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Calm Shattered, Perspective Required as Oil Soars

Steven Wieting, Chief Investment Strategist | +1 212 559 0499 | steven.wieting@citi.com

Maya Issa, Global Investment Strategy

Joe Fiorica, Global Investment Strategy

Saudi oil production facilities damaged, near-term oil price soars

- The calm that began to set in last week in global financial markets was broken by news that [Saudi Arabia's key oil production facilities have been seriously damaged](#) by “drone attacks” over the weekend. This has removed half of the country’s oil production and processing for an unknown number of days or weeks ahead in the worst threat to the Kingdom since the first Persian Gulf War in 1990.
- The news will greatly challenge any lingering views that Saudi production is somehow invulnerable to terrorism or other forms of attack. Iran-backed Houthi rebels in Yemen have claimed responsibility and warned that Saudi oil infrastructure remains a target. Citi’s Head of Commodity Research Edward Morse believes the security risk premium (and fundamental factors including the lost production) will boost the oil price by \$10 per barrel.
- Precisely how long it will take to restore production – with initial losses equal to about 5% of world oil consumption – is unknowable amid much speculation. Market views will focus importantly on whether the attack at the facilities in Abqaiq will set off a wider conflict. The US State Department named Iran as the culprit for the attack, downplaying the Houthi claim. In just the latest development, the Wall Street Journal reported that the US told Saudi Arabia strikes were launched from Iranian territory. If so, it would significantly increase the probability of military escalation, with various forms of remote strikes still far more likely than ground warfare.
- Near-term crude oil futures jumped about 14% at mid-day in New York. Prices one-year ahead were up just 4% by comparison, suggesting a large impact expected from supply disruptions relative to longer-lasting factors. Other financial markets initially showed a modest impact, but the reaction accelerated after the Wall Street Journal report. US shares were off 0.4%, with energy shares up more than 3%. US Treasury yields fell 5-6 basis points and the US dollar index rallied 0.4%.
- **Our perspective: Geopolitical events have a historic tendency of exaggerated initial impact in markets, with a smaller economic and market impact emerging over a short period of time (see figure 1).** As noted, the degree of any escalation with Iran is the more critical issue for longer-lasting supply risks. Temporary disruptions for repairs inside Saudi are very different, for example from a supplier like Venezuela, which will be impaired severely for many years as a result of internal disorder. The attack on Saudi energy infrastructure will raise a supply risk premium, but this is fundamentally different (for one example), from the loss of oil in Kuwait after the Iraqi invasion and occupation in 1990.

- At this point, markets can have no certainty as to the extent of the security escalation. Historical episodes suggest a significantly larger impact is priced in markets initially which fades when information becomes clearer.
- There are many mitigating factors that can limit economic damage. Saudi's readily available emergency supplies to the market are equal to roughly a month's supply at a similar pace to the disruption. The US's Strategic Petroleum Reserve – while less of a perfect match for lost output – is equal to four month's supply. US President Trump has already announced this will be tapped as needed.
- We have no doubt the global oil price will move toward a higher near-term equilibrium after this event as other supply disruptions are ubiquitous. However, with US oil output nearly double its level of a decade ago and net imports dramatically lower, the broad global oil price is well within familiar ranges. Today's quote for the global benchmark Brent is merely a four-month high. This is despite the tragic conflicts raging in the Middle East.
- **Takeaway: Economic weakness** (including the pending impact from a US strike at General Motors) **and international discord in all its various forms are reasons why the Global Investment Committee has small overweight in cash and gold at the moment. However, as we said in August, we believed “mounting economic fears may become overstated.”** The past weekend's news will remind investors of the risks. The outlook is, however, far more nuanced than a “doom or boom” scenario. Investors should see through any near-term market dislocations and remain carefully balanced in their asset allocation.

