Bi-Weekly
Geopolitical Report

By Bill O'Grady

October 2, 2023

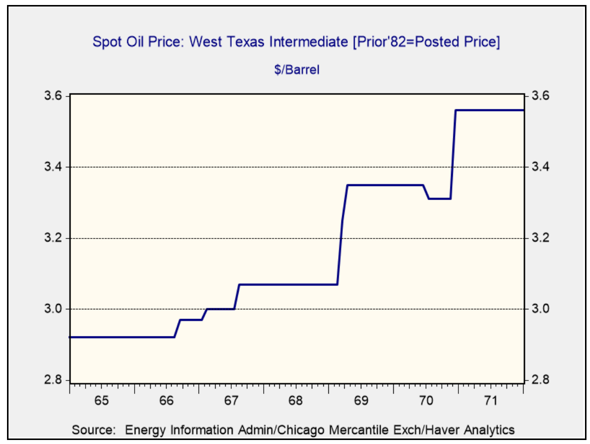
The Oil Weapon Returns

Oil is arguably the most critical commodity. Although food is perhaps more essential to life, most food production today is dependent on fossil fuels. Daniel Yergin's epic history of oil, *The Prize*,[1] examines who had oil, who needed oil, and what they did to secure it. Due to oil's importance, there has often been a geopolitical element to the commodity. We believe we are seeing yet another episode of oil being used for geopolitical purposes.

In this report, we open the discussion with two examples of using oil supplies for political purposes. Next, we offer a short history of oil in the Middle East. From there, we will examine recent developments. With this background in place, we will then look at how the power of oil affects presidential approval ratings. We will also show how OPEC+, especially the Kingdom of Saudi Arabia (KSA) and Russia, are using oil supplies to further their geopolitical goals. As always, we will conclude with market ramifications.

The Oil Weapon

In 1967, Israel launched preemptive airstrikes against Egyptian air forces, destroying most of them on the ground. Israeli land forces quickly invaded the Sinai Peninsula and within six days the forces of Egypt, Syria, and Jordan suffered a crushing defeat. As the Six-Day War was underway, Arab oil producers announced an oil embargo. The impact on oil prices was negligible. In the summer of 1967, oil prices rose $0.07 per barrel.

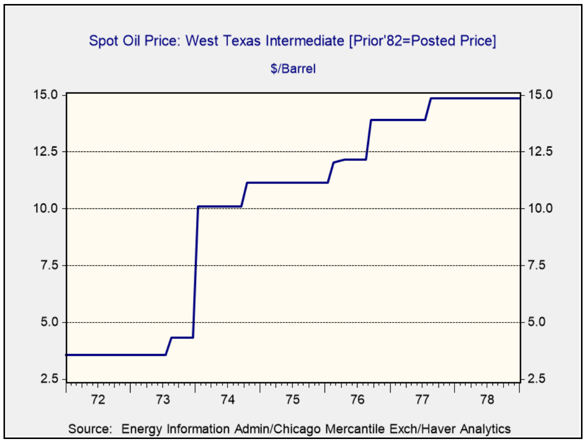


Why was there such an insignificant price response? Until 1971, the U.S. was the world's "swing producer" of oil. Essentially, through the actions of the Texas Railroad Commission, the U.S. maintained a buffer of untapped capacity. When the Arabs cut output, the U.S. offset the reductions, keeping prices mostly steady. In 1971, U.S. demand rose to the point where all available American production was necessary to balance the market. From this moment on, OPEC became the world's swing producer.

In 1973, during the Yom Kippur War, U.S. support for Israel triggered another Arab oil embargo. Due to the lack of U.S. capacity, this embargo was highly effective. As the following chart shows, oil prices jumped from $3.50 per barrel to $10.00 per barrel, a 286% rise. The rise in oil prices led to gasoline supply problems, [subjecting American drivers to long gas lines]; these

[1] Yergin, Daniel. (1991). *The Prize: The Epic Quest for Oil, Money, and Power*. New York, NY: Free Press.

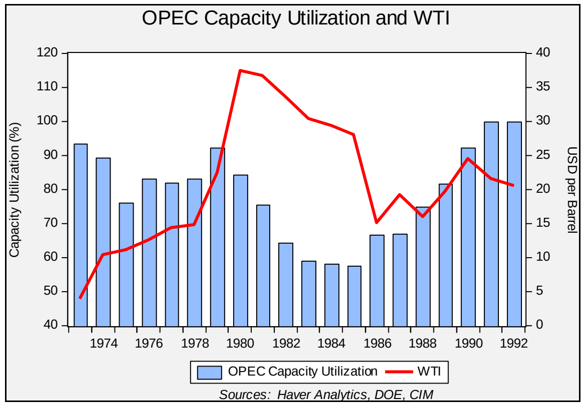
lines scarred Americans and led to worries about oil scarcity.



