May 16, 2018

Oil Prices Surge On Tight Market, Iran Deal Fears

- **Rallying oil contracts supported the commodity complex in April, with prices rising still further through May as President Trump's withdrawal from the Iran Deal stoked geopolitical risk premia.**
- **Beyond headline fears, the reimposition of US sanctions against Iran is expected to shave roughly 0.4 MMbpd off the country's oil exports (chart 1), far less than the 1.2 MMbpd hit Iranian exports took following the application of broad-based multilateral sanctions in 2012.**
- **Saudi Arabia and Kuwait have pledged to work with OPEC+ to relieve potential Iran-related tightness, muting market impacts; however, any sanctions relief comes as OPEC+ is expected to raise production in 2019, which will leave spare capacity low and support prices.**
- **Near-term price impacts related to the Iran Deal will likely be driven by sentiment and higher geopolitical risk premia, rather than a true loss of barrels to the physical market; in the longer term, sanctions will exacerbate future market shortages given tighter OPEC spare capacity as well as a far slower pace of Iranian production capacity growth.**

The Scotiabank Commodity Price Index advanced 2.1% m/m in April as robust gains in the Oil & Gas Index (+11.2% m/m) more than outweighed weakness in the Metals & Minerals (-4.2%) and Agriculture indices (-2.4%). WTI oil prices rallied $5/bbl through April to close the month at $69/bbl, stoked by a fundamentally tight market and a rising risk premium related to the anticipated US withdrawal from the Iran Deal.

Market concerns proved correct and President Trump nixed the Iran Deal in early May. Fundamentally-driven crude price gains have been supercharged by concerns over Iranian exports and the President's particularly hawkish rhetoric, with global benchmark Brent crude pushing $80/bbl (WTI $72/bbl) for the first time since before prices collapsed in 2014 (chart 2).

IRAN SANCTIONS REDUX: WHERE WILL OIL PRICES GO FROM HERE?

The oil market again finds itself in the throes of familiar political risk management after President Trump unilaterally withdrew the United States from the Iran Nuclear Deal—formally titled the Joint Comprehensive Plan of Action (JCPOA)—on May 8th, calling the agreement "defective at its core". Beyond the wide-ranging political and security implications, the key question for oil prices is: how will this impact Iranian exports? How many barrels are we going to lose and how quickly will they fall out of the market? Our base case scenario sees roughly 400 kbpd of Iranian oil—mostly the crude currently flowing to European refineries, as well as some of the volume heading for South Korea and Japan—lost to the market through November 2018 because of US sanctions snapback, though Saudi Arabia and its allies have stated their ability and willingness to fill in for displaced Iranian barrels and mute any sanctions impact to the physical oil market. Ultimately, the impact to oil balances will be determined by three key factors, including: 1) the severity of US sanctions enforcement, 2) the pushback from countries currently importing Iranian crude, and 3) OPEC+ supply relief.

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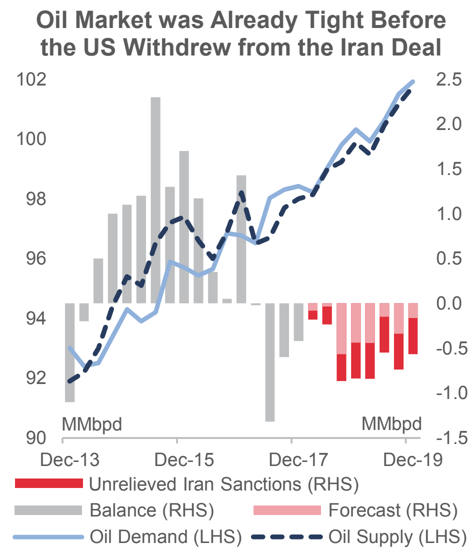
Chart 1



Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

Table 1

Scotiabank Commodity Price Index

April 2018	(% change)		
	M/M	Y/Y	YTD
All Commodity*	**2.1**	**13.0**	**9.6**
Industrials	**3.2**	**14.0**	**9.7**
Oil & Gas	11.2	16.1	9.1
Metal & Minerals	-4.2	6.4	2.4
Forest Products	2.9	23.6	25.5
Agriculture	**-2.4**	**8.3**	**9.1**

January 2007 = 100	2018		
	Apr	Mar	YTD avg.
All Commodity	**122.7**	**120.2**	**120.4**
Industrials	**119.8**	**116.1**	**117.1**
Oil & Gas	100.3	90.2	93.1
Metal & Minerals	122.8	128.2	128.2
Forest Products	166.6	161.9	159.8
Agriculture	**139.1**	**142.5**	**138.5**

* Weights: Oil & Gas (39.9%), Metal & Minerals (30.1%), Forest Products (14.7%), Agriculture (15.3%); Full technical note on page 7.

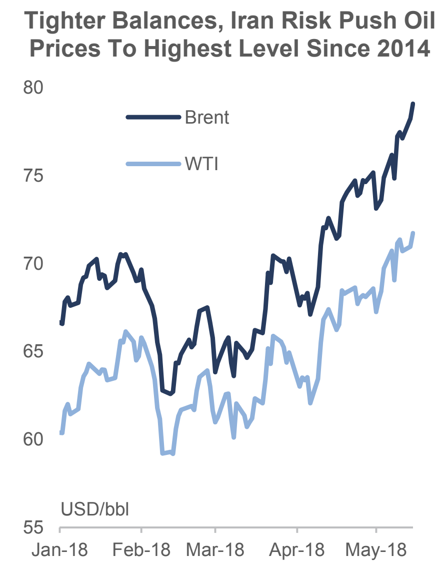
VIEW FROM WASHINGTON: HOW FAR WILL THE WHITE HOUSE GO?

It is hardly surprising that Trump scuttled the JCPOA. The President has been a long-standing opponent of the deal, repeatedly lambasted its failings on the campaign trail as well as through his first year in office, and recently appointed Iran hardliners to two of the highest foreign policy positions in government: Secretary of State and National Security Advisor. Equally unsurprisingly, the move was opposed by traditional US allies including the United Kingdom, France, and Germany, and supported by Iran's regional rivals including Israel and Saudi Arabia. While the US withdrawal from the Iran Deal was widely expected, the hawkishness of the President's speech caught the market off guard. Despite paying lip service to a desire to work with Iran toward a better deal, Trump pressed the need for a much more comprehensive agreement covering the regime's ballistic missile program, Tehran's regional posture, and terrorism, in addition to tightening existing restrictions of Iran's nuclear program. These demands go far beyond the initial, more modest goals of the JCPOA—namely, preventing an Iranian bomb—and officials in Tehran have indicated that the country has no interest in renegotiating new terms with Washington.

Despite not importing a drop of Iranian crude in decades, the United States has considerable power to dent the regime's oil exports by imposing secondary sanctions on third-party countries conducting business with Iran. When US efforts last ramped up in 2012, sanctions stymying Iran's ability to insure its tankers and financial restrictions related to the purchase of Iranian crude (either settled in US dollars or by firms with a US presence) proved to be the primary vectors impeding Iranian oil market access. Following the US JCPOA exit, we expect that payments and insurance will again serve as the key hurdles that Tehran will need to overcome in order to get its hydrocarbons to market. Current importers of Iranian crude will have 180 days to wind down purchases and may be able to secure exemptions to continue purchasing Iran's oil after the grace period ends, but the granting of said exemptions will be determined, in part, by the entity's proactive efforts to reduce Iranian crude exposure through the course of the 180-day grace period. This means that while sanctions are unlikely to directly bite into Iranian exports before November 4th, indirect reductions are expected to begin over the coming months as importers begin to position themselves for exemption applications.

