CQS Strategy Perspectives

The Middle East: Growing Complexity and Rising Geopolitical Risk

Sir Michael Hintze

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Introduction

In this edition of CQS Strategy Perspectives, we provide an update on our views on the oil price, trading strategies we find interesting given geopolitical developments and some historical context around recent developments in the Middle East. I believe these are timely and thoughtful issues to explore at this time. We have combined insights from across the firm and we have been delving into the topic in a number of ways over the last year, as well as having been active in trading around developments. It has been a focus across the investment teams who look to incorporate knowledge, experience and skills across different asset classes to find suitable cross-asset trades and hedges.

Sir Michael Hintze
and Team
CEO and Senior Investment Officer

An Update on our Outlook for the Oil Price

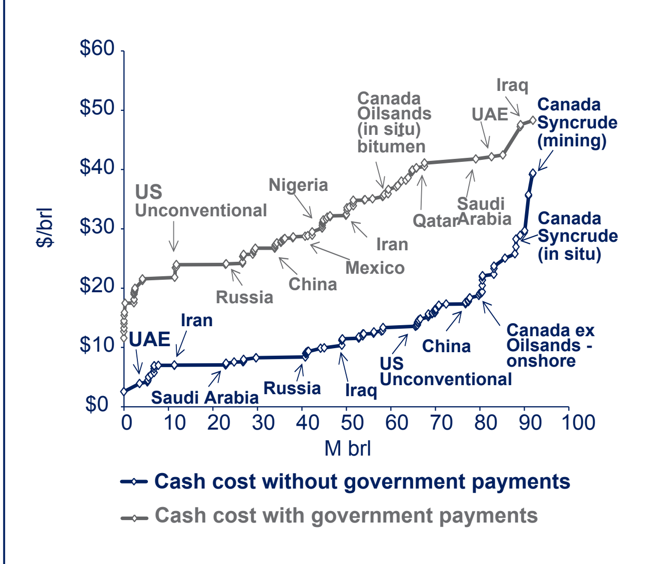
A year ago we published a *CQS Strategy Perspectives piece titled: 'Is This the End of OPEC?'* I posited that the decline in oil prices was structural, due to the changes to the market brought about by fracking and the fact that the KSA was no longer willing or able to act as a swing producer. My central view was that the oil price would remain at $45 +/- $15 per barrel and that a major change to the energy value chain was underway. Current events have pushed the oil price below the low end of that range for a variety of reasons including:

i. The cost curve, which has fallen by as much as $15-$20 per barrel[1] (see Figure 1), has meaningfully lowered the breakeven cost of production. This has been driven by weaker currencies (e.g. Russian Rouble) and lower oil service costs including operating efficiency (e.g. US shale production);

ii. OPEC has continued to increase production, driven by fiscal pressures and by elevated geopolitical instability in the Middle East; and

iii. Iranian exports coming online sooner than expected, aided by sizeable onshore and offshore storage.

Figure 1: Global Oil Cash Cost Curve (Opex by project on a Brent basis, $/bbl)[1]



However, it has become harder to forecast how much lower the price of oil could fall for a sustained period of time, made more complicated by four factors that influence the path of oil prices:

- We believe the oil majors' breakeven cost per barrel is now closer to the $25-30[2] range of current spot pricing, increasing the sensitivity (or delta) to small changes in current spot pricing;
- Increased cost of crude storage costs weighs negatively on spot oil pricing. Oil inventories are at historically high levels. As spare crude storage capacity becomes more costly, 'excess' oil production is sold directly into the spot market. This has the result of lower spot prices, higher degree of contango and increased price volatility;
- Such high inventory levels will likely curtail any rapid increase in spot oil prices. These inventories should act as a buffer to any 'shocks', geo-political or otherwise, that might otherwise have led to a sharp rise in spot oil prices; and
- Further capping any sharp increase in spot oil prices remains the US shale producers. Current estimates for the cost curve for US shale would indicate that producers could bring demand back online and hedge at oil prices above $45-$50 per barrel.[2]

Consequently, I believe that $40 +/- $15 per barrel is more likely over the medium-term. In the present context and given the current cost curve, my judgement is the $25 to $55 per barrel range is about right. However, both technicals and sentiment could drive the oil price outside this range in the short-term.

