BMI Research
A FitchGroup Company

MENA: Trade Tensions, Iran Update

July 2018

Contents

Global Trade Tensions

Risks Of Significant Further Ramp-Up In Trade Tensions

- Rising trade tensions between the US and key trade partners (including China, the EU, Mexico and Canada) suggest increased risks to global commodity prices, trade flows and tourism growth with potentially painful implications for the MENA region.

- While our core view remains for only modest further escalation, suggesting that the secondary effects on MENA will be limited, we continue to highlight significant risks, especially in the case of the US-China trade tensions.

- With US growth still strong, President Trump benefitting from significant ‘in party’ support and potential for a ‘rally round the flag’ effect as the Republicans press ahead with the appointment of Trump’s second Supreme Court pick, this could underwrite greater willingness to escalate trade tensions.

Prolonged Trade War Cannot Be Ruled Out

US-China Trade Scenarios

	Tariff/Non-Tariff Measures	Timeline
Core View: Trade Spat	Tariffs on USD34-70bn by both the US and China, with potential for increased Non-Tariff Barriers (NTBs).	First USD34bn to be implemented on July 6 by US and China retaliates. Trump will 'slow play' the implementation of the next USD16-36bn. We see significant scope for de-escalation as well, with the US removing the tariffs as part of a new deal with China before reversing its position and threatening other goods.
Downside Risk 1: Trade War Starts But Is Aborted	Tariffs on USD34-50bn by both the US and China, with potential for increased NTBs. Trump follows this with USD200-400bn in tariffs (effectively a blanket tariff on all Chinese exports) and China ramps up NTBs.	USD200-400bn in tariffs are only kept in place for a brief period of time before being removed. However, this scenario implies that the USD34-50bn worth of tariffs (hitting Chinese manufacturing, US agriculture, autos and energy) remain in place for a more prolonged timeframe.
Downside Risk 2: Trade War Starts and Stays	US implements near blanket tariffs on Chinese imports to the US and maintains them.	Tariffs are implemented but not removed. China significantly increases NTBs.

Source: BMI

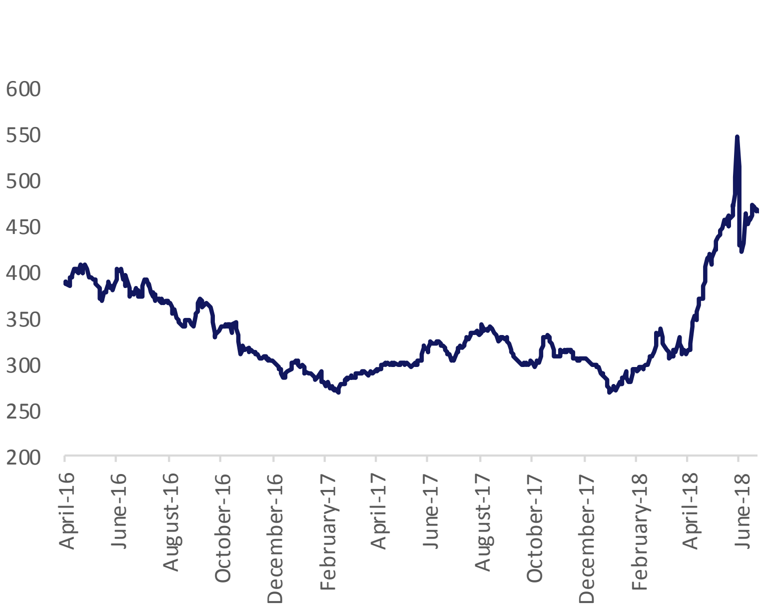
Global Trade Tensions

GCC Relatively Buffered...

- Trade tensions will have a limited impact on the GCC. Periodic bouts of global risk aversion will continue to weigh on the performance of 'risk' assets, including GCC bonds and stocks.
- Bahrain had been most impacted. Increased market 'risk off' (due to trade war fears) combined with concern over the country's weak macro fundamentals (including rapidly rising debt and low foreign reserves) and saw borrowing costs rise rapidly. However, with GCC neighbours having now voiced explicit financial support, this will likely temper upward pressure on bond yields.
- Oil prices look relatively well supported from a fundamental perspective, with falling Venezuelan production and planned US sanctions on Iran placing downward pressure on supply.

