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CIO Viewpoint

US/Iran nuclear talks still key to oil market outlook

Investment Solutions

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The Biden administration took office this year with plans to reverse many of its predecessor's policies. High on that list is returning the US to the 2015 accord limiting Iran's nuclear work in return for easing economic sanctions. Any nuclear deal would see Iranian oil return to the international market, capping prices as global supply increases. However, in the short-term, neither side wants to move first.

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Key takeaways

- The US and Iran are re-negotiating a 2015 nuclear deal; that may see Iranian oil return to the international market
- Regional tensions have increased as Iran continues to enrich uranium. The country holds presidential elections on 18 June
- Oil prices have hit two-year highs on returning demand and OPEC+ continues to increase supplies
- Further sustained price gains look limited, given the spare capacity. We maintain our USD 60 to 70 per barrel expectation for Brent crude over 12 months.

Donald Trump took the US out of the nuclear accord with Iran in 2018, formally the Joint Comprehensive Plan of Action (JCPOA), arguing that he could force the country to abandon nuclear development through tougher sanctions. The former US president targeted Iranian banks' ability to transact internationally and blacklisted the country's central bank and national oil company.

The US has imposed sanctions on the Iranian economy intermittently since the Islamic revolution of 1979. The first sanctions targeting Iran's nuclear programme date from 1995, in line with a United Nations resolution designed to prevent the country from building atomic weapons.

Sanctions outlawing trade and financial transactions increased consumer prices to Iranians, undermined the safety of the country's civil airlines and cut the supply of medical equipment and treatments. One of the sanctions' side effects was not foreseen in Washington. Restrictions on Iranians' access to international currency has created a market for cryptocurrency mining that drained Iran's electricity network and led to blackouts. In response, President Hassan Rouhani last month announced a national ban on crypto mining until 22 September 2021.

Non-compliance

On 23 February this year, Iranian authorities informed the body responsible for monitoring countries' nuclear activities, the International Atomic Energy Agency (IAEA), that it would no longer comply with the JCPOA and began to restrict monitoring. Iran says its enrichment programme is for peaceful purposes.

On the eve of renewed negotiations last week in Vienna, the IAEA expressed concerns. A lack of clarity, access and answers "seriously affects the ability of the Agency to provide assurance of the peaceful nature of Iran's nuclear program," the IAEA wrote.

Since February, Iran has produced uranium enriched to 60%, closer to the purity needed for nuclear weapons, according to an IAEA report. Uranium with a concentration of 3% or 4% of fissile isotope U-235 can be used to fuel nuclear power plants. Weapons grade uranium needs to be enriched to 90%. Since Donald Trump withdrew the US from the accord in May 2018, Iran's stockpile of 5%-enriched uranium has more than doubled (see chart).

The nuclear talks in Vienna ended on 2 June with a commitment by diplomats to return this week for a sixth and final round. The US and Iran both need to take "hard decisions" that may be domestically unpopular, according to the European Union's chief negotiator, Enrique Mora.

Accidents or sabotage

Talks come as tensions around the Iranian nuclear enrichment programme intensify. Iran has accused Israel of a series of efforts to sabotage its programme. That includes assassinations of experts working on the project, most recently of the leading Iranian nuclear scientist, Mohsen Fakhrizadeh, in November 2020. Since the US pledged to re-negotiate the nuclear accord with Iran, Israel and Iran have accused one another of a series of incidents. Most recently, on 2 June, the Iranian navy's largest vessel by tonnage caught fire and sank in the Gulf of Oman, and the same day a fire erupted at a state-owned oil refinery outside Tehran.

Any solution is complicated by the politics of the Middle East. Israel has opposed lifting sanctions on Iran unless a deal tackles both weapons and support for proxy conflicts in the region. In the meantime, Israel is navigating its own political turmoil. Prime Minister Benjamin Netanyahu was challenged last week after a total of 15 years in office since 2009. A coalition including nationalists and representatives of Israel's Arab minority assembled with little more than their opposition to Mr Netanyahu in common. As we publish, the coalition is working to form a government and the parliament may move to vote on 9 June, according to its speaker.

