Economics

ING WHOLESALE BANKING

Global

# Attacking Iran

## The market impact of a surprise Israeli strike on its nuclear facilities


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### A high impact, if low probability, scenario?

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**The financial markets are assuming that an Israeli and/or US attack on Iran is unlikely. However, bellicose rhetoric from Israel and an imminent build-up of US forces in the Gulf suggest that they could be in for a shock.**


**An imminent attack would seem unlikely,** given the weakness of the Israeli and US administrations, and hopes for regime change in Iran. However, Iran's threats to Israel's existence, and fears that it will acquire nuclear weapons within two years, suggest that President Bush may sanction action before he leaves office at the end of 2008.

**However, within a month** the US will have two aircraft carrier battle groups and a new expeditionary Marine strike force in the Persian Gulf, which might provide a shield for an Israeli bombing of Iran's facilities. Israel reportedly has the weaponry to at least delay the nuclear programme.

**A key imponderable is the extent of Iranian retaliation.** Although missile and terrorist attacks on Israel and US interests would be likely, the threat of massive US retaliation, regional conflict and long-term damage to its political and commercial interests might limit Iran's response.

**The financial market impact would be dramatic,** even if Iranian retaliation were restrained. Risk assets have risen strongly over the past three years, and a surprise attack on Iran would catch out markets pricing in little volatility. The US dollar, government bond yields, stock markets and industrial raw materials would all fall. Oil and gold prices, could spike, boosting related equities, debt and currencies. Other credit spreads would widen, and the unwinding of carry trades would see funding currencies benefit, although Japan, dependent on Iranian oil, might lag others such as the Swiss franc. A prime casualty might be the Turkish lira, which could fall 10-20%. The duration of these effects would depend on the extent of Iranian retaliation: a constrained response would make them short-lived.

**Top trades *in the event of an attack on Iran***

**Currencies**
Buy CHF, Buy NOK
Sell TRY

**Commodities**
Buy Oil and Gold
Sell industrial commodities

**Equities**
Outperform Oils, Lukoil, Gazprom
Sell Turkey, Israel

**EM Bonds**
Russia/Kazakhstan – Outperform
Sell Turkey/Iraq

**Developed Bonds**
Buy 5yr US paper
Buy Euro 10*10yr volatility
Sell Itraxx Main

# Attacking Iran

***Markets assume no attack, and regime change would support this***

For the moment, the global financial markets regard the risk of a US or Israeli strike on Iran as a remote possibility. Indeed, after their respective misadventures in Iraq and Lebanon, both the US and Israeli administrations would seem to lack the political strength to carry off such an attack in the near term, preferring to hope that spontaneous regime change in Iran will reduce the threat posed by its efforts to develop nuclear weapons. Nevertheless, both remain determined to thwart these efforts. This puts a timescale of two years on possible diplomatic or military solutions, which happens to coincide with President Bush's remaining tenure.

***Yet risk of near-term attack does exist***

However, later in this report, we examine the arguments that suggest that an attack on Iran's nuclear facilities, probably by Israel, may not be as remote a possibility as the markets appear to think. We outline a scenario in which Israel attacks 5 or 6 of Iran's nuclear facilities in late February or March 2007, with strikes that may be completed within hours, days or at most weeks. We argue that direct US involvement is possible, but that US forces might instead act as a shield to deter Iran from escalating any retaliation beyond the expected Shahab-3 missile, Hamas and Hizbollah attacks on Israel. Although the probability of such a scenario may remain low, the impact on the global markets would be sufficiently dramatic, albeit perhaps short-lived, to warrant investors' attention. Indeed, the threat of action could impact on prices.

We start this report with our assumptions for the immediate global market reaction to such an 'imminent strike/limited response' scenario. We then discuss in more detail the background to the scenario and the alternative possibilities, including the potential for broader retaliation by Iran.

## The impact on the financial markets

***The Iraq case gives us some clues on the flight from risk***

The response of the financial markets to the onset of the war in Iraq provides us with some clues as to how they would react to an attack on Iran (see charts below). The combination of threatened disruption in oil supplies and a general flight from risk assets might lead to:

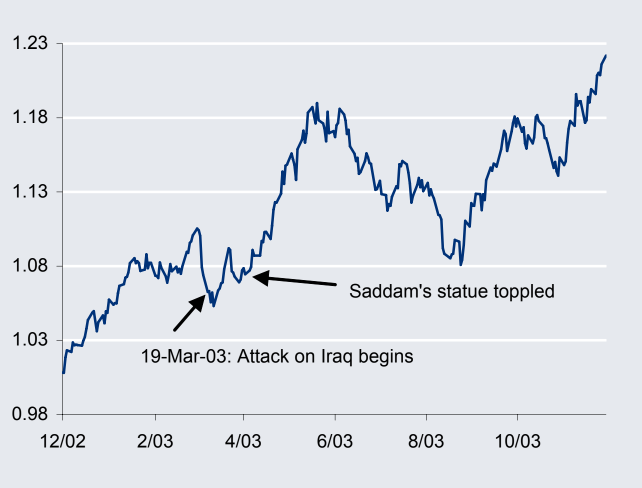
- Surging oil prices.
- Sharp declines in stock prices.
- Sharp falls in bond yields and interest rate expectations.
- Wider credit spreads.
- Possible weakness in the US dollar.