Although American support for Israel was the key event causing the embargo, it wasn't the only concern among oil producers. Oil was mostly priced in USD and the dollar depreciated rapidly after President Nixon closed the gold window in August 1971. Oil producers were upset about the loss of purchasing power. Complicating matters further was the fact that oil producers pricing their oil in USD had accumulated the U.S. currency. U.S. financial officials were worried that these oil producers would lend their dollars to European countries through the Eurodollar market, exacerbating U.S. inflation pressures. To prevent this outcome, Henry Kissinger and Nixon's Treasury Secretary George Shultz reached an agreement with the KSA and other Middle Eastern oil producers in which they would price their oil in dollars and then recycle those dollars into the U.S. Treasury market.[2] In addition, the U.S. would facilitate arms sales to the Middle Eastern Arab states.

In this case, the oil weapon worked. Over time, the U.S. increased its security role in the Middle East. The Carter Doctrine, which stated that the U.S. would respond with military force to any outside power trying to gain control of Persian Gulf oil flows, was the clearest expression of American security support for the region.

Significant changes in oil supplies worked in the other direction as well. In the mid-1980s, the KSA had been cutting production to maintain OPEC price targets. By 1985, OPEC capacity utilization had fallen to below 60%. The Saudis, tired of losing market share, responded by boosting production, which caused oil prices to plunge.



Although the KSA's decision to boost production was not intended to harm the Soviet Union, the resulting price decline did likely accelerate the unraveling of the Soviet empire. Thus, oil price swings can have serious geopolitical effects.

The 1973 Arab Oil Embargo was a direct deployment of the oil weapon. The 1986 output surge was more about reclaiming market share, but the geopolitical impact was significant. Not all changes in oil production patterns are implemented for geopolitical goals, but some can be.

Other Historical Points

Perhaps the apex of U.S./KSA relations was the Gulf War in 1990-91. After Saddam Hussein invaded Kuwait in August 1990, the

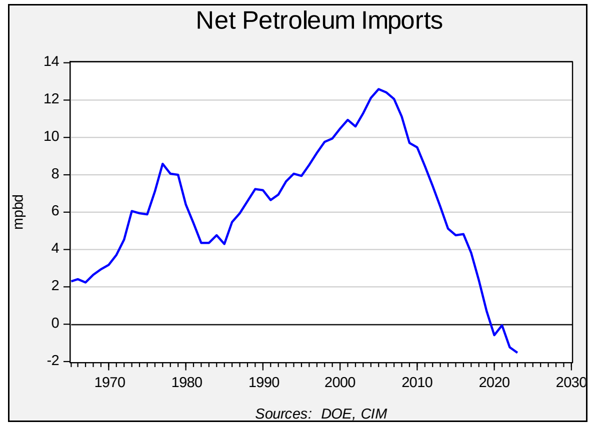
[2] Thompson, Helen. (2022). *Disorder: Hard Times in the 21st Century*. Oxford, U.K.: Oxford University Press, pages 105-06.

Saudis invited Western militaries, primarily American, to the kingdom. A large coalition of forces gathered from August through January 1991, and then in early January, the air campaign began. After weeks of nearly continuous airstrikes, ground troops entered both Kuwait and Iraq, liberating Kuwait. Western troops remained in Saudi Arabia and in other regional states.

Over time, relations between the U.S. and the KSA deteriorated from this elevated point. In Saudi Arabia, Islamist activists vehemently opposed "infidel" soldiers in the kingdom and pressed for their removal. The 9/11 attacks, with numerous Saudi national participants, further undermined relations. The U.S. invasion of Iraq in 2003 was deeply unpopular in the KSA; Riyadh feared that ousting Saddam Hussein would undermine geopolitical stability. Saudi Arabia's fears were unfortunately realized when Iran's relative position in the region improved as Iraq became unstable despite a large U.S. military presence. In 2003, U.S. forces left the KSA.

The next major complication to emerge was the U.S. shale revolution. This technology led to an unexpected rise in U.S. oil output, upsetting the rationale that had underpinned U.S./KSA relations. Since 1973, the U.S. provided an appropriate level of security support for Saudi Arabia, and in return the Saudis generally supported reasonable oil prices. The Saudis aimed to be the highest or second highest foreign supplier of crude oil to the U.S.