Developments since January 2015

Over the last 12 months, we have witnessed a further slowdown in China, both US-led and Russian-led international intervention in Syria, Saudi-led Gulf intervention in Yemen, and the concession of territory in Iraq' but entrenchment in Syria' by the so-called Daesh. Finally, lengthy talks between Iran and the P5+1 (the five Permanent Members of the UN Security Council plus Germany), culminated in the lifting of sanctions against Iran. All of this occurred against a background of broader Gulf anxiety over perceived Iranian engagement in adjoining Iraq, Syria and Yemen.

Source: [1]Rystad, Morgan Stanley Commodity Research 'The Commodity Manual', 30 November 2015. Note: average differentials added to wellhead economics to derive a Brent equivalent. [2]CQS analysis as at 31 January 2016.

Oil prices are currently flirting with $30 per barrel, with some forecasts for a further decline to as low as $10 per barrel[3]. Oil's share of global GDP has fallen from over 5% in January 2015 and is now below 2%[4]. Furthermore, OPEC itself has seen substantial changes; Indonesia was readmitted in September, now that it is a net exporter of oil once again; and the November '15 OPEC Production Agreement resulted in running production guidelines rather than targets, and made no mention of the prior output target of 30m barrels per day. While there was agreement to meet again in June 2016, the clear signal to markets was that supply will continue unconstrained.

The initial reaction of global markets was to price in the potential benefits of a decline in energy prices (and this will return as a theme once oil prices stabilise). However, the sustained drop in oil prices since mid-2015 has led the market to focus on the implication for cash generation of oil producers – both sovereign and corporate. Sovereign oil producers have relied upon oil revenues to fund increased fiscal spending and fiscal deficits have sharply increased as the price of oil has dropped. Corporate oil producers have relied upon higher oil prices to fund dividends, sizeable capital spending plans and debt service. We believe both sovereign and corporate oil producers consequently are very motivated to respond to lower prices with higher production, exacerbating the situation.

Markets, particularly the US high yield market, have been negatively affected. The US high yield market has seen energy rise both in absolute size (up four-fold) and as a proportion of the market in the last ten years. Currently, energy represents 14.9% of notional ($200bn) of the US high yield market, up from 11.3% of notional ($112bn) in January 2011 and 8.3% ($53bn) in January 2006[5]. Given the rapid cashflow drop and subsequent deterioration in credit quality of lower oil prices, the US high yield market was pulled wider and weaker. High yield spreads have widened to levels typically seen in a full-fledged recession: today the US high yield index is 825bps, up from 540bps in January 2015 and 385bps in January 2014[5]. The energy sub-index has seen spreads widen from 380bps in January 2014 ($85 WTI), to 800bps in January 2015 ($60 WTI) to 1,800bps today ($30 WTI)[5]. Estimates of default rates have risen accordingly, with Moody's estimating US energy default rate of just over 5% and an overall global default rate at the end of 2016 at 3.9%, up from 3.0% currently. Moody's notes that there have been 22 defaults in the energy sector over 2015, of the total of 90 defaults[5].

Following approval of the nuclear deal, Iran secured removal of sanctions, further adding to oil supplies. In January 2016, the International Atomic Energy Agency (IAEA) monitoring report stated that Iran had taken necessary steps curtailing its nuclear activities, and that there were currently no indications of activities focused on the development of nuclear explosive devices. This approval by the IAEA opened the doors to cement an agreement between Iran and the P5+1 and led directly to the lifting of international and economic sanctions.

Consequently, Iran could export oil onto the international market again. Some estimates suggest that Iran could add up to 500,000 barrels a day to its current output of 2.9m barrels a day, placing further pressure on an already low oil price[6].

In our view, this adds up to significant geopolitical complexity: a more assertive Gulf led by the Kingdom of Saudi Arabia (KSA) faces a newly-liberated Iran that can provide real economic competition and potentially finance other interests across the region, albeit under the close watch by the West over both nuclear and wider activity. Add to this mix the implications of sustained lower oil prices and possible government succession concerns in the region in the medium-term, and we anticipate increasing competition, periods of instability and periodic confrontation (although, importantly, we do not expect state-on-state direct conflict). We discuss the historical context and the geopolitical trends in more depth later in this note.