***But how big and lasting would the effects be?***

Yet while the direction of the market responses might be clear cut, the example of Iraq might not give us a reliable guide as to how big or lasting the effects would be:

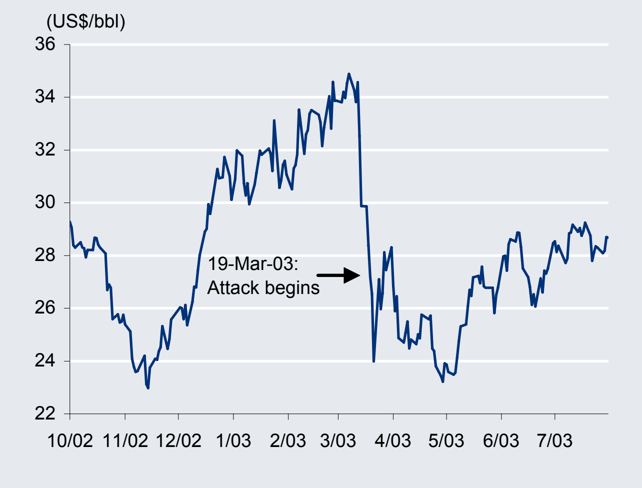
- A sudden, surprise assault on Iran's nuclear facilities might prompt a much more sudden market reaction than we saw in the case of Iraq. The markets spent weeks in advance pricing in the Iraq conflict: indeed, such was the confidence in the initial outcome, the market responses had partially reversed in the week prior to the invasion. With an air strike, the Israelis might seek to keep the timing more of a surprise.

**Fig 1 EUR/USD rates – 2002-03**



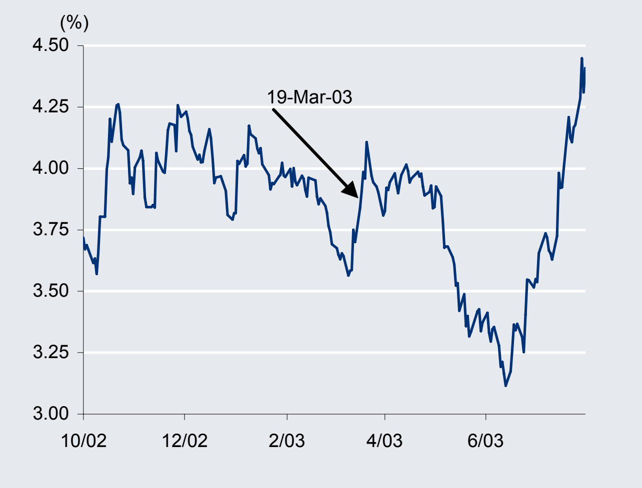

Source: Reuters

**Fig 2 Brent crude prices – 2002-03**



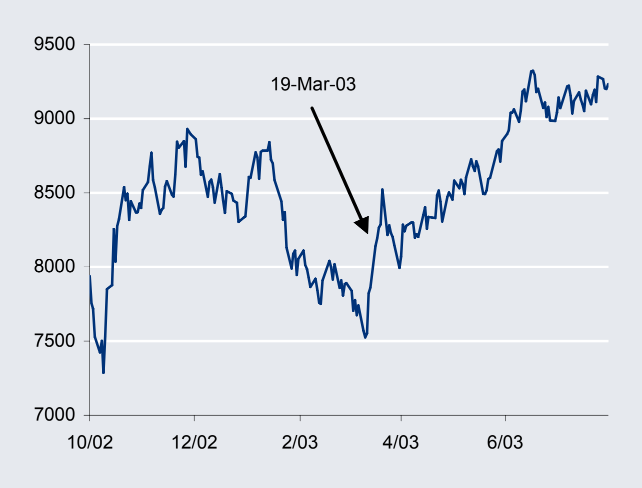

Source: EcoWin

**Fig 3 US 10-year yields – 2002-03**




Source: EcoWin

**Fig 4 Dow Jones index - 2002-03**




Source: EcoWin

- The smaller scale and duration of this action relative to a ground invasion of Iraq might mitigate its impact.
- If Iran chose to direct retaliation solely at Israel – then lasting market consequences may be largely limited to Israel alone (see later).

