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Iran's U.S. Drone Shoot-down and International Oil Market

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An event came to further escalate tensions over the Iranian situation. On June 20, Iran's Revolutionary Guard announced that it shot down a U.S. military drone invading Iranian airspace. "Iran made a very big mistake," U.S. President Donald Trump said in denouncing Iran and giving a warning. Depending on what action the United States would take, their tensions could escalate further.

The Revolutionary Guard said that it shot down the Global Hawk drone as the plane intruded into Iran's airspace over southern Iran's Hormozgan province early in the morning on June 20 (local time). A U.S. Central Command spokesman admitted that an Iranian surface-to-air missile shot down the U.S. military drone but noted that the drone did not invade Iran's airspace but was attacked in international airspace over the Strait of Hormuz. The spokesman rebutted the Iranian announcement, describing the attack as groundless. In response to reports about the attack, President Trump said Iran made a big mistake that the United States would not tolerate. He thus strongly denounced Iran and indicated that he would take some retaliatory action.

The United States and Iran differed widely over the Iranian airspace intrusion and are racing to provide evidence. As is the case with attacks on tankers in waters off Oman on June 13, the two countries are seeking to find facts regarding the shoot-down. Anyway, Iran's U.S. drone shoot-down is destined to escalate bilateral tensions. What action President Trump would take after vowing not to tolerate the shoot-down would attract global attention. While demonstrating his tough attitude, however, President Trump remarkably indicated his prudent attitude by saying that the shoot-down might not have been intentional and that the situation would differ if a manned airplane were shot down.

The drone shoot-down greatly shook the crude oil futures market. In New York, the key West Texas Intermediate futures contract soared by $2.89/bbl from the previous day to $56.65/bbl. In London, the key Brent futures contract jumped by $2.63/bbl to $64.45/bbl, scoring this year's largest single-day hike. Crude oil futures prices hit this year's highs in late April when the United States indicated its full oil embargo against Iran. Later, however, crude oil prices turned down, with the key Brent futures price slipping below $60/bbl on June 12. In response to the tanker attacks on June 12, however, crude oil futures prices rallied, putting an end to their one-month-long weakness. After the sharp increase on June 20, Brent scored a steep rise of about $5/barrel or nearly 10% from the bottom on June 12.

Numerous variables will play key roles in forecasting future crude oil prices, including the future course of Iran's oil exports after their fall to around 0.8 million barrels per day in May under the full oil embargo, global economic conditions, U.S. shale oil production growth, oil supply disruptions attributable to geopolitical risks in major oil-producing countries other than Iran, their degrees, and responses to such disruptions from the OPEC-plus group led by Saudi Arabia. Depending on the conditions of various variables and their combinations, the supply-demand balance on the international oil market and crude oil prices will widely differ. Among numerous variables, however, the geopolitical situation regarding Iran could exert very great influence on the international oil market. The key point in this regard would be whether a military clash would occur and how the military clash would be, irrespective of the probability of the clash.

As indicated by some remarks by President Trump, he is not necessarily sticking to a hardline attitude against Iran or hoping for a military clash or war with Iran. In some sense, he could consider matters with the next presidential election in mind and give priority to deal-making. Within the U.S. administration, however, some people including Trump's National Security Adviser John Bolton have taken an even more hardline attitude against Iran. In response to the tanker attacks, Washington on June 17 announced a plan to send an additional 1,000 troops to the Middle East. Including 1,500 troops that Washington vowed in May to send to the Middle East, the United States is thus adding a total of 2,500 troops to its forces in the region. Furthermore, the United States has dispatched an aircraft carrier strike group to the Middle East and deployed additional Patriot air-defense missile units in the region, stepping up pressure on Iran. As tensions are growing under such pressure, events such as the drone shoot-down are expected to escalate the confrontation into an unforeseen or accidental clash that could expand.

The following overviews how the presence or absence and the characteristics of a military clash would influence the oil market. In the absence of any military clash, tensions would not necessarily decline. As any clash is avoided even under high tensions, the market may remain nervous. In this case, other variables than Iran's geopolitical risks may dominate the oil supply-demand balance and prices. However, crude oil prices would grow more sensitive to any news indicating deteriorating tensions, rising sporadically in response to such news. If no downside risks to the global economy emerge, with the other oil supply and demand variables remaining stable, crude oil prices may moderately increase from the present levels toward the end of the year, being supported by the OPEC-plus group's production cut.

If a military clash occurs, the situation may depend on whether the clash would be limited or escalated into a prolonged military clash. If the confrontation escalates on some event like the drone shoot-down and leads to a temporary, limited pinpoint U.S. attack, with Iran remaining restrained, the scale and duration of the clash may be limited. Even in this case, the clash itself may trigger buying on the crude oil futures market to boost prices. Even if any clash is limited, it may affect safe passage through the Strait of Hormuz for a limited period of time, discouraging tankers from going through the strait. Crude oil prices may then rise from the present range and shoot up occasionally depending on the degree of the influence on oil supply and market concerns about the influence's seriousness.

If a military clash develops into a full military confrontation accompanied by repeated retaliations, a geographical expansion and the destabilization of the whole Middle East, oil supply may be seriously affected. Any safe passage through the Strait of Hormuz may remain difficult until the confrontation is resolved. The geographical expansion of the confrontation and the destabilization of the Middle East may affect not only the passage through the Strait of Hormuz and Iran's oil production but also supply from other major Middle East oil producing countries (such as

Iraq and others) where oil production may decline on foreign companies' withdrawal from oil production and physical damage. If the expansion of the military confrontation damages oil production facilities in major oil-producing countries, oil supply may further be affected. In such worst case, crude oil prices may spike and fluctuate at higher range, with the international oil supply-demand balance tightening. Such development may trigger market-stabilization efforts by the International Energy Agency and other organizations and greatly affect the global economy.

At present, it is difficult to forecast future developments, with the situation growing uncertain. We must further enhance our effort to collect information and analyze various possibilities in consideration of the ever-changing situation.

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