Shale oil upset this balance. As U.S. oil production rose, net petroleum imports fell. Since 2020, the U.S. has become a net petroleum exporter.

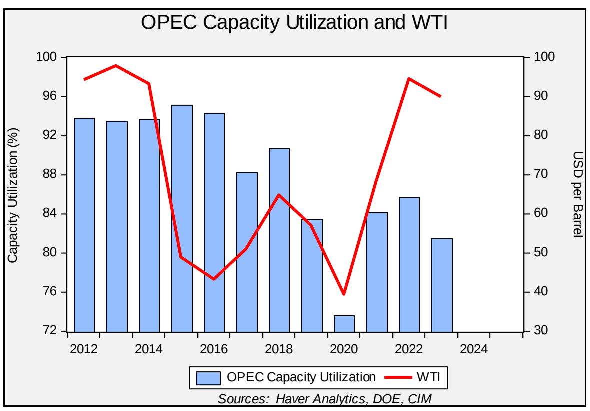


As the U.S. has become less dependent on foreign oil, a key element of the U.S./KSA relationship has changed. Not only is it more difficult for Washington to expend military resources to protect the Middle East, but Persian Gulf oil producers are looking to solidify their relations with the largest oil importers—China is now at the top of that list..

Changes in the Saudi governance structure became important as well. In June 2017, King Salman deposed his first crown prince, Muhammad bin Nayef, and replaced him with his son, Mohammed bin Salman. The new crown prince is much younger than the man he replaced and, perhaps most importantly, King Salman ended the Saudi royal family's practice of elevating a son of the founder, Ibn Saud, to king. It was clear that, due to the lack of available candidates for king, the next generation had to take over. Bin Nayef is a grandson of Ibn Saud, but he isn't a son of the current king. By elevating his own son, King Salman is setting a precedent where the other grandsons of Ibn Saud might be sidelined. Once Crown Prince Salman becomes king, he may be inclined to appoint one of his own sons to succeed him.

Given King Salman's advanced age and declining health, Crown Prince Salman is the *de facto* leader of the KSA. Known by his initials, MBS has already made major changes to the kingdom. He has curtailed the power of the religious authorities and has broken down social barriers between the sexes. He has also become a force in global sports by creating a rival to the U.S. Professional Golfers Association and building a soccer league. He also has plans to build a futuristic modern city called Noem.

To fulfill his objectives, MBS needs to generate significant cash. Thus, he needs high levels of oil revenue. Initially, he tried to take on the U.S. shale industry by flooding the oil market with the hopes that low oil prices would lead shale producers to leave the market. Because of the nature of shale production, oil producers can be remarkably flexible in production patterns, which means the plan to undercut them really didn't work.



OPEC, under Saudi influence, raised production in 2015-16. Prices were already under pressure and they fell even lower. Fearing further price declines, the Saudis petitioned Russia and several other former Soviet states to create OPEC+ in 2016. By expanding the cartel and cutting production, oil prices were able to recover.

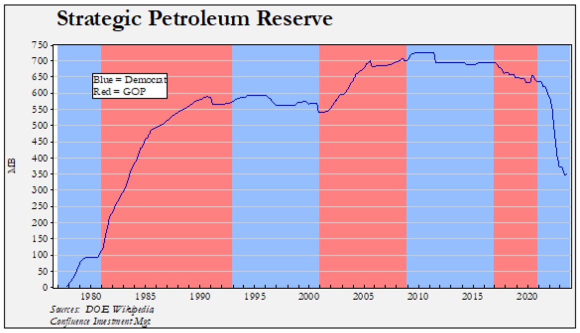
There is one other event worth noting. On September 14, 2019, drones and cruise missiles struck the Saudi oil processing facilities at Abqaiq. Direct responsibility for the attack was claimed by the Houthis, a group based in Yemen and supported by Iran. So, by proxy, Iran attacked a key Saudi oil facility. The U.S. did not militarily retaliate against Iran. Instead, there were some financial sanctions applied, but given the gravity of the attack, the response from Washington was seen as modest at best. Although Saudi Arabia was able to make repairs more quickly than initially expected, Riyadh saw the lack of U.S. retaliation as a sign that the U.S. could not be relied upon for Saudi security.

Recent Developments

In February 2022, Russia invaded Ukraine. On paper, the Russian military should have easily rolled into Kyiv, but for several reasons, the war went horribly wrong for Moscow. Ukraine's military repulsed the initial thrust of the invasion, and the war has evolved into trench warfare in eastern Ukraine.