Figure 1: Geopolitical Events and Shocks – Impact on Financial Markets over Short and Long Periods

Geopolitical Event	Date	S&P 500 (% since event date)			Crude Oil (% since event date)			MSCI World ex USA (% since event date)			DXY Dollar Index		
		Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days
Pearl Harbor	12/7/1941	-6.87	-2.90	-12.02									
Cuban Missile Crisis	10/19/1962	-3.78	7.61	17.16									
JFK Assassination	11/21/1963	-2.81	3.06	8.28									
US Bombs Cambodia	4/29/1970	-15.30	-6.43	-4.94	0.00	0.00	0.00	-10.45	-17.01	-16.07	-0.20	-0.23	-0.51
Arab Oil Embargo	10/18/1973	-16.26	-5.61	-15.11	67.44	72.09	287.04	-14.68	1.96	-18.53	6.98	4.68	12.31
USSR Invades Afghanistan	12/24/1979	-2.27	5.37	-7.78	8.33	8.33	8.33	3.94	3.94	11.85	-1.06	-0.71	5.91
US Bombs Libya	4/15/1986	2.95	-1.39	0.16	-3.91	8.70	-15.65	0.00	6.19	8.16	-4.15	-4.80	-5.30
US Invades Panama	12/15/1989	-2.06	-3.73	-3.43	2.82	5.08	-6.21	0.00	3.67	-7.04	0.31	-1.69	-0.44
Gulf War	12/24/1990	-4.16	0.09	12.10	17.75	-20.67	-31.32	1.75	1.75	15.97	-0.21	-3.61	4.90
World Trade Center Bombing	2/26/1993	-0.31	1.67	2.04	-0.18	-3.44	-5.81	0.00	8.52	18.62	0.18	-1.15	-4.79
911	9/11/2001	-11.60	0.45	4.34	-4.09	-17.68	-31.98	-8.48	3.24	5.48	-1.08	0.29	1.85
US Invasion of Iraq	3/20/2003	2.49	2.06	15.57	-8.16	-5.86	-6.54	1.53	4.58	22.05	0.84	-1.85	-7.89
Russian Annexation of Crimea	2/26/2014	1.16	0.68	3.62	-3.77	-2.43	-0.92	-2.42	-0.45	3.25	-0.40	-0.31	-0.10
North Korea Related													
Korean War	6/23/1950	-12.80	-8.67	1.20									
Operation Paul Bunyan	8/18/1976	-3.15	1.64	-4.32	0.00	0.00	0.00	0.00	-0.26	-7.60	0.07	-0.57	-0.12
2006 Nuclear test	10/9/2006	0.90	2.60	4.60	-1.46	1.09	-7.43	0.46	4.33	8.09	0.43	-1.32	-2.21
2009 Nuclear test	4/25/2009	-1.28	5.09	13.05	-3.73	19.56	36.56	-2.32	12.28	21.21	0.52	-5.54	-7.04
2013 Nuclear test	2/12/2013	0.02	2.88	7.53	-0.27	-8.18	-12.49	-0.99	1.15	5.73	0.59	3.12	3.96
2016 Nuclear test	9/9/2016	-2.55	-0.81	2.97	-3.38	14.12	16.54	-2.06	-0.81	-0.72	-0.01	1.36	6.05
2017 Escalation	8/7/2017	-0.24	-0.64	4.44	2.19	7.00	21.65	-0.26	-0.49	3.60	0.23	-1.22	1.62
Missile test over Japan	8/28/2017	0.08	2.69	6.43	-0.83	10.37	23.06	-0.25	1.80	5.45	0.05	1.25	0.62

S&P 500	Initial Impact %	30 days %	90 days %	Initial Impact %	30 days %	90 days %	Initial Impact %	30 days %	90 days %	Initial Impact %	30 days %	90 days %
Average all events	-3.7	0.3	2.7	4.0	5.2	16.2	-2.0	2.0	4.7	0.2	-0.7	0.5
Average ex WW2	-3.5	0.4	3.4									
Average ex WW2 and Oil Embargo	-2.9	0.7	4.4	0.1	1.0	-0.8	-1.2	2.0	6.1	-0.2	-1.1	-0.2

Source: Bloomberg as of September 14, 2019

Note: last two 2017 events refer to North Korean nuclear and long-range missile tests.

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