Source: [3]The Daily Telegraph 'Oil could crash to $10 a barrel, warn investment bank bears', 12 January 2016. [4]Bloomberg as at 2 January 2016. [5]Bloomberg as at 14 January 2016. [6]International Business January 18 2016: Iran Set to Pump More Oil Into Market Glut.

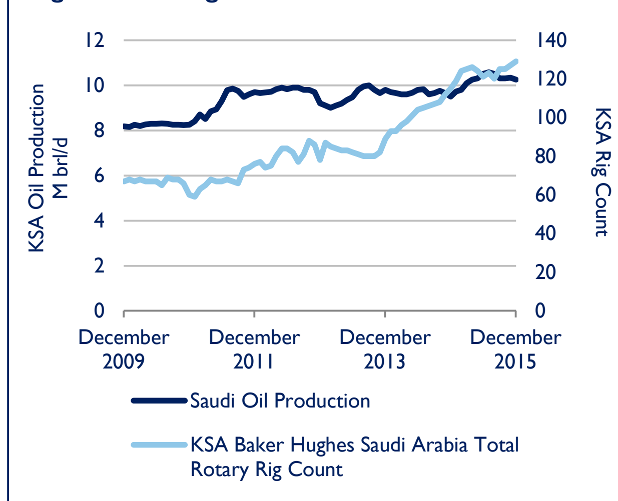
Trade Opportunities

We think there are three interesting trades that are mispriced by the market related to the theme: (1) short credit risk on KSA; (2) short credit risk on other related sovereigns; and (3) long Out-of-the-Money upside risk on oil via call spreads.

1 We believe opportunities exist in owning protection (short credit risk) on KSA for several reasons

- Many Gulf States are running significant fiscal deficits, which they have been financing recently through liquidation and repatriation of external assets.
- Press reports highlight growing pressure on the KSA's currency peg to the US dollar. An abrupt change or removal of the peg could dramatically increase investors' concerns over the stability of KSA's credit quality and perception of the region's geopolitical stability.
- KSA's operations in Yemen will require ongoing funding, exacerbating fiscal deficits. This is pressure unlikely to reduce. The latest budget indicates significant increases in defense spending and KSA intend to show leadership across the Gulf Region.
- Current KSA/Iran tensions. We believe there is a low probability that a 'shooting war' will develop from current tensions, but it is a non-zero probability. The escalation of tensions highlights an historical distrust and lack of mutual respect between the House of Saud and Iran over a variety of issues.
- Nevertheless, we think the market is underpricing the tail risk.
- Absent the low probability of a 'shooting war', we believe that the current state of heightened tension will lead to further escalation in the price war already at play in oil production – both KSA and Iran will continue, if not accelerate, production with ongoing downward pressure on oil prices over the medium term.
- We believe a strong leading indicator of the production intentions of KSA is its rig count. We observed a strong pickup in KSA rig count over 2014 ahead of the OPEC shift in price strategy and in direct response to the surprising effectiveness of US shale drilling and the rapid growth of electric cars. The KSA rig count and KSA oil production are both shown on Figure 2 below. The latest uptick in KSA rig count over the last 6 months leads us to believe that KSA may look to increase production further. In short, we believe that KSA will continue to use oil production as part of its overall strategic plan. This will continue to weigh on oil prices in the short term.

Figure 2: KSA Rig Count and Oil Production[7]



Source: [7]Bloomberg as at 31 December 2015.

2 We believe opportunities may exist in owning protection (short credit risk) on other sovereigns which would also be impacted by KSA and Iran tensions – Israel, China, Turkey, Russia and Japan

- We like owning protection on specific sovereigns in the Middle East area, given our view that the region is facing (a) greater geopolitical tension that could escalate very quickly due to a variety of triggers, (b) weak and deteriorating fiscal situations, and (c) the economic impact of a global price war amongst oil producers.

- While it is not an oil producer and does not exhibit the same fiscal stress as other regional sovereigns, we believe that Israel remains a key geopolitical factor for the region. Given pricing, we believe opportunities may exist in owning protection on the Israel sovereign.