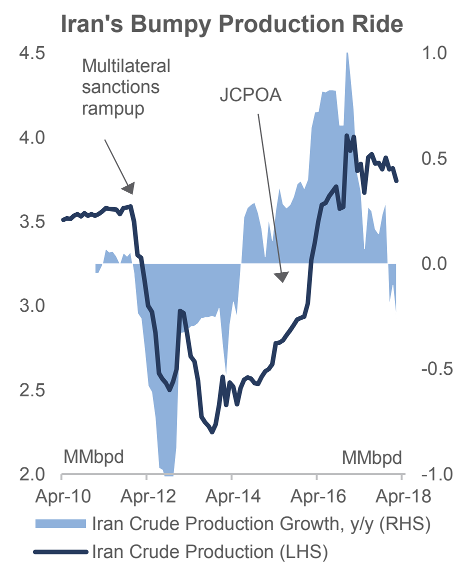
It remains to be seen if Trump's hardline rhetoric will translate to strict sanctions enforcement, but recent diplomatic history—NAFTA negotiations, TPP flip-flopping, North Korean rapprochement, China trade tariffs, etc.—indicates the likely need to downplay hardline expectations based on the hawkishness of the initial statement. It is also notable that Washington did not trigger the formal snapback provision of the JCPOA, which would have pressed other JCPOA signatories to follow the US lead, opting instead for a unilateral withdrawal. Regardless of US enforcement intensity, carrots are typically better motivators in international affairs than sticks; forced cooperation with an unpopular, unilateral US re-sanctioning of Iran is almost certain to have a more muted impact relative to the post-2012 experience. In 2012, sanctions followed multi-year efforts by both the Bush and Obama administrations to build support among the international community, and Iranian exports quickly fell by 1.2 MMbpd (chart 3). Today, most of those same countries have committed to trying to make the JCPOA work and the International Atomic Energy Agency (IAEA), which was tasked with monitoring Iran's post-JCPOA nuclear activities, maintains that Tehran remains compliant with the deal's terms, complicating any legal justification that Washington may advance in an effort to build future multilateral support.

Chart 2



Source: Scotiabank Economics, Bloomberg.

Chart 3



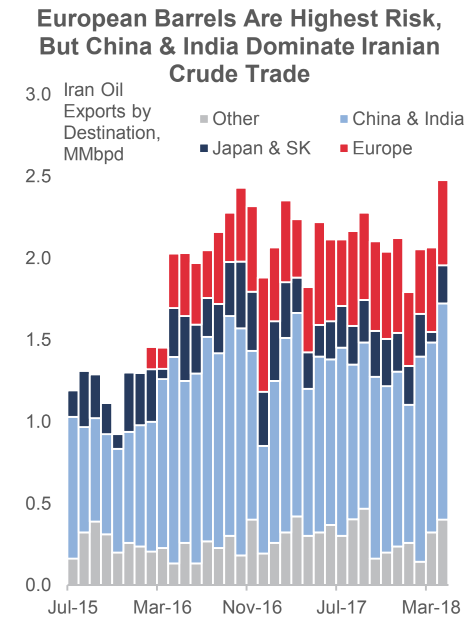
Source: Scotiabank Economics, OMI.

CONSUMPTION, PRODUCTION JUNCTION: HOW ARE IRAN'S CUSTOMERS AND COMPETITORS GOING TO REACT?