***BUT the impact might be greater than this***

However, in some ways, the impact might be greater than it was in the Iraq case:

- Volatility levels in the financial markets are at record lows, and while a strike on Iran may be over quickly, its impact could be magnified by this fact.
- An assault on Iran could pose even bigger risks to international relations.
- The threat to global oil output would be substantially greater.
- The US is now in a weaker military and political position than it was four years ago.

***A price worth paying***

Such thoughts might be seen as a serious deterrent for the US supporting an Israeli attack on Iran in the first place. But it must be remembered that the US administration is not viewing its agenda through an economic prism. As an administration official, when asked in late 2004 about the mounting costs of the war in Iraq put it, they pale “compared with the costs that the terrorists would like to inflict on us”.

# Oil – US$65-80/bbl plausible

***The Iraq scenario suggests oil back to the mid-US$60s***

If the market responses in the build-up to the Iraq war were replicated, this would imply a US$9/bbl increase in the oil price, taking Brent from US$55/bbl to US$64/bbl. However, this would almost certainly prove to be an underestimate given that Iranian oil production of 4m barrels per day in 2005 is double the 2m barrels per day produced by Iraq in 2002, and Iran is a bigger net oil exporter.

**Fig 5 Net oil exporters and importers (2005)**

| Top oil exporters | 000bbl/day | Top oil importers | 000bbl/day |
|---|---|---|---|
| Saudi Arabia | 9,144 | US | - 13,825 |
| Russian Federation | 6,798 | Japan | - 5,360 |
| Norway | 2,756 | China | - 3,361 |
| Nigeria* | 2,580 | Germany | - 2,586 |
| Venezuela | 2,454 | South Korea | - 2,308 |
| Iran | 2,391 | France | - 1,961 |
| United Arab Emirates | 2,374 | India | - 1,701 |
| Kuwait | 2,363 | Italy | - 1,692 |
| Iraq* | 1,820 | Spain | - 1,618 |
| Algeria | 1,761 | Netherlands | - 1,071 |
| Mexico | 1,781 | Taiwan | - 884 |
| Kazakhstan | 1,156 | Singapore | - 826 |
| Qatar | 1,000 | Belgium & Luxembourg | -809 |

* This is a production figure only, there is no consumption data.
Source: BP

***Above US$80/bbl is implausible unless Iran decides on wide-ranging retaliation***

More importantly, an air strike on Iran would be qualitatively different to the invasion of Iraq. While there would be no immediate threat to Iran's own oil production, the threat of Iranian retaliation against supplies from the rest of the Gulf might spook the oil markets. Panic speculative buying would quickly revive talk of US$100+/bbl oil.

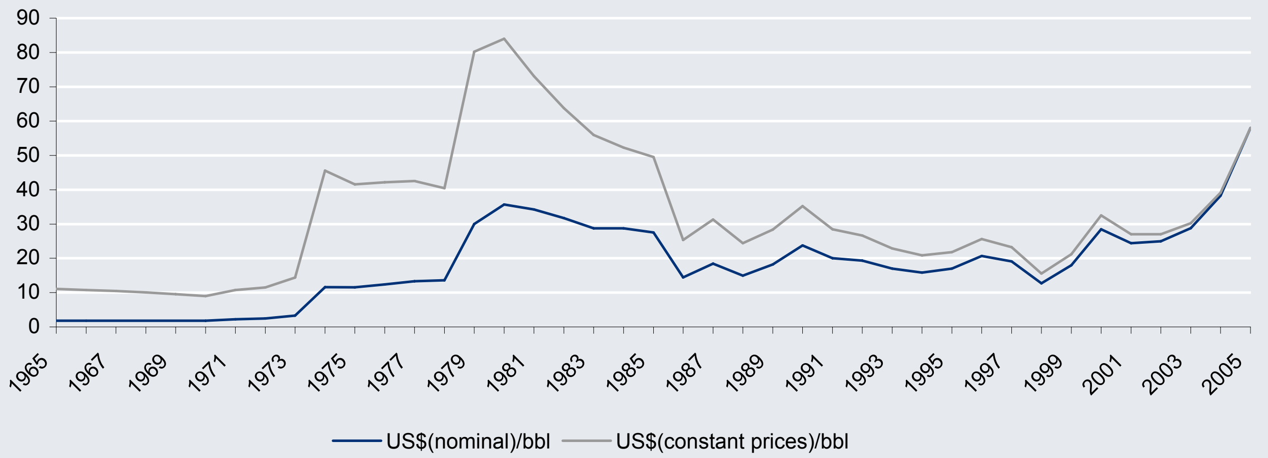
***1981 attack had no obvious impact on oil prices***

After an initial speculative spike in oil prices, much would then depend on whether Iran delivered on any threats to disrupt oil supplies. If an Israeli attack only met with Iranian retaliation against Israel alone, any hike in oil prices would probably be temporary. Note that after its 7 June 1981 attack on the Iraqi Osiraq nuclear reactor, oil prices were not dramatically affected. Iran/Iraq were already at war, OPEC was in disarray, the US was entering recession and there was no Iraqi retaliation.

