Iran-U.S. conflict

Regional instability set to rise

9 JANUARY 2020

ALEXIS GARATTI
Head of Economic Research
Alexis.Garatti@eulerhermes.com

MANFRED STAMER
Senior Economist
Manfred.Stamer@eulerhermes.com

EXECUTIVE SUMMARY

- The elimination of Iranian General Qassem Soleimani after a targeted U.S. airstrike could be a game-changer for the whole stability of the Middle East. An escalation of the conflict between the U.S. and Iran seemed to be irreversible, as evidenced by the launch of ballistic missiles by Iran targeting U.S. troops. However we don't expect a scenario of a full-fledged war, as confimed by a more conciliatory tone of communication recently adopted by President Trump.
- In the short-term, we expect a contained impact on oil prices, growth and inflation. Our model suggests an upward revision of our central oil price scenario from 62 USD/bbl to USD 65.5 in 2020. A short-lived temporary peak of 100 USD/bbl is conceivable should a situation of extreme tensions re-occur repeatedly. A sustainable increase of 10 USD/bbl in oil prices would cut global growth by around -0.1pp per year and increase global inflation by +0.3pp per year.
- In the medium-term, U.S. foreign policy is likely to continue being a source of uncertainty. The U.S. is progressively disengaging from being an important provider of world public goods (of security), President Trump's foreign policy could be influenced by domestic factors such as the impeachment proceedings or 2020 Presidential elections, while the theory of game (maximax players) or US history (Nixon Madman Theory) show us how difficult it is to deal with unpredictable presidents. The confrontation between Iran and the U.S. is likely to remain high over the next months, while uncertainty originitating in the US will weigh on global growth.
- What does it mean for markets? Inflation expectations and equity markets are expected to react to short-term volatility only, as the negative impact on fundamentals is likely to remain limited. According to our estimates, a stabilization of oil prices at 80 USD/bbl at an horizon of one year would only trigger a correction of 2% of MSCI world. However, the negative impact on the MSCI world index increases significantly after one year, to -9% (after 20 months) should oil prices remain at 80 USD/bbl. Given the fact that we describe a regime of higher uncertainty, gold prices are the likely winners of this situation.

On 3 January 2020, the U.S. killed General Qassem Soleimani, the Head of Iran's Islamic Revolutionary Guards Corps, in a targeted airstrike at Bagdad airport in Iraq. Jamal Mohammad Jaafar al-Tamimi, also known as Abu Mahdi al-Muhandis, the Iraqi deputy commander of the Popular Mobilisation Units (PMUs) and commander of the Iranian proxy Kataib Hizbullah in Iraq, was also killed. Soleimani was widely considered to be the second most powerful man in Iran behind Supreme Leader Ali Khamenei. The latter promised 'harsh vengeance' for the assassination. On 8 January 2020 (2am local time), Iran carried out missile attacks on two Iraqi air bases housing U.S. forces, in retaliation for the killing of Soleimani, declaring the assault as an act of self-defense. This was the most direct attack by Iran on the U.S. since the seizing of the U.S. embassy in Tehran in 1979. At the end of the day, President Trump mentioned that there were no victims in targeted sites and adopted a rather more conciliatory tone of communication, while confirming further sanctions on Iran.

Limited impact on oil prices, growth and inflation

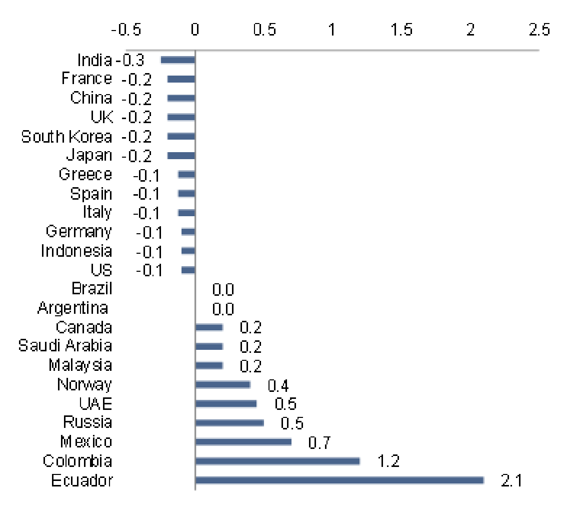
The most obvisous consequence of the escalation between the US and Iran deals with oil prices. A new regime of uncertainty will be key in regards to the fluctuations of oil prices. We use the US Economic Policy Uncertainty index as a proxy of global political uncertainty and introduce this variable in an equation estimating the log of oil prices in function of other variables such as the log of the US GDP and the log of Dollar index.

