flows from the Persian Gulf. Almost a third of global seaborne oil trade moves through the Strait of Hormuz. While some portion of oil flows could be diverted to avoid the Strait, it still leaves roughly 14m b/d of oil supply at risk. A significant disruption to these flows would be enough to push prices to $120/bbl. If disruptions persist towards the end of the year, we could see Brent trading to new record highs, surpassing the record high of close to $150/bbl in 2008.

Any disruptions to shipping through the Strait of Hormuz would also have a significant impact on the global LNG market. Qatar, which makes up around 20% of global LNG trade, uses this route to export LNG. Unfortunately, there is no alternative route. This would leave the global LNG market extremely tight, pushing European gas prices significantly higher.

How to make up for any potential supply shortfalls?

Any significant supply disruptions which push oil prices meaningfully higher. This would likely see governments around the world tapping into their strategic petroleum reserves. This would obviously have to be led by the US, which sits on more than 400m barrels of crude oil in its SPR.

The other solution would be OPEC tapping into its spare production capacity. OPEC has spare capacity of more than 5m b/d, and while they are in the process of bringing supply back online, a disruption to Iranian supply may prompt them to bring this supply back at an even quicker pace.

It's important to note that while OPEC can provide a buffer to the market in the case of a loss in Iranian oil supply, it becomes more difficult if tensions spread. The bulk of spare production capacity sits in the Persian Gulf. So, if we are seeing disruptions to oil flows through the Strait of Hormuz, this spare production capacity will be of little help to the global oil market. Given the importance of the Strait, any disruptions would lead to a more globally coordinated response to ensure that energy flows at this chokepoint are not severely disrupted.

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