Iranian oil exports reached 2.5 MMbpd in April, more than double what the regime was exporting at the end of 2015 before the JCPOA was implemented. Nearly two-thirds of those shipments sail east to Asia and one-fifth head west to Europe, with the balance being absorbed by Iran's regional neighbours including Turkey and Syria (chart 4). We anticipate that the barrels at highest risk of displacement following the US withdrawal from the JCPOA are the roughly 500 kbpd currently being imported by European refineries, and our base case sees a 70% reduction in those volumes. European imports were the fastest to fall off following the 2012 sanctions ramp-up, but much of that was due to coordinated European support; today, we expect smaller though still significant reductions in European imports of Iranian crude despite opposition from EU governments, mostly due to the difficulties surrounding USD settlements, trade financing, and tanker insurance. We also see modest declines in Japanese and South Korea imports given those countries' interest in maintaining a strong relationship with Washington during nuclear negotiations with North Korea; prior sanctions used a rough 20% reduction benchmark as indicative of a country's attempt to diversify away from Iranian crude, which is a prerequisite for an exemption application. Other consumers of Iranian crude (China, India, Turkey, etc.) are expected to maintain current import levels and may even absorb some of the barrels displaced from European markets, which would lessen the bite of sanctions on physical balances. **However, our base case simply sees a continuation of import levels outside Europe, Japan, and South Korea, with total Iranian exports falling by roughly 400 kbpd (19%) from 12-month average levels** (table 2).

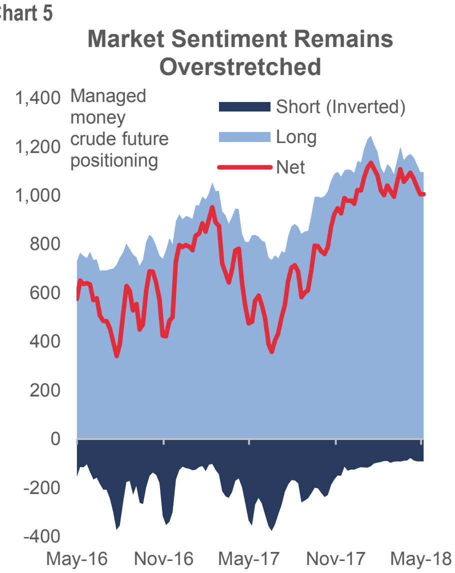
There is also the possibility that any additional market tightness stemming from lost Iranian barrels will be relieved by increased production from Saudi Arabia and its GCC allies, which have indicated that they are willing and able to provide supply support if needed. While it is easy to imagine a situation where there is no change to physical market conditions as lost Iranian barrels are simply replaced by OPEC member relief, the market is unlikely to view it in such a sanguine manner. We already expect OPEC+ to begin lifting its production restrictions in the latter half of 2019, and estimates of spare capacity get particularly tight if you assume another 400 kbpd of Iranian replacement supply on top of the release of barrels withheld as part of the OPEC+ agreement. As such, **any near-term price impact from the US withdrawal from the JCPOA is likely to be driven by sentiment and a higher perceived geopolitical risk premium, rather than a true loss of barrels to the physical market.** Sentiment remains overstretched and money managers accumulated considerable bets on rising crude prices in the run-up to Trump's Iran announcement (chart 5), and the needed rationalization of lopsided positioning is expected through the summer as the market reduces its expectation of sanction-related impacts. **In the longer term, however, the lack of Iranian production is likely to tighten future market balances** both due to tighter spare capacity through the rest of OPEC as well as a far slower pace of Iranian production capacity growth due to sanctions-related restrictions on access to capital and oil sector services.

Chart 4



Sources: Scotiabank Economics, TankerTracker.

Chart 5



Note: Combined futures & options; WTI & Brent.
Source: Scotiabank Economics, Nymex, CFTC.

Table 2

Iranian Oil Exports (kbpd)	05/17 - 04/18 Avg	US JCPOA Exit Impact Estimate (by 11/18)	Notes
Europe	516	-361	70% Reduction
Japan & SK	232	-46	20% Reduction
China & India	1082	0	No Impact
Other	298	0	No Impact
Total Exports	2128	-408	19% Reduction