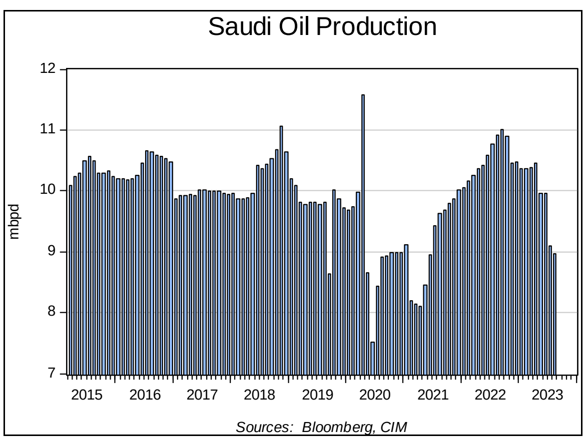
In response to the invasion, the U.S. and its allies applied draconian sanctions on Russia, effectively freezing the country's dollar and euro foreign reserves. Even gold sales were curtailed. Russia has been able to continue oil sales as the global oil market has been restructured. Essentially, Russia's sales to China and India have supplanted its sales to Europe and the West.

Initially, after the invasion, global oil prices rose, with WTI exceeding $100 per barrel. Fearing that the global economy was going to suffer due to high oil prices, the U.S. and its allies implemented the most aggressive Strategic Petroleum Reserve (SPR) sales in history.



The combination of strategic sales and Russia's continued oil sales pushed oil prices into the mid-$60s. Washington eventually slowed the SPR sales and promised to replenish the SPR if prices were around $60 per barrel.

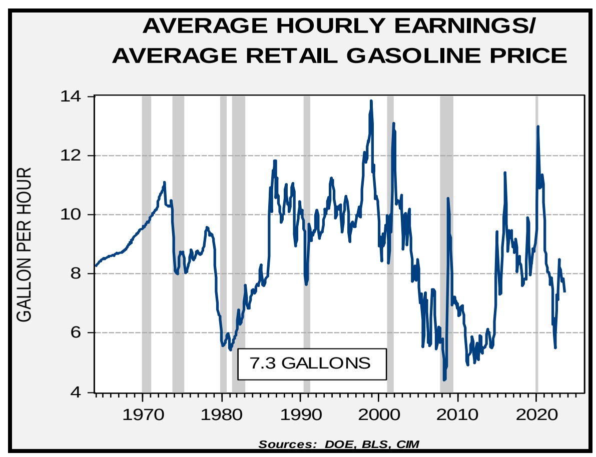
At the April OPEC+ meeting, the KSA, UAE, and Iraq announced a unilateral production cut of 1.0 mbpd. And then, the Saudis announced yet another 1.0 mbpd cut in June. As the chart below shows, since mid-2022, Saudi oil production has fallen by a little over 2.0 mbpd.



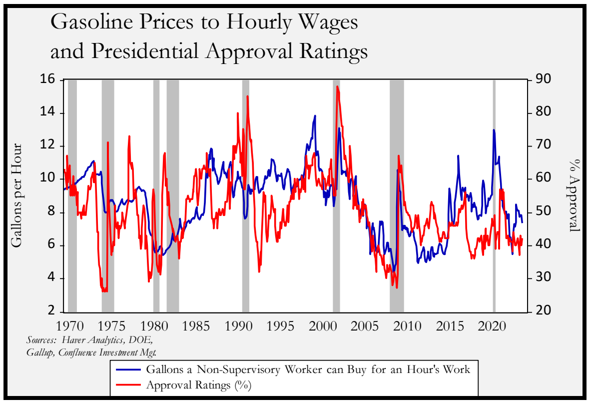
In July, nearby contract oil prices were trading around $70 per barrel. The announced cuts and the recent decision to extend those cuts into December (with cooperation from Russia) have sent prices back above $90 per barrel.


(Source: Barchart.com)

The New Oil Weapon
It is generally held that high oil prices are unpopular with voters. That's probably not strictly true; consumers don't use crude oil directly but do consume products made from it, e.g., gasoline, diesel fuel, propane, etc. To better understand the impact of gasoline prices, we need to scale gasoline relative to wages.



Specifically, we divide the hourly earnings for non-supervisory workers by the average retail gasoline price. This tells us how many gallons of gasoline a worker can purchase with an hour's work. Currently, this number is 7.3 gallons. That's a bit below the average of 8.3 gallons, but well above the worst levels seen in the early 1980s, in 2008, and in 2012. If we overlay this data with presidential approval ratings, we can see a relationship.