***OPEC's spare capacity is well above Iran's net export total, so impact could be limited***

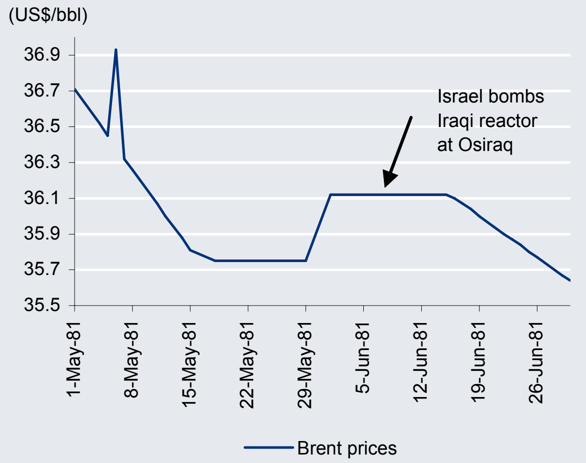
Indeed, in such a limited response scenario, prices might soon be falling back. First, spare capacity in OPEC countries has soared in the past 1-2 years and is now equivalent to around 3.5-4.0m barrels a day, well above Iran's net export level and double the figure of late 2004 when China's demand surge pulled oil sharply higher. Second, it is worth remembering that even when 15% of US refining capacity was knocked out by hurricanes, oil only approached US$80/bbl. Thirdly, oil demand would probably at least temporarily be knocked back as consumer and business demand fell in response to the news of the attack on Iran. Thus, in the absence of sustained Iranian action to disrupt supplies, oil prices would be unlikely to breach historical peaks for long.

**Fig 6 Oil prices in nominal dollars and constant July 2005 prices**



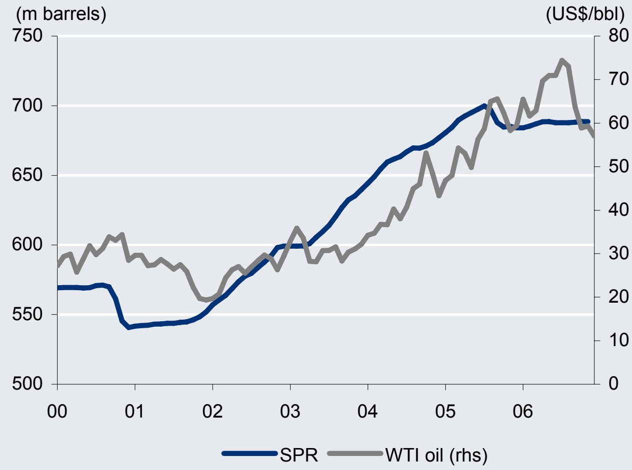

Source: ING, BP

**Fig 7 Any attack may not have a multi-week effect**




Source: EcoWin

**Fig 8 US SPR hit 95% capacity in 2006**




Source: EcoWin

***US has reserves to cover 75 days of imports***

Moreover, the US may have learned a valuable lesson from 2003, which is that more judicious use of the Strategic Petroleum Reserve (SPR) could help restrain price hikes. The US has hiked its SPR by 150m barrels since the Iraq invasion, and it is now at around 90-95% capacity. In addition, crude inventories – while they have dipped in recent months – remain well above the 8-year average of 300m barrels, at roughly 320m barrels. As US import demand is roughly 13m barrels per day, even if the US could buy no oil from anyone, it could last for some 75 days on current consumption levels. But as we see supply as likely to be maintained from Nigeria and others, this is improbable.

***However, unlike Iraq in 1981, Iran may see some advantage in threatening to disrupt oil supplies***

However, back in 1981, it was not in Iraq's interest to disrupt oil supplies or anger the US which was supporting it in its war with Iran at the time. Iran may have different priorities this time. As we discuss later in the report, it may see the threat, if not the reality, of disruption to oil supplies as its most effective retaliatory weapon.

# Currencies – buy CHF, sell TRY

*CHF and NOK ideally positioned to benefit, JPY to a lesser extent*

In the event of an Israeli strike on Iran, US dollar weakness would be likely given that the US would generally be perceived to have given the strike at least its tacit backing. The threat of a geo-political or terrorist backlash against the US and a flight from risk assets would undermine confidence in the US dollar.