GCC Support Tempering Some Investor Concerns

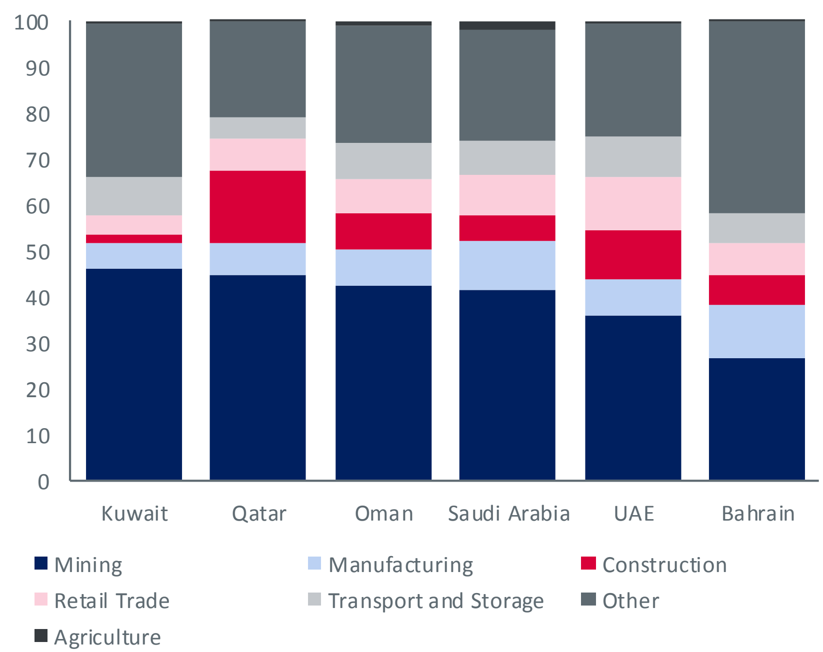
Spread Of Abu Dhabi – Bahrain 2026 USD Bond Yields, bps



Source: Bloomberg, BMI

GCC Dependent On O&G Sector Growth

GCC – GVA By Sector, %



Note: Data from 2016. Mining predominantly comprised of oil and gas extraction. Source: UN, BMI

Global Trade Tensions

…But Escalation Would Still See Some Fallout

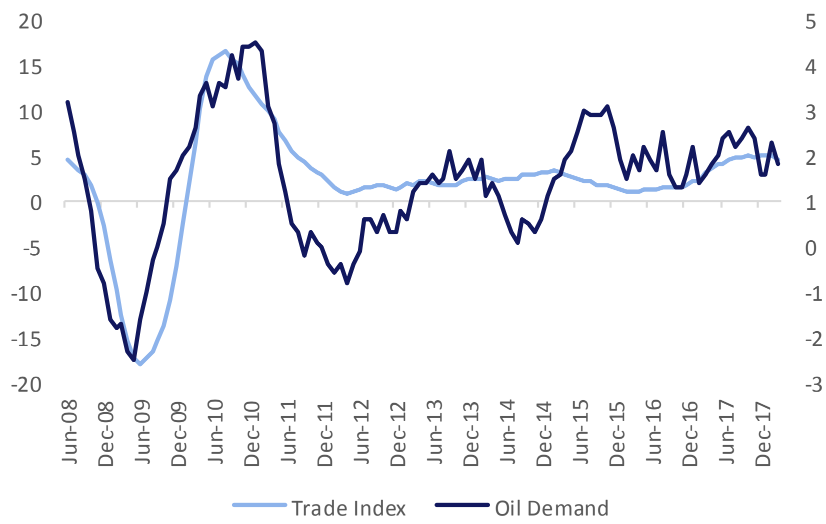
- A more significant escalation of the US-China trade war would be far more damaging to the GCC, weighing on global business and consumer sentiment and supressing demand for crude. In turn, this would feed through to weaker fiscal revenues, exports and investment across the region.

- It would also offer headwinds to trade and tourism, likely impacting UAE (and especially Dubai) most significantly.