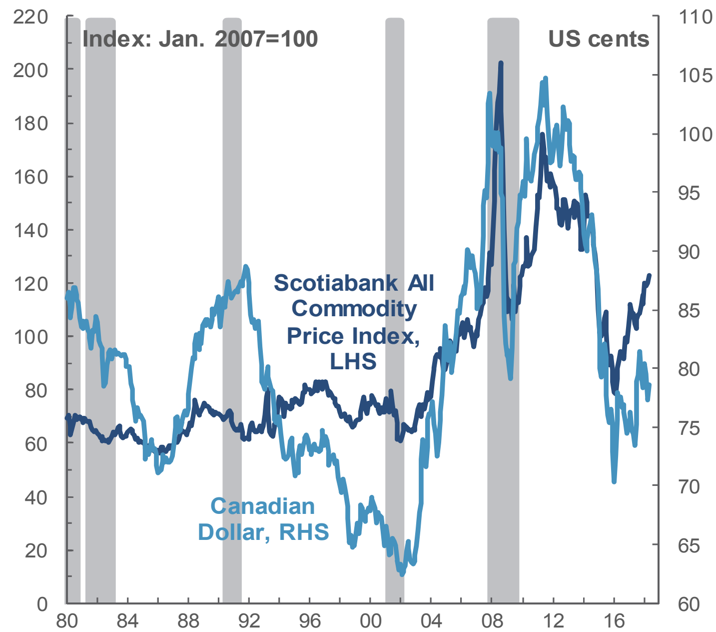
Source: Scotiabank Economics, Bloomberg TankerTracker.

Price Outlook		Monthly Avg. Low	2000–2016 Period Avg.	Monthly Avg. High	2017	2018ytd	2018F	2019F
Oil & Gas								
Crude Oils								
West Texas Intermediate	USD/bbl	19.40	62.70	134.02	50.85	64.56	65	68
North Sea Brent Blend	USD/bbl	19.06	65.53	134.56	54.75	69.32	70	73
WCS - WTI Discount*	USD/bbl	-42.50	-16.85	-5.50	-12.74	-22.43	-22	-20
Natural Gas								
Nymex Henry Hub	USD/MMBtu	1.81	4.94	13.46	3.02	2.81	2.80	2.85
Metals & Minerals								
Base Metals								
Copper	USD/lb	0.62	2.35	4.48	2.80	3.14	3.10	3.25
Nickel	USD/lb	2.19	7.26	23.67	4.72	6.12	6.00	6.50
Zinc	USD/lb	0.34	0.81	2.00	1.31	1.51	1.60	1.60
Aluminium	USD/lb	0.58	0.86	1.39	0.89	1.00	0.95	1.00
Bulk Commodities								
Iron Ore	USD/t	27	108	302	72	72	63	60
Metallurgical Coal	USD/t	39	127	330	188	215	182	160
Precious Metals								
Gold	USD/toz	261	869	1,772	1,257	1,329	1,310	1,300

* 2008-16 average.