Our estimates show that an increase by 1% of this proxy of global political risk triggers an appreciation by 0.25% of oil prices. We assume a long-lasting change in the current regime of uncertainty embodied by a yearly rise of 25% in our political risk indicator. In this case, oil prices are expected to increase by USD 3.5 per barrel. This is the reason why we decide to revise our central scenario for oil prices in 2020, from USD 62 per barrel to USD 66. A peak at 100 in the case of extreme tensions is conceivable considering the level of risk, should the EPU Index hit record-high observed in recent years.

A sustainable increase of 10 USD/bbl in oil prices would cut global growth by around -0.1pp per year and increase global inflation by +0.3pp per year

Higher oil prices would have a negative impact on oil importers (India, China, France) but favor oil exporters. We estimate that 10 USD/bbl higher oil prices would cut real GDP growth by -0.2pp per year for the Eurozone and China and by around -0.1pp for the US (see Figure 1 below). The main channel would be a squeeze in household purchasing power lowering consumer spending. Besides the oil sector, beneficiaries would be renewable energy/power generation, construction in oil exporting countries, while consumer-oriented sectors would be hit. In terms of inflation, were oil prices to rise durably to 80 USD/bbl, reflationary pressures should take over. In the Eurozone for example, inflation should increase to 1.8% in 2021 from the current 1.5% expected. In general a 10% increase in oil prices push global inflation up by +0.4pp per year.

Figure 1: Impact on GDP growth after 1year from a permanent increase in oil price of USD10bbl



Sources: IHS Markit, Allianz Research

This uncertainty is likely to last over the medium-term

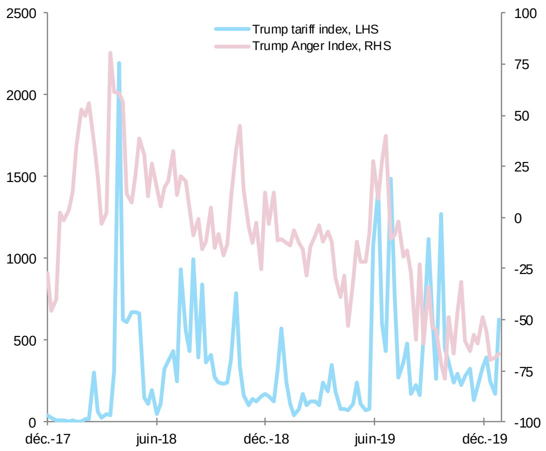
In our view, this event provides another illustration of what we annouced as being an important feature of the economic cycle in 2020. We indeed expect the U.S. foreign policy to be an external disturbance on global trade and investment via what we call a shock of uncertainty. Since the election of President Trump at the end of 2016, we have observed a major shift in this foreign policy as the U.S. does not assume anymore its historical function of being a major provider of world public goods. The latter deal with contributing to maintaing security via military interventions, promoting trade via the WTO, preserving economic stability via the IMF, and organizing a global coordination of economic policies via the G20. After the arrival of

President Trump, the U.S. foreign policy switched from being the most active provider of world public goods to prioritizing the "America first policy". The recent deterioration of the geo-strategic climate in the Middle East, epitomized by this extreme level of tension with Iran, directly results from these new orientations, which led, as main consequences, to a stronger influence of Turkey, Russia and Iran in the region. The impression that the situation in the Gulf has a lower strategic importance for the U.S. could also be reinforced by the fact that the US is now a net oil exporter.