- By contrast, we would expect China to maintain high levels of foreign investment, including projects like the industrial area around Duqm Port, in a bid to continue ensuring access to resources, supporting the growth of key SOEs and building soft power.

Oil & Trade Closely Interlinked

Global Trade Index (LHS) & Oil Demand Growth (RHS)



**Oil demand = six-month rolling average, % y-o-y change; based on data from markets representing over 75% of global consumption. Trade index = six-month rolling average, % y-o-y change; 2010 =. Source: CPB, JODI*

BMI Research A FitchGroup Company

Iran: Impact Of US Sanctions

Sanctions Will Hit Iran Hard

- The re-imposition of US nuclear-related sanctions - ordered by President Donald Trump on May 8, as he announced the US's withdrawal from the 2015 nuclear deal - will have far-reaching consequences for the Iranian economy and political landscape.

- Our core view envisions a 'muddle through' scenario. Sanctions will weigh directly on growth through limiting exports and investment, but also undercut access to foreign currency, leading to severe goods shortages and prompting bouts of significant social unrest.

- That said, the downside risks are significant. Our worst case scenario examines the risks of pushback from the population prompting a potentially tumultuous regime change or Iran restarting nuclear weapons development, likely leading to rising regional tensions.

- Even in the best case scenario - in which the US demonstrates far greater flexibility on sanctions than we expect - economic and political pressure will only slowly abate.

Two Waves Of US Sanctions Ahead

Timeline For Re-Imposition Of Nuclear Deal-Related US Sanctions On Iran

Deadline:	US Sanctions Re-Imposed On:
6 August	Purchase/acquisition of USD banknotes by Iranian government
	Iranian trade in gold/precious metals
	Sale/supply/transfer to/from Iran of graphite, raw/semi-finished metals (including aluminium, steel, coal)
	Significant transactions related to trade in Iranian rial, maintenance of significant rial-denominated funds outside Iran
	Purchase/facilitation of issuance of Iranian sovereign debt
	Iran's automotive sector
	US imports of Iranian carpets and food (and related financial transactions)
	Export/re-export to Iran of commercial aircraft and related parts (and related activities)
4 November	Iranian port operators, shipping and shipbuilding sectors
	Iranian petroleum-related transactions
	Transactions with the Central Bank of Iran, designated financial institutions in Iran, provision of financial messaging services to Iran
	Iran's insurance sector
	Iran's energy sector

Source: US Treasury, BMI

Iran: Impact Of US Sanctions

Three Scenarios

- Below we outline our core view, as well as two alternatives representing what we see as the best and worst cast scenario for Iran in 2018-2020.
- Iran's response to the US's sanctions will have major implications for the country's economic and political trajectory. Notably, in our downside scenario, one potential catalyst for destabilisation would be a decision by the Iranian government to begin pursuing a nuclear weapon.

Iranian Response To Sanctions Will Be A Crucial Determinant

Scenarios For Iran Post Sanctions

Scenario	Potential Catalyst(s)	Key Implications	Growth (2019)
Base Case	The US demonstrates some flexibility in negotiations over waivers and Iran shows some restraint in its retaliation against re-imposed sanctions.	Iran's economy muddles through, substantially weakened by sanctions, but still kept afloat by the maintenance of trade and financial links with allies such as China and Russia.	-4.3
Best Case	The US and/or Iran shift towards a more conciliatory policy, facilitating negotiations over a 'new' deal; or the international community shows stronger-than-anticipated willingness to counter US sanctions.	The effect of sanctions on trade and cross-border transactions are watered down substantially, allowing the economy to gradually regain some confidence and strength.	-1.2
Worst Case	Iran, convinced the US is pursuing 'regime change', retaliates aggressively against sanctions, prompting the international community to align against it; or the US successfully secures tight international compliance with sanctions, for example by offering concessions on trade.	Sanctions cause a dramatic fall in trade and financial flows, spurring a sharp deterioration of already-challenging economic conditions that in turn causes a political destabilisation. A severe multi-year depression would then be likely to follow.	-7.0