- We view China and Japan to be a 2nd derivative factor to lower oil prices and Middle Eastern geopolitical stress. As such, we like owning protection on the Chinese sovereign and the Japan sovereign at select target pricing.

- Russia and Turkey are other second derivative trades, which also exhibit similar fiscal stress and geopolitical risk factors. We like to tactically trade both Russia and Turkey sovereign risk, as they are volatile, but again, we would look to enter at select target pricing.

- The table below highlights 5 year sovereign CDS for the majority of Gulf Region sovereigns.

Sovereign CDS[8]

5 year CDS Spread (bps), DTCC Net Notional Outstanding

	Current 5 Year CDS (bps)	Last 12 Months		Outstanding ($bn)
		High (bps)	Low (bps)	
Israel	94	94	57	1.12
Abu Dhabi	105	114	49	0.94
Dubai	265	271	170	0.44
Qatar	103	109	40	0.98
Saudi	191	200	54	0.64
Bahrain	385	385	255	0.12
Lebanon	455	460	345	0.57
Egypt	490	490	280	0.13
Turkey	297	340	173	8.15
South Africa	340	375	185	4.59
Russia	329	650	245	5.44
Kazakhstan	315	340	210	0.33
China	117	142	78	12.01
Japan	51	74	20	6.10

[8]Source: Bloomberg, DTCC, 7 January 2016.

3 We believe the market is underpricing the risk that oil spikes higher on Middle East events. We like being upside tail risk on oil by being long OTM call spreads as well as via energy equity baskets

- The oil supply has increased far more than oil demand. Global production is currently 96m barrels per day, up some 2.4m over 2015 in aggregate[9]. Current "rule-of-thumb" consensus estimates show the elasticity is such that each additional 1m barrels per day has an impact of 20% to 25% (lower) on the price at current demand. The increase in supply has been driven by two primary factors: (1) OPEC has increased supply by circa 3m barrels per day over 2015, as shown in Figure 3; and (2) US oil production, both conventional and shale-driven, has not fallen in face of the drop in oil pricing, although it has stopped growing, as shown in Figure 4. We are watching US production with interest.

- While oil production from US shale has declined in response to lower prices there has been a dramatic decline in the oil rig count from 1600 to 498.[9]

- Oil demand has increased, but at a significantly slower pace than supply. The elasticity of demand to the oil price drop of circa 67% since the OPEC announcement in November 2014 has been an increase of 1.5m barrels per day; this is roughly half of the increase in supply over the same period. We monitor several factors to track oil demand, but the most prominent leading indicator is automotive miles driven in the US (see Figure 5). The International Energy Agency also models its estimate for oil demand, which is shown in Figure 6 (on page 8).

Figure 3: Total OPEC Production[9]

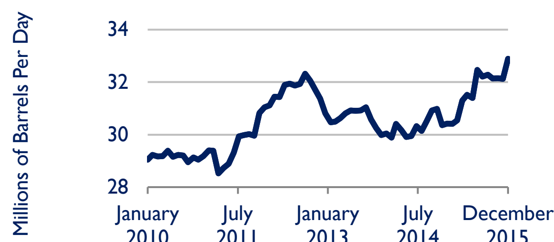
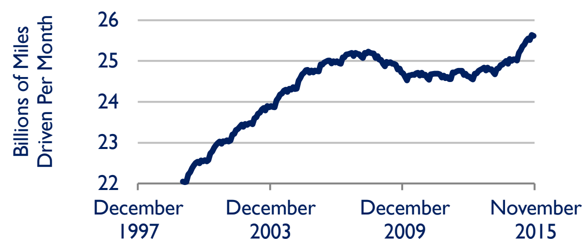


Figure 4: US oil production doubles from 5m to 10m BOE 2011-2015[10]

Figure 5: Total US Miles Driven[11]



Source: [9]Bloomberg, as at 31 December 2015. [10]Bloomberg, as at 1 January 2016. [11]Bloomberg, as at 31 November 2015. 25 day moving average.