The decision of targeting General Qassem Soleimani has also to be placed in the context of U.S. domestic affairs, which are currently dominated by the debates surrouding the impeachment proceedings. President Trump is likely to deal with this issue in the following manner:

- By using the proceedings as a platform of communication to discredit Democrats.
- By adopting a victimization strategy in order to benefit from the support of all Republicans.
- By being influenced by domestic affairs in his foreign policy. In a same vein, President Clinton was accused in 1998 to instrumentalize airstrikes in Iraq War to draw public opinion's attention away from his own impeachment. Even if this kind of ideas are simplistic, we have identified a certain link between domestic affairs and orientations of external policy in the US. We have in particular developed a President Trump's Anger Index (taking into account the performance of the equity market, the fluctuations of the USD and President Trump's approval rate), which shows a certain correlation with the number of his tariff policy initiatives (see Figure 1).
- By purposely making hostile countries think that he is irrational and unpredictable (Nixon Madman Theory) in order to avoid attacks. In our view, President Trump could be compared with a maximax player. In the theory of games, the maximax player maximizes his expected gains with a lower consideration for the level of risk. In trade and military negotiations, it can be demonstrated that the best strategy, when playing with this kind of player, consists of buying an insurance (doing concessions) in order to avoid the most adverse scenarios that the maximax player is ready to envisage.

Figure 2: Trade tariffs initiatives (number of times that articles in Bloomberg mention the words "Trump" and "tariffs") and President Trump's anger index (in function of USD, equity and approval changes)



Source: IHS Markit, Bloomberg, Allianz Research

Regime of higher instability and uncertainty in the Middle East region

The killing of Soleimani has escalated the already high Iran-U.S. tensions, reignited frictions in the Middle East in general and raised fears of a full-blown conflict between Iran and the U.S. The following are likely consequences of the incident.

Iran is likely to further retaliate against the U.S. Anything in the Middle East region that is linked to the U.S. or allies (e.g. embassies, companies, high-level officials, troops, citizens) is at high risk to be targeted. But targets outside the region are also at risk (as occurred after the assassination of Iranian nuclear scientists 2010-2012 when Iran attempted attacks in Azerbaijan, Bulgaria, India and Thailand). This consequence was confirmed with the launch of missiles on U.S. troops located in Iraq. However, given the significance of General Soleimani, this military strike appears to be a modest response, although Iranian authorities characterized the attack as being "proportionate". Hence it is not certain if this was the end of Iran's retaliation. Only time will tell.

As a consequence of any Iranian retaliation, the U.S. is very likely to retaliate in return. Any U.S. reaction could be forceful, as the killing of Soleimani indicates a shift by the U.S. from mediation (multiple mediations between Iran and the U.S. via several third countries were underway while the assassination took place) to direct confrontation. A targeted intervention against Iranian assets on Iranian soil (e.g. oil and nuclear infrastructure) or against Iranian oil tankers is possible. President Trump mentioned the fact that the US administration had identified 52 targets in Iran. Such tit-for-tat retaliation could eventually spiral out of control, resulting in a full-blown war. Yet, while the probability of such a scenario has increased following the January 3rd incident, it is not our base scenario. First, Iran does not want a full-blown war as it has a good understanding of the U.S. military power and has a history of easing off when facing a vast military threat. Second, U.S. President Trump still wants to avoid a large-scale military engagement, especially in an election year. He confirmed this impression by adopting a more conciliatory stance during his press conference of January 8th 2020.

The state of the Iranian economy is another reason why Iran will likely want to avoid an all-out war. The re-imposition and extension of U.S. sanctions since May 2018 has moved the country into extensive international isolation and the economy into dire straits. Real GDP contracted by -5% in fiscal year 2018/19 and is set to drop by another -7% in 2019/20 and should shrink further thereafter. The Iranian Rial has lost 70% of its value vs. the USD on the black market (the official rate has been kept steady) since May 2018, resulting in persisting high double-digit inflation (30% in 2018, 40% in 2019). Full-fledged sanctions on oil exports have curbed Iran's fiscal revenues and constrain the budget that can be allocated to financing a war.

However, Iran will accelerate its non-compliance with JCPOA (the Iran nuclear deal). Iran's non-compliance had already begun in 2019 after the U.S. withdrew from the deal in 2018. The killing of Soleimani should have convinced Iran that a rescue of the deal is highly unlikely now.

Iran is likely to intensify its targeting of oil infrastructure and shipping of GCC states that are strongly linked to the U.S., notably Saudi Arabia, but also the UAE and Kuwait. A blocking of the Strait of Hormuz is also possible.