Given that market positioning is already 'long' euros, we believe a greater beneficiary of dollar weakness might prove to be the Swiss franc (CHF) which is already at historically low levels. Moreover Switzerland is less dependent on oil than most (2% of its electricity is generated by fossil fuels). The Norwegian krona (NOK) and Japanese yen (JPY) may also benefit, though the latter may be marginally impacted by concerns over Japan's dependence on Iran's oil imports.

*Buy low delta EUR puts/CHF calls*

*Carry trade may be unwound if uncertainty is sustained*

In terms of speculative positioning for this event risk, we see value in owning three-month low delta EUR puts/CHF calls. CHF weakness in 2006 and early 2007 has for a large part been driven by the exceptionally benign global investment environment – a situation which would reverse under our scenario.[1] A sharp appreciation of the 'safe haven' CHF or JPY could trigger an unwinding of 'carry trades', due to value-at-risk (VAR) issues. This might hit particularly exposed carry trade currencies. The three most popular have included Turkey, Indonesia and Brazil. The latter two are net exporters of energy so may be expected to benefit from a surge in energy prices.

VIX calculations suggest Turkey is most exposed, with BRL, MXN and PHP also exposed, with the SGD and THB looking least vulnerable.[2] However, Asian currencies could suffer if Asian stock markets sold off, while the HUF might suffer if the CHF is strengthening.

**Fig 9 VIX calculations of currency vulnerability**

| | VIX | PHP | IDR | TRY | BRL | MXN | HUF | SGD | THB |
|---|---|---|---|---|---|---|---|---|---|
| VIX | 1 | | | | | | | | |
| PHP | 0.304171 | 1 | | | | | | | |
| IDR | 0.177287 | 0.457042 | 1 | | | | | | |
| TRY | 0.599398 | 0.217816 | 0.23066 | 1 | | | | | |
| BRL | 0.497769 | 0.334371 | 0.180108 | 0.518446 | 1 | | | | |
| MXN | 0.481873 | 0.334657 | 0.01298 | 0.530425 | 0.529999 | 1 | | | |
| HUF | -0.01375 | -0.02524 | 0.255652 | 0.032605 | -0.15827 | -0.07867 | 1 | | |
| SGD | -0.10019 | 0.167086 | 0.529291 | 0.044087 | -0.03107 | -0.061 | 0.661216 | 1 | |
| THB | -0.0254 | 0.339081 | 0.511458 | 0.197693 | 0.167657 | -0.08576 | 0.468707 | 0.730421 | 1 |

Source: ING, Bloomberg

*Close long TRY positions by mid-February*

We would recommend scaling down long-Turkish positions through January and February. The very expensive option of shorting the currency might be worth considering in February-March, but is very reliant on this 'Attacking Iran' scenario bearing out.

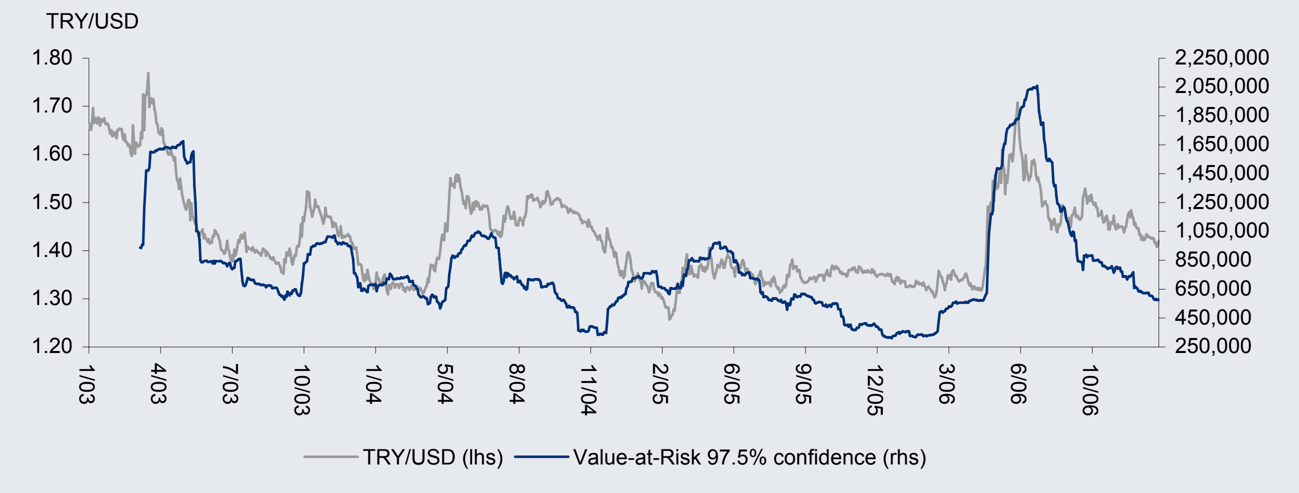
*Turkey is the most exposed of the carry trade beneficiaries – 20% loss possible*

Turkey is a heavy net importer of energy. We see the Turkish lira as the most vulnerable currency to a sharp move stronger in the CHF and/or JPY. This might be attributed to Turkey's geographic proximity to Iran and questions over whether Turkish airspace or airbases were used in the attack, as well concerns over Iraq's unity. A 10-20% weakening of the currency is quite plausible. Indeed, we saw a similar move in March 2003.