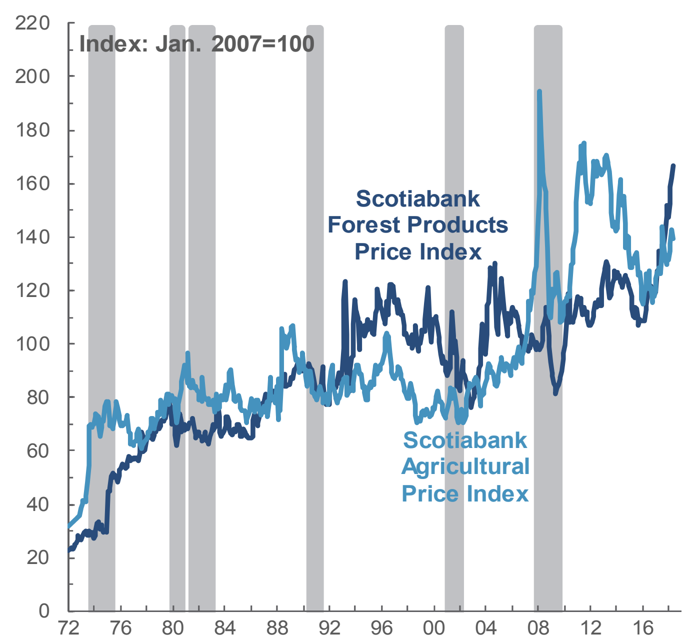
Scotiabank All Commodity Price Index

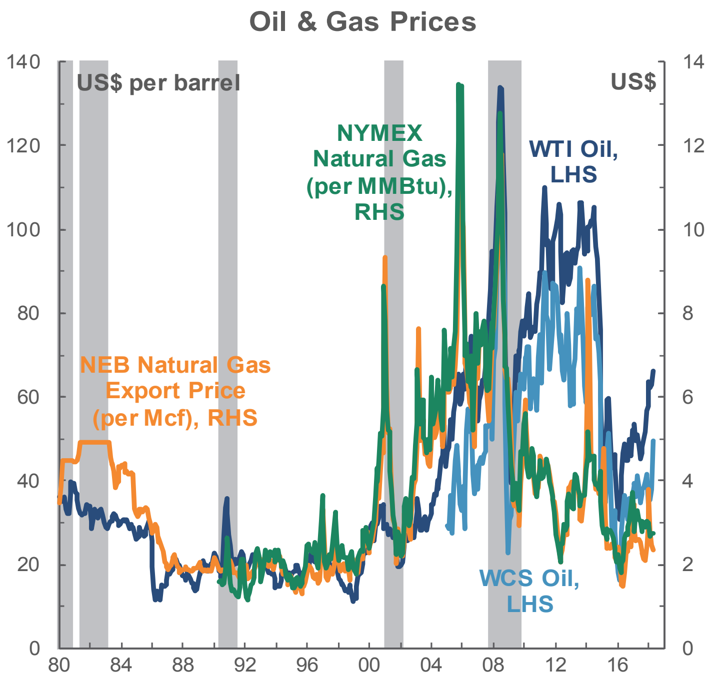
Canadian Dollar vs. Commodity Prices



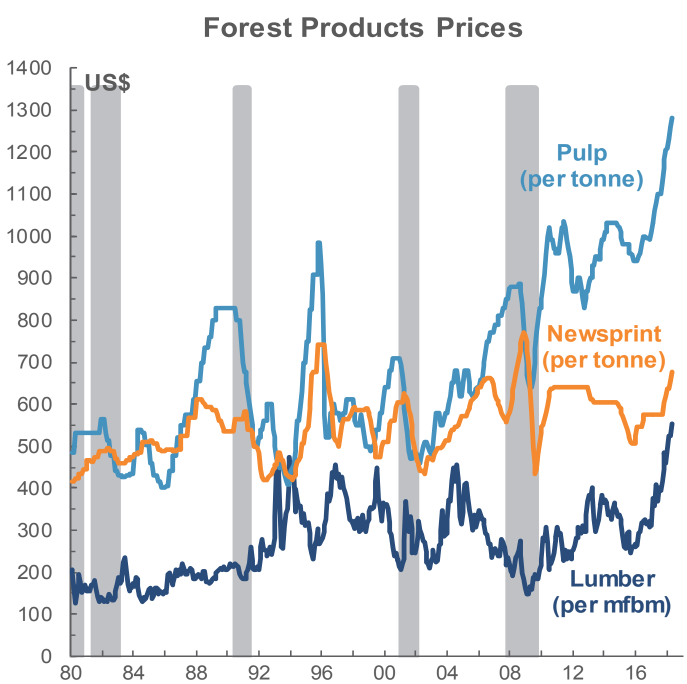
Scotiabank Oil & Gas and Metal & Mineral Indices