Iran-aligned militias in the Middle East region (such as Hezbollah in Lebanon, Hamas and Islamic Jihad in Gaza) are likely to maintain their current level of attacks against Israel. This means that Hezbollah will likely continue to launch drones and/or missiles from Syria against Israel but refrain from attacking Israel from within Lebanon, and Israel refrains from attacking Lebanon and Hezbollah, so that both sides avoid a full-scale war. Attacks by Hamas and the Islamic Jihad should remain limited to short-range rocket fire at civilian settlements bordering Gaza. However, if a full-blown war between Iran and the U.S. breaks out, it is almost certain that Hamas, Islamic Jihad and Hezbollah would join in a war against Israel.

In Iraq, pressures will mount that the U.S. and other NATO troops shall leave the country. There is already a non-binding vote of the Iraqi parliament in support of ordering U.S. forces out of the country. Moreover, Iran-backed militias in Iraq are likely to intensify attacks on U.S. bases as well as U.S. companies (especially Exxon and oil service companies) in the near future. Eventually, it is also possible that U.S. and other NATO troops will leave the country. This will result in greater influence of Iran in Iraq, contrary to the U.S. intentions. In the north of Iraq, it could also result in a resurgence of IS, thereby raising instability in Iraq again.

Syria may come increasingly under the influence of Russia and Turkey. A U.S. withdrawal from Iraq would also undermine the supply chains for its troops in the north of Syria so that the U.S. may also withdraw from that region. Russia's actions in the region hitherto have already led to greater influence there and it is likely to increase further.

All in all, the killing of General Soleimani on 3 January 2020 is highly likely to result in a stepped-up confrontation between Iran and the U.S. with more lethal skirmishes over the next months. The confrontation is most likely to remain controlled (base scenario) but the risk of a full-blown war between the two sides is not negligible and should be taken into account when doing business in the region. In any case, already high regional instability in the Middle East has further increased.

Temporary impact for the markets

In terms of impact on inflation expectations or reaction of the equity market, the upward revision of our central oil price scenario is not significant enough for now to imply drastic changes besides the usual short-term volatility accompanying similar events. According to our estimates, a stabilization of oil prices at 80 USD/bbl at an horizon of one year would only trigger a correction of 2% of MSCI world. However, the negative impact on MSCI world increase significantly after one year, to -9% (after 20 months) should oil prices remain at 80 USD/bbl. Given the fact that we describe a regime of higher uncertainty, gold prices are the likely winners of this situation.

ABOUT ALLIANZ

The Allianz Group is one of the world's leading insurers and asset managers with more than 86 million retail and corporate customers. Allianz customers benefit from a broad range of personal and corporate insurance services, ranging from property, life and health insurance to assistance services to credit insurance and global business insurance. Allianz is one of the world's largest investors, managing over 650 billion euros on behalf of its insurance customers while our asset managers Allianz Global Investors and PIMCO manage an additional 1.4 trillion euros of third-party assets. Thanks to our systematic integration of ecological and social criteria in our business processes and investment decisions, we hold the leading position for insurers in the Dow Jones Sustainability Index. In 2017, over 140,000 employees in more than 70 countries achieved total revenue of 126 billion euros and an operating profit of 11 billion euros for the group.

ABOUT EULER HERMES

Euler Hermes is the global leader in trade credit insurance and a recognized specialist in the areas of bonding, guarantees and collections. With more than 100 years of experience, the company offers business-to-business (B2B) clients financial services to support cash and trade receivables management. Its proprietary intelligence network tracks and analyzes daily changes in corporate solvency among small, medium and multinational companies active in markets representing 92% of global GDP. Headquartered in Paris, the company is present in over 50 countries with 5,800+ employees. Euler Hermes is a subsidiary of Allianz, listed on Euronext Paris (ELE.PA) and rated AA- by Standard & Poor's and Dagong Europe. The company posted a consolidated turnover of €2.6 billion in 2016 and insured global business transactions for €883 billion in exposure at the end of 2016. Further information: www.eulerhermes.com, LinkedIn or Twitter @eulerhermes.

These assessments are, as always, subject to the disclaimer provided below.