3 We believe the market is underpricing the risk that oil spikes higher on Middle East events. We like being upside tail risk on oil by being long OTM call spreads as well as via Energy Equity baskets *(continued)*

- The forward curve for oil remains in contango, but has been a particularly poor indicator of spot oil over the last several years. Figure 7 shows the forward curve at various points in time over the last five years, demonstrating the market's poor ability to forecast realised spot prices. The market failed to anticipate the scale of the increase in OPEC production. Despite being wrong last year, the forward curve continues to anticipate supply reduction, indicating a move to $50 per barrel oil in two years time.
- The majors, with upstream and downstream operations, have benefited from stronger refinancing margins hence outperformed the oil price significantly as can be seen in Figure 8.
- As a result, we believe that oil majors' equity will exhibit less convexity to any sharp spike in spot oil prices than other assets, making them a less desirable trade.
- Sentiment and positioning in oil equities is low, which means that the broader sector is susceptible to a rapid repricing in the face of a sudden, sharp spike in spot oil. A recent Bank of America Merrill Lynch Fund Manager Survey showed that positioning in the Oil & Gas equity space is at a 1.5 standard deviation underweight. In contrast, sentiment towards the sector in equities has improved.
- These two factors combined means the sector is vulnerable to a squeeze higher upon any geopolitical-driven spike in spot oil prices. We believe that the best way to position for this is through broader sector baskets or ETFs, rather than through the oil majors' equity.
- However, we continue to believe that the highest convexity trade remains in OTM call spreads on spot oil directly.

Figure 6: IEA Global Oil Demand[12]

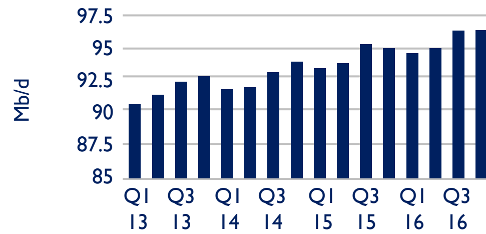


Figure 7: 8 year Forward Curve for Brent[13]

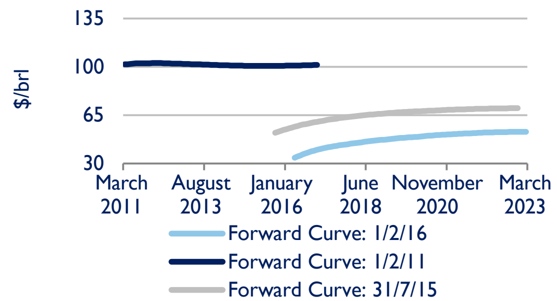
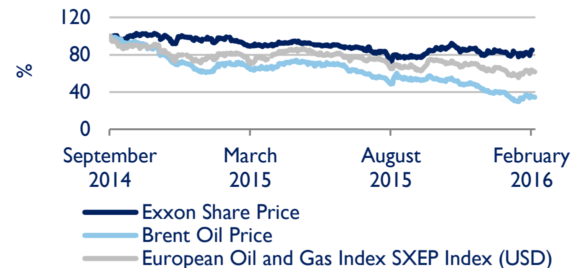


Figure 8: Spot Prices of Crude vs. European Majors Index vs. Exxon Share Price[13]



Source: [12]https://www.iea.org/oilmarketreport/omrpublic, 19 January 2016. [13]Bloomberg as at 8 February 2016, chart rebased to 100.

Finally, our outlook on oil as it relates to our broader macro view:

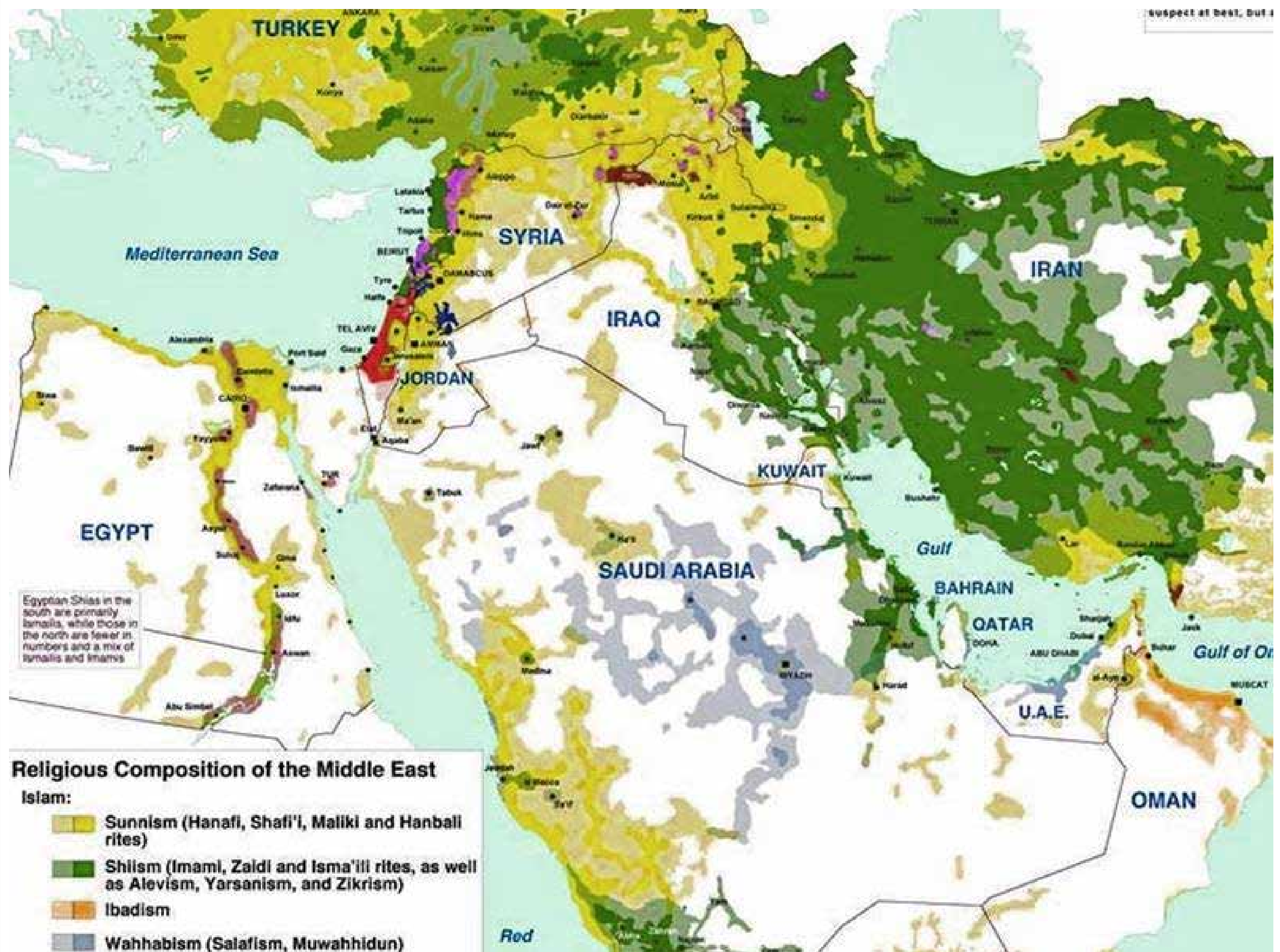
- We remain of the view that oil will remain in the range of $40 +/- $15 per barrel over the medium-term. This is a moderate reduction of our earlier expectation of $45 +/- $15, as detailed in our January 2015 publication. The key drivers of the change relate to recent geopolitical events resulting in higher production (e.g. Iran, Saudi) as well as lower cost curves due to shifts in currency rates and efficiency gains.
- We believe that current lower oil prices remain a support of broader global growth, particularly for China. The offset to this new regime of lower oil prices has been felt in US credit markets and in parts of the global equity markets. Furthermore, there is growing concern regarding contagion into the financial system.
- We believe that US economic growth is more insulated to a sharp spike in oil prices as a consequence of any geopolitical events than in the past, given the domestic production capacity in place. Put another way, any KSA-Iran escalation should lead to an increase in the differential between Brent and WTI.
- We believe that oil prices continue to be a key factor for US energy credit spreads and, as a result, for broader sentiment for US high yield.