Note: Growth (2019) = real GDP growth forecast, % chg y-o-y. Source: BMI

Iran: Impact Of US Sanctions

Core View: Increasing Economic Pain…

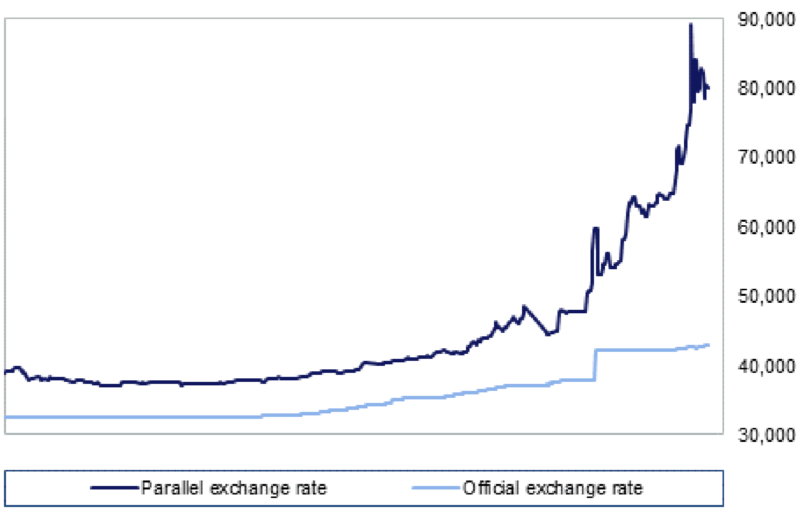
- The US will likely grant some companies waivers on oil-related sanctions in a bid to cap global prices, ensuring countries like Turkey and India continue receiving some Iranian oil (albeit well below current levels). China will likely maintain oil exports or even increase them slightly given its elevated appetite for mineral products and channels (such as SOEs) through which it can import with limited US exposure.

- Even still, Iran's exports will plunge, with our O&G team forecasting a decline from 2.5mn b/d currently to just 1.3mn b/d by end-2019. Meanwhile, already-low foreign investment will fall further as companies with US exposure - including virtually all Western entities and private multinationals - exit Iranian projects.

- As exports and investment inflows slow and cross-border financial transactions are made trickier, the gap between the black market and parallel FX rates will continue to widen. Coupled with more expansionary fiscal policies to ease popular discontent, this will inevitably drive up inflation, weighing on consumption and business activity across the board.

Rial To Remain Under Pressure

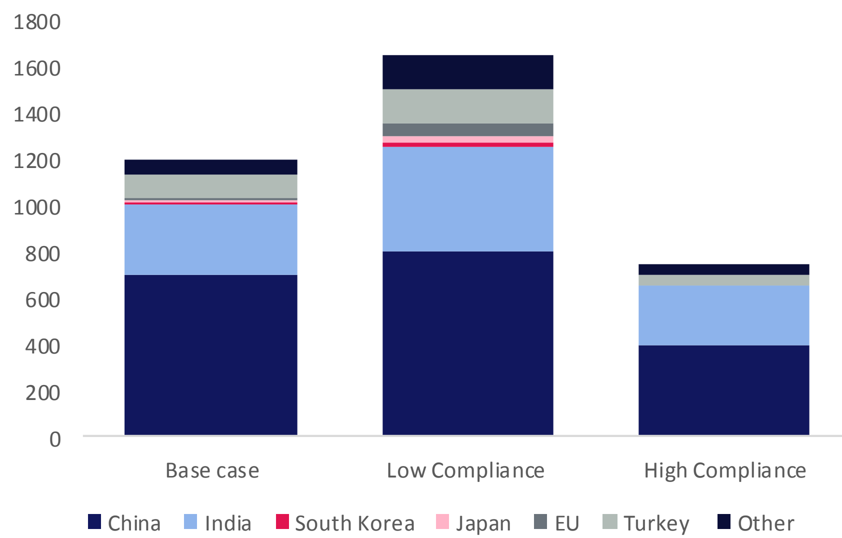
Iran - Official & Parallel Exchange Rates, USD/IRR