Over the entire history of the data, the correlation between the two variables is +41.7%. The strongest period of correlation ran from 1978 to the end of 2007, when the correlation was +74.8%. We note that since 2008, the correlation has declined to +18.1%, which likely reflects political polarization. Thus, while rising energy costs are not a positive factor for incumbent politicians, they may not be as powerful as they once were.

The recent actions by OPEC+, ostensibly Russia and the KSA, suggest a concerted effort to raise oil prices. Beyond the obvious goal for a commodity producer to receive more money for their product, could there be anything else behind the rather aggressive actions? ***We contend that both nations are trying to affect the U.S. presidential election***.

Russia's Rationale: Russia's position is rather simple. It is engaged in a war in Ukraine that is, by proxy, pitting NATO against Russia. As noted above, the Ukrainians have fought valiantly, but their ability to continue in the war depends on the flow of arms and support from Europe and the U.S. If President Biden is re-elected, we expect current support to continue. However, there is significantly less support for Ukraine among the current Republican presidential candidates. That isn't to say that if a Republican wins the White House then it's guaranteed that the U.S. would withdraw support, but there is a better chance of this happening if a Republican were to win. Thus, it behooves Moscow to take steps that would support Biden's defeat.

Saudi Arabia's Rationale: The Saudi position is far more complicated. On one level, there is a degree of personal animosity between MBS and President Biden. During his candidacy, Biden promised to make MBS a "pariah" for his involvement in the murder of Jamal Khashoggi. Now, the president has been forced to deal with MBS due to Saudi Arabia's key role in global oil supplies. Nevertheless, efforts to improve relations have not shown much progress.

However, beyond the personal differences, the Saudis do want concessions from the U.S. that could lead to a change in oil policy. The U.S. wants Israel and the KSA to normalize relations, thereby creating an extension of the Abraham Accords. The Saudis want the following three items in return:

1. A security guarantee from the U.S.;
2. Nuclear power reactors with the ability to enrich uranium; and
3. An improvement in the Palestinian situation.

These demands will be hard to meet. First, the U.S. has been trying to reduce its commitments to the Middle East for some time in order to prepare for Great Power competition with China. Throughout the KSA/U.S. relationship, Washington has preferred informal commitments. President Carter came the closest to a formal doctrine, but that was more about the entire Persian Gulf and was not specific to Saudi Arabia. Since the end of the Second Persian Gulf War, the U.S. has been trying to reduce its role in the region. Thus, a formal security guarantee is a commitment the U.S. would prefer to avoid. That doesn't mean it won't occur, but the costs would be high. And since personal relations between Biden and MBS are strained, the Saudis are unlikely to be amenable to anything less than a formal declaration. In other words, it is less probable that the U.S. will be given the "benefit of the doubt."

The U.S. will likely support the building of nuclear reactors in Saudi Arabia, but allowing nuclear enrichment would be an uncomfortable escalation for Washington. After all, the U.S. staunchly works to hamper Iranian efforts in this area; it would be a change in policy to suddenly support a Saudi program. Having Israel participate might mitigate some of these concerns, but it would still heighten tensions in the region and would probably lead Iran to expand its efforts in its own nuclear program. We note there has been some progress in this area. The KSA has agreed to IAEA oversight of its uranium enrichment which will give the U.S. some international "cover" for these activities. If progress continues, it could lead to normalization and perhaps lead the Saudis to add some barrels back to the market.

Although the U.S. would presumably support an improved situation with the Palestinians, Israel would not be keen on this development. To some extent, this is an area where diplomatic finesse could be applied; it all depends on how serious the KSA is on this issue. We suspect if the Saudis get most of what they want on the first two demands, then this one might be met with cosmetic improvements.

Will the U.S. give the KSA what it wants? The earlier chart on page five showing Saudi oil production likely holds the key. If the U.S. and Israel are able to make a deal, then the Saudis could return 2.0 mbpd of oil to the markets which would likely bring down prices to the $60 per barrel range. Russia, by itself, would not be able to prevent this price decline.

Ramifications

For the time being, we expect OPEC+ to maintain production cuts to keep oil prices elevated. We also expect the Biden administration to do its best to mitigate those high oil prices. Unfortunately, the earlier release from the SPR makes further large sales unlikely, barring a global emergency that would provide a rationale for such a release. The risk to oil prices rests on negotiations between the KSA, U.S., and Israel regarding normalizing relations between Israel and the KSA. Until clear evidence emerges that a deal has been struck, investors should expect oil prices to remain elevated.

Bill O'Grady
October 2, 2023

This report was prepared by Bill O'Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.