  We believe a sustained rise in oil prices would have a direct (positive) impact on credit quality for US energy credits and should be supportive for US high yield spreads. However, the contra-factual is not the case as most market participants have already begun to differentiate US high yield energy from the rest of US high yield credit risk. This bifurcation of US high yield occurred over 2015 and, as a result, further declines in oil prices should not weigh on non-energy US high yield. In contrast, much of US high yield energy is already being priced based upon the remaining liquidity runway, which is almost linearly tied to oil prices at this point as hedges-in-place have begun to roll off over 1H16. Our modal view is that oil prices will continue to trend downward, meaning that US high yield energy will remain under stress.
- To be clear, global risk premia would rise upon any geopolitically driven spike in oil prices. The above points simply illustrate our view on the first order and second order economic impact. The rise in risk premia will be transmitted through asset valuations, but we believe it would have a larger (negative) impact on China and Emerging Market equities over US equities and a potential (positive) impact on US high yield credit.

The Gulf: Strategic Snapshot

The GCC States occupy oil & gas rich lands in a critical strategic location. They lie at the interface between the Arab and Persian Worlds, and the head of the Indian Ocean adjacent to three of the world's key strategic chokepoints on which they depend for imports as well as exports. Just as importantly in the current context, they occupy a unique place at the heart of Islam; KSA sees itself as protector of Sunnis (c.85% of 1.6bn Muslims globally), notably from Iran from which elements purport to represent the world's Shia, including those living in, or nationals of, GCC states.

On security, most GCC states coalesce to the KSA view of existential threats from a strategic enemy to the East (Iran) and the collapsed states that surround them, although UAE and Qatar have been more open to independent thought and action, and Oman has tended to be seen as an outlier and diplomatic conduit to Iran. In other respects, even when they face similar challenges, they each have different visions for their future societies and on the speed and extent of economic transformation, tourism, transport and technologies; the UAE embraces a vision of post-Arab modernism.



Source: http://mapsontheweb.zoom-maps.com/post/57331716828/religious-composition-of-the-middle-east

For long-term success they each have to overcome the common challenges of: dry lands, large public sectors, unsustainable social contracts, oil dependent economies, young populations, and in some cases huge proportions of expatriate workers. They need to deliver on their ambitious national development programmes, manage significant economic and social pressures, and achieve economic diversification and significant investment in infrastructure, while managing security threats endemic in their dangerous region. They know the status quo is not an option; the question is 'change – how far and how fast?'

The 1979 revolution in Iran transformed Arab/Persian relations and historic tensions between Sunni and Shia, and has been followed by almost constant confrontation. Most Gulf states see an aggressive anti-Sunni Iran which is active in the Lebanon and Palestine, and fuels the chaos of Iraq (supporting the Iraqi Government against Daesh but being linked to militias involved in kidnappings), Syria (supporting the Assad regime) and Yemen (supporting the Houthis). There is real fear of encirclement by a Shia crescent, heightened by perceptions of an Obama 'pivot' away, a weak US on Syria, and the P5+1 nuclear 'deal' with Iran.

Recent Gulf operations in Yemen show increasing regional expeditionary capability and a new KSA willingness to take the regional lead; very ambitious defence spending plans and increased engagement by KSA with Pakistan show long-term intent despite the economic challenges. In the medium-term, however, US and UK maritime and air forces will remain the primary guarantors of the security of Gulf States, and of their critical infrastructure and lines of communication from Iranian military capability which has increased despite sanctions. With international partners, they will promote security in international straits and across the Indian Ocean from East Africa to India, and from Pakistan to Tanzania.

While 'direct state-on-state conflict' between the Gulf states and Iran is highly unlikely, if Iranian activity in the wider region endures recent events suggest that Sunnis will be supported by their counterparts in the Gulf, possibly militarily as in Yemen, and that instability across the wider region will continue. In time, continuing instability could threaten the very existence of nation states, from in the Middle East to Africa, promote further mass migration, and undermine the international system.

Iranian interference is also perceived by Gulf States to threaten their internal stability, not least among the Shia populations of KSA and Bahrain. Security in the oil rich Eastern Province of Saudi Arabia has been particularly tight for some time, and in the last year the government in Riyadh was at pains to show support to the Shia community following Daesh attacks on Shia mosques there. There is a threat of further terrorist or sophisticated cyber-attacks against infrastructure such as that on Saudi Aramco in August 2012 which was attributed by many to Iran. The additional security challenge for Gulf States is to distinguish internal and external actors, political opposition and security threats, and seek to mollify rather than inflame tensions. They do not generally receive credit for progress made (the award of the European Union's Chaillot Prize for Human Rights to Bahrain in late 2014 went almost unreported) but many of their friends have acknowledged that they have some way to go.