Source: Bonbast, Bloomberg, BMI

Substantial Reduction Appears Likely

Iran - Oil Export Scenarios, '000b/d



Note: High/low = high/low compliance with re-imposed US sanctions. Source: EIA, BMI= export volumes for end-2019. Source: EIA, BMI

Iran: Impact Of US Sanctions

Core View: …But Iran Still Likely To Avoid Large-Scale Political Change

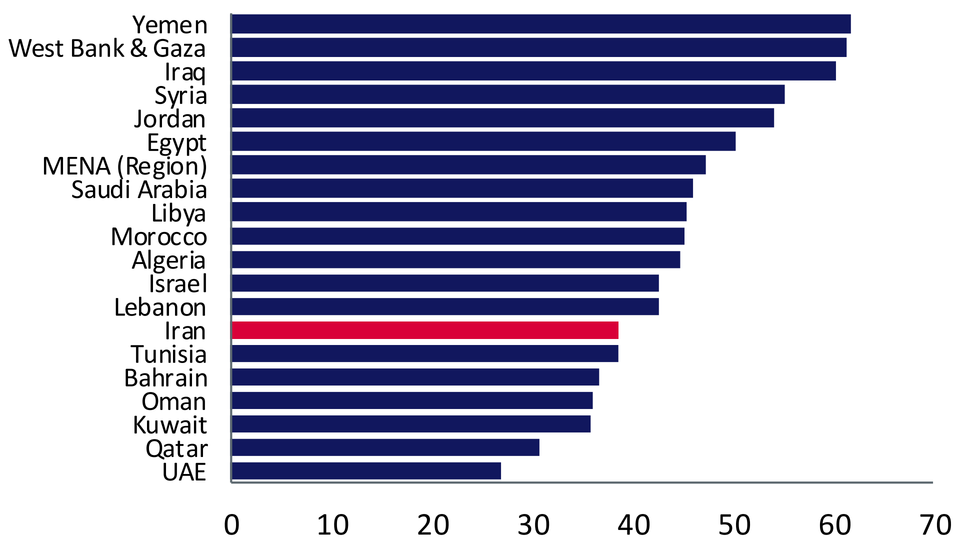
- Iran's increasingly poor economic prospects will feed popular discontent, prompting outbursts of unrest. However, while political risks have risen, as long as oil exports continue at some level (keeping the economy more or less afloat), our core view remains for the current regime to remain in place.

- Even limited oil revenues will likely be enough to ensure the armed forces, including the Revolutionary Guards, continue to benefit from the current regime remaining in place, ensuring their loyalty. This, coupled with the current unorganised nature of the opposition, makes it unlikely that a popular attempt to overthrow the regime would succeed.

- On the foreign policy front, while we see scope for some 'retaliation' by Iran (such as ramping up its support for the Houthis in Yemen), we do not believe the government will be eager to alienate the EU, Russia or China. This may limit appetite for a more extreme ramping up of the Iran-Saudi proxy war and/or temper willingness to break the JCPOA and begin developing nuclear weapons.

Comparatively Older Population Will Temper Some Appetite For Regime Change

MENA – Percentage Of Population Under 25



Source: UN, World Bank, BMI

Iran: Impact Of US Sanctions

Best Case Scenario: Sanctions Relief No Panacea

- In our best case scenario, US sanctions are drastically watered down due to greater-than-expected progress in negotiations between Iran and the US (perhaps as Iran proves more willing to cede ground) or stronger-than-anticipated willingness from the international community to counter US sanctions.