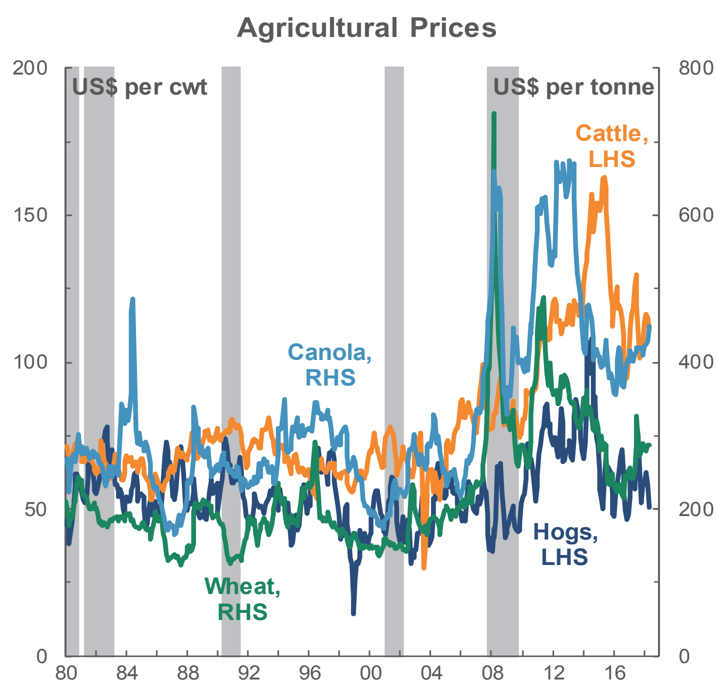
Scotiabank Forest Products & Agricultural Indices




Oil & Gas Prices
US$ per barrel
US$
NYMEX Natural Gas (per MMBtu), RHS
WTI Oil, LHS
NEB Natural Gas Export Price (per Mcf), RHS
WCS Oil, LHS
140
120
100
80
60
40
20
0
14
12
10
8
6
4
2
0
80
84
88
92
96
00
04
08
12
16


Metals Prices
US$ per lb.
US$ per lb.
Nickel, RHS
Copper, LHS
Zinc, LHS
Aluminium, LHS
5
4
3
2
1
0
25
20
15
10
5
0
80
84
88
92
96
00
04
08
12
16


Forest Products Prices
US$
Pulp (per tonne)
Newsprint (per tonne)
Lumber (per mfbm)
1400
1300
1200
1100
1000
900
800
700
600
500
400
300
200
100
0
80
84
88
92
96
00
04
08
12
16


Agricultural Prices
US$ per cwt
US$ per tonne
Cattle, LHS
Canola, RHS
Hogs, LHS
Wheat, RHS
200
150
100
50
0
800
600
400
200
0
80
84
88
92
96
00
04
08
12
16

Technical Note
Scotiabank Commodity Price Index — Principal Canadian Exports
January 2007 = 100

This Index has been designed to track the spot or transactions prices paid in U.S. dollars for key Canadian commodities and resource-based manufactured goods in export markets. The weight of each component is based upon its net export value in 2010. Prior to January 2007, the weight of each component was based on its export value in 1995-97, except for crude oil & refined petroleum products, uncoated freesheet paper and linerboard, where net exports were used. Canada imports a significant quantity of these products, and use of their export value alone would have overstated the importance in Canada's trade performance.

The following prices are included:

OIL & GAS

Crude Oil & Refined Petroleum Products (US$ per bbl) MSW light sweet crude oil at Edmonton (previously Edmonton Par crude) and Western Canadian Select heavy oil at Hardisty, Alberta; price differentials off WTI near-by futures from Bloomberg.

Natural Gas (US$ per mcf) Average export price quoted by the National Energy Board.

Natural Gas Liquids (NGLs – Propane, Butane, Ethane & Pentanes-Plus) (US$ per bbl), Propane at Edmonton & Sarnia.

METALS & MINERALS

Copper & Products (US$ per lb) LME official cash settlement price for grade A copper.

Zinc (US$ per lb) LME SHG cash settlement: prior to Sept 1990, U.S. producers' price for high-grade zinc delivered.

Lead (US$ per lb) LME official cash settlement price; prior to Jan. 1991, U.S. producers' price for common grade delivered.