Recent events have not had the significant repercussions on markets which might be expected. Seen in context and not as isolated incidents but connected, they disclose significant strategic pointers. The execution of Sheikh Nimr al-Nimr was one of 47 executions, 43 of which were Sunni extremists as Riyadh set out its stall against terrorism from every quarter; the co-ordinated reaction to the subsequent localized attack on the Saudi Embassy in Riyadh

saw significant GCC coherence and international criticism of Iran for failing to protect a diplomatic facility. The capture of US boat crews off Farsi Island was extraordinary for the uncharacteristic conduct of the US and Iran. Washington, the world's leading proponents of freedom of navigation, made little of the fact that the Iranian capture and arrest was unlawful. Tehran, masters of extracting every ounce of diplomatic leverage from any tactical event, made little fuss and acted with lightning speed. These were clear signals of the importance to the US and Iran of the nuclear deal and may well reinforce KSA resolve.

We believe 2016 will see an acceleration of new and revived economic relationships between Iran and the international community, but also close scrutiny of Iran's compliance with its new obligations by Israel and others, and continued tensions over the other sanctions in place and with Iranian engagement in the wider region. It will be a year of important elections in the US and in the region; some are also predicting successions. These risk instability in normal times, but in the current circumstances, will be watched even more carefully for signs of significant changes to fiscal and foreign policy.

About the Author

Sir Michael Hintze

Sir Michael is the founder, Chief Executive and Senior Investment Officer of CQS. He is also a Senior Portfolio Manager. Michael serves as a Director on the CQS Supervisory Board (Board of Directors) and chairs the CQS Strategy Board.

Prior to establishing CQS in 1999, Michael was a Managing Director in the Leveraged Funds Group at CSFB, having previously spent 12 years at Goldman Sachs in a variety of roles including; Executive Director and Head of UK Equity Trading. He began his career in finance in 1982 with Salomon Brothers, New York, after working as an Electrical Design Engineer for Civil and Civic Pty Ltd in Australia, where he had also served in the Australian Regular Army in the Royal Australian Electrical and Mechanical Engineers, latterly as a Captain. Michael has significant and wide-ranging philanthropic interests and to consolidate these, the Hintze Family Charitable Foundation was established in 2005 since when over 200 charities have received funding from the Foundation.

Michael is a fluent Russian speaker. He holds a BSc in Physics and Pure Mathematics and a BEng in Electrical Engineering both from the University of Sydney. He also holds an MSc in Acoustics from the University of New South Wales, an MBA from Harvard Business School and received a Doctor of Business honoris causa from the University of New South Wales.

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Since inception, the firm has placed fundamental analysis at the heart of its investment process and we follow a collaborative multi-disciplinary approach seeking adjacencies across all areas in which we invest. Our robust operations and risk management platform provides all mandates with liquidity management and risk monitoring which, in our view, should enable our investment professionals to be more nimble and effective throughout all market environments.

[1]Source: CQS, estimated as at 1 February 2016.

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Europe: MarketAxess Bid-Ask Spread Index (BASI) Developed by MarketAxess Research, the MarketAxess BASI demonstrates the relationship between overall market liquidity and transaction costs by tracking the spread differential between buy and sell trades of the most actively traded corporate bonds. The U.S. index is calculated daily using executed trade data from publicly-disseminated FINRA TRACE data and also incorporates trade data from the MarketAxess trading system. The European index is calculated using quoted price information available through Trax's end-of-day pricing feed, Trax Pricing. The quoted prices from Trax Pricing are also enriched with traded prices as a means of validating the data.

The S&P/LSTA Index tracks the 100 largest loans in the S&P Global Leveraged Loan Index, using market bids from third-party providers. LCD's European Leveraged Loan Index (the ELLI) is a gauge to track performance of the asset class in the European market.

The Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded. The US Corporate High Yield Index is a component of the US Universal and Global High Yield Indices. The index was created in 1986, with history backfilled to July 1, 1983.

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