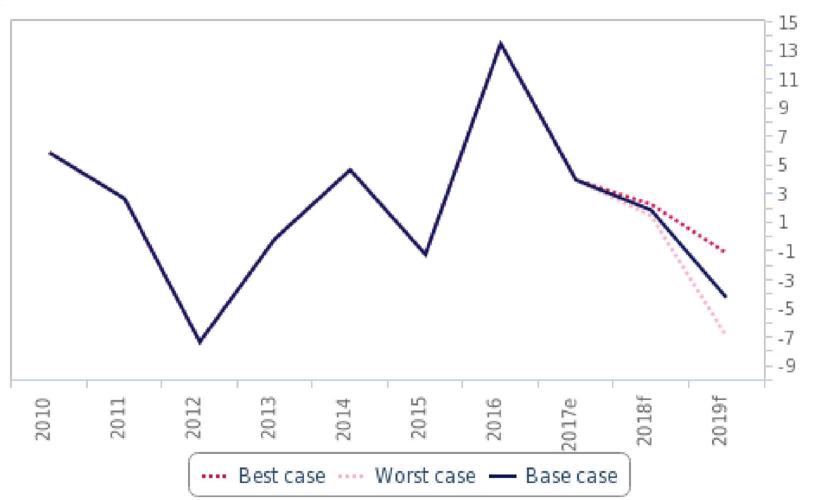
- Iranian oil exports and foreign investment inflows would still initially be reduced, albeit to a far lesser extent than in our base case scenario, and likely for a limited time period only. Rial depreciation would slow as confidence in the Iranian economy slowly rebounded.

- Risks of widespread popular unrest would decrease, although protests would still take place sporadically as economic conditions would take time to improve, particularly in the more rural areas of Iran.

- Rouhani would be more likely to retain support from the moderate and reformist voter bases, boosting his chances of securing a favourable outcome in the 2019 parliamentary elections and handing over office to a likeminded successor in the 2021.

Even The Best Case Scenario Will Bring Challenges

Iran - Scenarios For Real GDP Growth, % chg



Note: e/f = estimate/forecast. Source: UN, BMI

Iran: Impact Of US Sanctions

Worst Case Scenario: Regime Change Would Bring More Economic Pain Before Gain

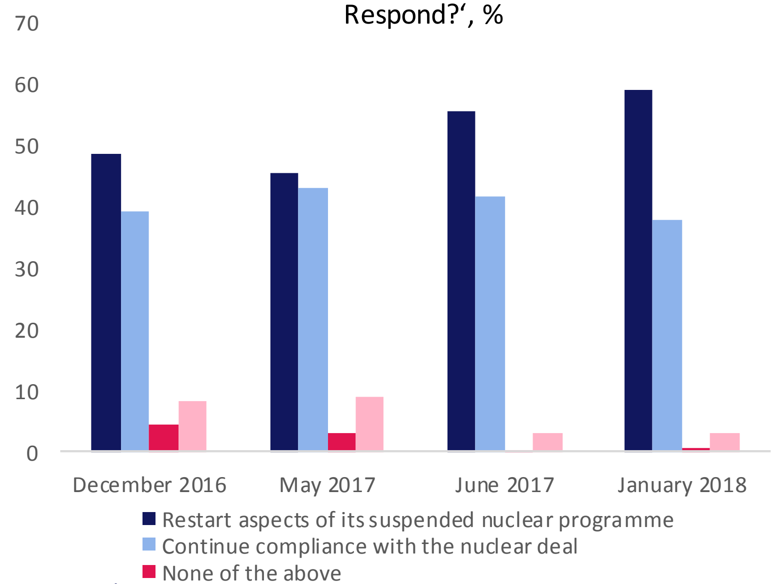
- In this scenario, oil exports and investment drop even more than we expect. This could occur because the Iranian regime feels under pressure from popular discontent and retaliates to the US sanctions aggressively, prompting the international community to align against it. Alternatively, a trade deal with the US and China could encourage the latter to cut its ties with Iran.

- Significant political destabilisation, leading to regime change, could occur in any scenario. However, it would be more likely in this scenario. Organised support from a large cross-section of the population would be important, but we believe elements of the military would eventually have to throw their weight behind such a movement for it to succeed.

- While a new government could allow Iran to re-engage with the international community more significantly in the long term, political instability in the short term would significantly weigh on Iran's economic prospects and potentially impact the wider Middle East given the size of Iran's population and the country's far-reaching influence.

Considerable Popular Support For Aggressive Response

Iran - Survey: 'If The US Violates The Nuclear Deal, How Should Iran Respond?', %



Note: Survey last carried out January 16-24 2018; sample size = 1,002, margin error = +/- 3.1%. Source: Center For International And Security Studies At Maryland, IranPoll, BMI

Proxy War Could Ramp Up Rapidly

Countries Where Iran Supports Proxies or Allies

Source: Deutsche Welle, BMI