Aluminium & Products (US$ per lb) since 1979, LME official cash settlement price.

Nickel (US$ per lb) since 1980, LME official cash settlement price.

Gold (US$ per oz) 'LBMA Gold Price PM' as of March 20, 2015.

Potash (US$ per tonne) Standard potassium chloride, spot price, FOB Vancouver.

Sulphur (US$ per tonne) Solid, spot price, FOB Vancouver.

Metallurgical Coal (US$ per tonne) Contract price for premium-grade hard coking coal, FOB Vancouver.

Iron Ore (US cents per dmtu) Spot price fines 62% Fe, CFR Qingdao, China; prior to Jan 2011, term-contract price for concentrates 66% Fe from Labrador/Quebec to Northern Europe (FOB Sept-Iles).

Uranium (US$ per lb) U_3O_8 near-by-futures from Bloomberg.

Molybdenum (US$ per lb) since March 1992, MW dealer oxide.

Cobalt (US$ per lb) MW dealer price.

FOREST PRODUCTS

Lumber & Wood Products, Western Spruce-Pine-Fir 2x4 No.2 & Btr (US$ per mfbm) FOB mill.

Oriented Strandboard (US$ per thousand sq. ft.), U.S. North Central region, 7/16 inch.

Pulp, Bleached Northern Softwood Kraft (US$ per tonne) Transactions price, delivery USA.

Newsprint (US$ per tonne) Average transactions price, 48.8 gsm, delivery Eastern USA.

Groundwood Specialty Papers (US$ per ton) Supercalendered-A paper, 35 lb., delivery USA.

Linerboard (US$ per ton), delivery Eastern USA with zone discounts.

AGRICULTURE

Wheat & Flour (US$ per tonne), DNS No 1 14% protein Duluth, Minn; prior to April 2011 No.1 CWRS, 13.5% protein at St. Lawrence.

Barley (US$ per tonne), since Dec.1994, No.1 at Lethbridge, Alberta.

Canola & Oilseeds (US$ per tonne) No.1 Canada, in store Vancouver.

Cattle & Beef (US$ per cwt) Steers over 1,051 pounds at Toronto; from Jan 1993, Ontario average.

Hogs & Pork (US$ per cwt) 100 Index Hogs at Toronto; from Jan 1993, Ontario average.

Fish & Seafood (US$ per lb) West Coast silver coho salmon; Atlantic lobster prices; prior to 1986 cod fillets & blocks.

Scotiabank Commodity Price Index — Components And Weights

Index Components	Net Export Value In 2010 (millions of dollars)	Index Weight (per cent)
OIL & GAS INDEX	**46,537**	**39.90**
Crude Oil & Refined Products	33,231	28.49
Natural Gas & LNG	11,741	10.07
NGLs	1,565	1.34
METAL & MINERAL INDEX	**35,109**	**30.10**
Copper	3,160	2.71
Zinc	1,255	1.08
Lead	579	0.50
Aluminium	6,045	5.18
Nickel	4,246	3.64
Gold	4,678	4.01
Coal	4,757	4.08
Iron Ore	3,346	2.87
Potash	5,161	4.42
Sulphur	457	0.39
Uranium	891	0.76
Cobalt	288	0.25
Molybdenum	246	0.21
FOREST PRODUCTS INDEX	**17,081**	**14.66**
Lumber & Wood Products	4,673	4.01
OSB	812	0.70
Pulp	6,818	5.85
Newsprint	2,734	2.34
Groundwood Spec. Papers	1,971	1.69
Linerboard	87	0.07
AGRICULTURAL INDEX	**17,901**	**15.35**
Wheat & Flour	4,693	4.02
Barley & Feedgrains	1,088	0.93
Canola & Oilseeds	5,398	4.63
Cattle & Beef	1,640	1.41
Hogs & Pork	2,378	2.04
Fish & Seafood	2,704	2.32
TOTAL INDEX	**116,643**	**100.00**