[1] For details contact Chris Turner

[2] For details contact Luis Costa

Fig 10 TRY vs USD compared to VAR




Source: ING, Bloomberg

# Equities and commodities – Buy oil/Russia/Gold and Sell Turkey/Israel

*As stock markets fall, oil stocks could outperform*

Stock markets would be likely to suffer across the board as oil prices and risk aversion increases. In contrast to the currency effect, where the US unit would suffer more than the other majors, the US stock market would be among the least affected. In common with other recent setbacks, risk aversion and higher volatility would hit other developed markets harder, and emerging markets worse still. However, within this general picture, oil stocks should rise in response to the initial spike in oil prices. Most major energy stocks do have exposure to the Gulf region (eg, Exxon Mobil in Qatar or Total in Iran) but total exposure to Iran itself is no more than 2% of reserves for any company.[3]

*Four categories of markets within EMEA*

Within emerging markets, we would identify four types of market:

- **Markets where any initial spike in the oil price would be seen as beneficial** – Russia, Kazakhstan. We would recommend taking advantage of presently weak oil prices to buy options in easily tradable liquid Russian energy stocks such as LUKOil and Gazprom.
- **Markets which would be seen as less affected** – Czech Republic, Poland, perhaps Romania.
- **Regional markets which, despite attractive fundamentals, would likely be sold off as a knee-jerk reaction to any attack** – Israel, Egypt.
- **Markets which would suffer disproportionately to a reversal in risk appetite and/or the carry trade** – Turkey (especially given currency weakness).

*Buy South African gold stocks*

Since risk aversion would benefit precious metals prices, South African, Russian and Kazakh gold stocks should do well, such as Gold Fields, Harmony and Anglo-Gold in South Africa, Kazakh Gold and Polyus from Russia. However, depending on the depth and duration of any drop in business confidence, non-precious metals and other industrial commodity prices might fall back as markets feared a contraction in demand.

[3] See "Sustaining Risk – Pan-Euro oils: the end of easy oil", 7 September 2005, by Jason Kenney.

*Sell Turkey, Egypt and Israel*

The Turkish, Egyptian and Israeli stock markets (see Figure 14) would obviously suffer. Drops of 15-20% would be likely in this scenario, with Turkey additionally hit by the market overweight in that market. If confined to Israel we would recommend Ebit Systems and construction stocks and go short the banks. We would be tempted to see a significant sell-off in Turkey (particularly if the currency were to weaken sharply) and Israel as an interesting entry point to both markets

# Debt – flight to quality

*US bonds would likely rally in a flight to quality*

The initial response in the money and bond markets would likely be a classic 'flight to quality', with funds flooding out of risk assets into government paper. In the midst of a general fall in government yields, expectations of interest rate cuts would lead to steepening in yield curves. For comparison, 10-year US Treasury yields fell by 60 basis points in the run-up to the Iraq war, which from current levels would imply a move to around 4.1%. Again, the depth and longevity of the fall in yields would depend on the extent of Iranian retaliation. The figure below shows some recommended trades in the developed markets.