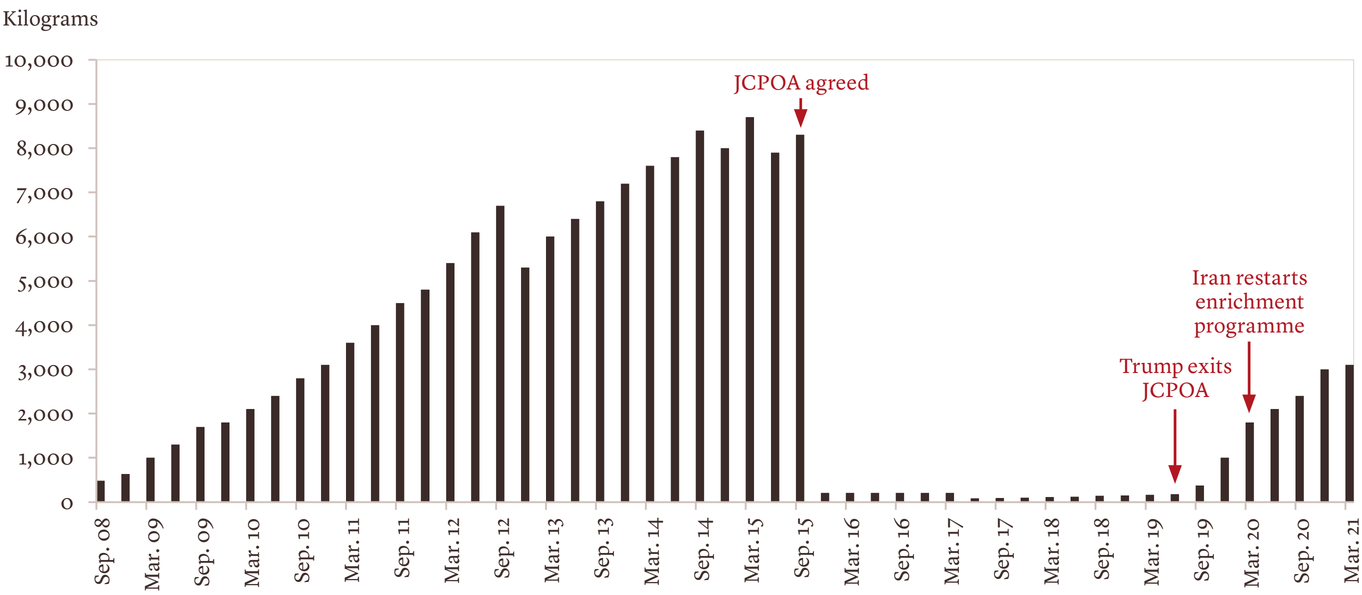
Presidential election window

For the US, there is a short-term incentive to make progress. On 18 June, Iranians will elect a new president as the second term of Mr Rouhani ends. Iranian electoral authorities have announced seven candidates for the election from a list of 592 applicants. The list, approved by Supreme Leader Ayatollah Ali Khamenei in late May, indicates that the next president is likely to be a hardliner opposed to a nuclear deal and further engagement with the West.

The leading candidate, Ebrahim Raisi, is a cleric and the current head of the country's judiciary. Mr Raisi has the backing of almost three-quarters of those planning to vote, according to the Fars news agency.

Still, polls suggest that a choice limited to hardliners will lead to low levels of turnout. Almost one third of the 59 million eligible Iranians say that they do not plan to vote.

Iran's 5% enriched uranium stockpile (in kilograms)



Source: IAEA data, compiled by Bloomberg

Over a barrel

International oil markets are paying close attention to the prospect of renewed Iranian exports. An estimated 1.5-to-2 million barrels per day (bpd) of Iranian crude are excluded from the market by sanctions. Were sanctions to be lifted, Iran may supply between 0.5 and 1 million barrels per day to the oil market.

The Organisation of the Petroleum Exporting Countries and allies (OPEC+) agreed last week to maintain their plan to increase supplies through July. A year after the cartel made a record 9.7 million barrels per day cut in response to economic shutdowns, the producing nations collectively decided to increase supply by more than 2 million bpd over the next three months. Brent crude oil prices have reached USD 72.22 per barrel, their highest level in more than two years, bringing the increase to 27% this year.

With OPEC+ holding spare capacity, Russia not back to pre-pandemic production levels and US shale oil rebuilding balance sheets, potentially allowing them to increase output later this year, the world is not running out of physical oil.

With all of these factors capping price rises, there are reasons to expect credit and equity-related assets as well as the currencies of oil exporters to benefit from current prices.

The risk to this scenario is that competing interests within OPEC+ may be exacerbated by a unilateral Iranian return to international oil markets. Iran is already exporting some oil, albeit discretely. S&P Global Platts, a commodity data provider, estimates that Iran has skirted US sanctions with exports of between 400,000 and 900,000 barrels of crude per day to China this year.

OPEC+ members appear to be comfortable with higher oil prices and do not expect any return of US shale production – or Iranian oil - to international markets in the very near future. The cartel has a policy of reacting to market demand rather than anticipating changes, which may trigger a short-lived overshoot in oil prices.

“There will always be a good amount of supply to meet demand, but we’ll have to see demand before you see supply,” Saudi Energy Minister Prince Abdulaziz bin Salman said on 3 June.

Any further sustained price gains look limited, given the still high inventories and volume of spare capacity in OPEC+. Prices remain supported by market expectations for rising demand as economies re-open. Investor fears of inflation are also driving financial support for oil prices as a hedge. Over the next 12 months, we expect Brent crude to trade between USD 60 to 70 per barrel.

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