**Fig 11 Developed market bonds – trade ideas**

| | Trade | Details |
|---|---|---|
| 1 | **Buy 5yr US outright or Set 5/30yr steepener** | Start 5yr yield = 4.58%, Target 4.25%. Start 5/30yr spread = 12bp, Target 25bp. **Rationale:** The 5yr area is already the richest point on the US curve, but would richen further in anticipation of easier monetary policy from the Fed. It is a part of the curve that anticipates Fed moves well in advance, and would be a central beneficiary from shifts out of riskier assets. |
| 2 | **Buy US 10yr, Pay US 10yr Swap** | Start 10yr swap spread = 46bp, Target 60bp. **Rationale:** Position for wider US swap spreads, which is optimally done in the 10yr area where there is maximum potential for widening pressure to materialise in best total returns. We would anticipate more swap widening in the 10yr area than in the 5yr area. |
| 3 | **Buy 2yr Eurozone** | Start 2yr yield = 3.90%, Target 3.60%. **Rationale:** Being long the Eurozone front end presents a good safe haven play with maximum exposure to the euro against a backdrop where pressure is taken off the ECB to hike rates further. |
| 4 | **Buy 30yr Eurozone** | Start 30yr yield = 4.04%, Target 3.75%. **Rationale:** Getting long the 30yr adds a maximum interest rate sensitivity to the euro exposure, and fits with a scenario where there is buying right along the curve. |
| 5 | **Buy Eurozone 10yr linker, Sell Eurozone 10yr conventional** | BEI = 2.05%, Target 2.20%. **Rationale:** Play the higher inflation expectations view coming from higher energy prices by buying inflation, either in the US or the Eurozone. We prefer the 10yr BEI in the Eurozone as shorter-term BEIs are slightly too high as a starting point. |
| 6 | **Buy 10yr Bund, Sell 10yr Greece** | Start 25bp, Target 30bp. **Rationale:** Expect a flight into core market coupon liquid issues. This should coincide with an underperformance of peripheral Eurozone paper, and especially from smaller issuers such as Greece and Portugal (although Italy too would suffer due to the low credit rating). |
| 7 | **Buy EUR 10yr*10yr volatility, i.e. buy a straddle (put+call) on a 10yr swap with 10yr until expiration** | Increased uncertainty by definition results in both larger actual and implied volatility. The latter is better played through long-term options. We buy EUR long-term volatility as it trades cheaper than US equivalents. Current premium EUR 10yr*10yr = 731bp, target 800bp.) |
| 8 | **Instead of buying long-term volatility (trade #7), one can sell in the money payer swaptions (right to pay fix)** | Short-term options are trading cheap but this event would result in lower swap rates. Sell in-the-money payers to profit from the richer volatility skew and the large delta effect. Both USD and EUR are fine. For example: Sell the 6mth*10yr EUR payer 25bp in the money (strike 3.935) gives us a premium of 2.47bp. |
| 9 | **Buy HiVol (sell protection), Sell Itraxx Main (Buy protection)** | Start 23bp, target 40bp. **Rationale:** The so-called de-compression trade in € credit would perform as the lower-rated reference entities within the HiVol index suffer in line with the Crossover index and emerging markets. The trade is supported by the fact that the 23bp give is only 2bp off all time lows. |
| 10 | **Buy Crossover index (Buy protection)** | Start 220bp, Target 300bp. **Rationale:** Underperformance of emerging market debt would effect lower-rated corporate asset classes. The iTraxx Crossover index (speculative grade) is trading 5bp outside all-time lows. Returns would be optimised by buying the index (short credit). |
| 11 | **Buy Lower Tier 2 bank paper, Sell Tier 1 bank capital paper** | Start give 45bp, Target give 70bp. **Rationale:** A flight to quality would benefit higher seniority financial papers. Tier 1 trades most in line with other high-beta segments. The trade also benefits from a defensive tone supported by Basel II preferences. |

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***EM bonds may suffer, but oil producers may outperform***

Emerging debt is unlikely to fare well in an environment of risk aversion and flight to quality. However relative out-performance would be likely from oil credits, such as Venezuela, Nigeria, and Russia. Corporate bonds from Russia and Kazakhstan as well as Cemex bonds in Mexico may do very well. In the medium term Russia may also do well as the market begins to re-price the relative geopolitical risk in Putin's Russia vs the Middle East region.

***Iraq would be a net loser as oil prices rise, but civil war worsens***

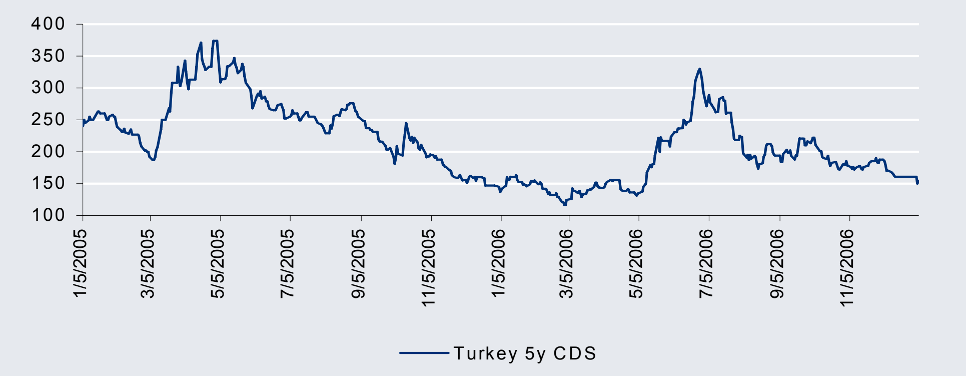
Iraqi debt might suffer despite a rise in oil prices, given the threat of Iran trying to worsen the civil war there in the hope of hiking costs for the US involvement in the Middle East. The unity of the country may be questioned.

For further trade ideas and sensitivities, see *Iran will soon be back in the picture: Who is most at risk*, 22 February 2006.

***Turkey again would suffer***

Turkish Eurobonds are very likely to suffer, as indeed all Turkish assets would. We would recommend buying 5-year Turkish CDS which at present levels offer good entry points at present.

**Fig 12 Turkey 5y CDS**




Source: Bloomberg

**Fig 13 Relative impact of changes in the international price of oil**

| | Net exports (million bpd) | Annual net export value based on 2005 average US$51.94/bbl (US$bn) | Net oil exports (as % of 2005 GDP) | Annual impact of US$20/bbl change (US$bn) | Annual impact of US$20/bbl change (as % of 2006F GDP) |
|---|---|---|---|---|---|
| Nigeria* | 2.3 | 47.6 | 48.1 | 17.1 | 14.3 |
| Venezuela | 2.5 | 46.5 | 37.2 | 17.9 | 12.1 |
| Kazakhstan* | 1.2 | 21.3 | 37.7 | 8.4 | 11.7 |
| Russian Federation* | 6.8 | 125.2 | 16.4 | 49.6 | 5.3 |
| Colombia | 0.3 | 6.0 | 5.0 | 2.3 | 1.8 |
| Mexico | 1.8 | 33.8 | 4.4 | 13.0 | 1.5 |
| Argentina | 0.3 | 5.8 | 3.2 | 2.2 | 1.1 |
| Egypt | 0.1 | 1.5 | 1.6 | 0.6 | 0.5 |
| Brazil | -0.1 | -1.9 | -0.2 | -0.7 | -0.1 |
| Indonesia | 0.0 | -0.6 | -0.3 | -0.2 | -0.1 |
| Romania | -0.1 | -2.4 | -2.4 | -0.9 | -0.8 |
| China | -3.4 | -63.7 | -2.9 | -24.5 | -1.0 |
| Slovakia | -0.1 | -1.4 | -3.0 | -0.5 | -1.0 |
| Hungary | -0.2 | -2.9 | -2.6 | -1.1 | -1.0 |
| Poland | -0.5 | -9.1 | -3.0 | -3.5 | -1.0 |
| Turkey | -0.6 | -12.3 | -3.4 | -4.7 | -1.2 |
| South Africa | -0.5 | -10.0 | -4.2 | -3.9 | -1.5 |
| South Korea | -2.3 | -43.8 | -5.6 | -16.9 | -1.8 |
| India | -1.7 | -32.2 | -5.5 | -12.4 | -1.9 |
| Philippines | -0.3 | -5.9 | -6.1 | -2.3 | -2.0 |
| Ukraine* | -0.3 | -5.4 | -6.5 | -2.1 | -2.3 |
| Thailand | -0.7 | -12.7 | -7.2 | -4.9 | -2.6 |
| Bulgaria | -0.1 | -2.1 | -7.8 | -0.8 | -2.6 |

*Russia/Kazakhstan/Ukraine use Urals (50/bbl in 2005), Nigeria at Forcados (56/bbl), for all others we average WTI/Brent
Source: BP, ING GDP forecasts

**Israeli Markets – Caught in the Crossfire**

Even in the event of limited retaliation by Iran, Israeli markets would be especially vulnerable for the weeks or few months that a conflict might last.

1) There need not be any significant impact on oil prices, as oil installations, pipelines or tankers would not be impacted. Note that in 1981, oil prices actually fell in the month that Israel attacked Iraq (see Figure 5).

2) The last period of ballistic missile attacks on Israel occurred when the ILS was fixed to the US dollar, but historically, ILS and bond prices have not moved in line with terrorist attacks.

3) Equities may suffer, due to the perceived impact on economic growth. Terrorism and Scud attacks have both had a negative impact on tourism, and the height of the intifadas also impacted on retail sales. The war in Lebanon had some impact, but the market recovered within a month.

Below we note key events in Israel and the impact (or not) on the stock market. Unfortunately we do not have data for 1991.

**Fig 14 Israeli stock market (TA-100) and key events (1992-2007)**


**1** Rabin elected as Prime Minister

**2** Oslo agreement signed by Israel-PLO

**3** Israel and PLN signs agreement on Gaza in Cairo

**4** Israel & PLN signs interim agreement in Taba (Oslo II)

**5** Israel launches the Grapes of War operation against Lebanon

**6** Israeli Parliament agrees on Hebron protocol (including Israel withdraws from 80% of Hebron)

**7** Wye River Plantation agreement signed between Netanyahu and Arafat

**8** Israel cabinet votes to pull troops out of South Lebanon

**9** Camp David ends

**10** 2nd Intifada starts

**11** Sharon wins Parliamentary elections

**12** Netanya bombing

**13** Haifa (neighbourhood of)

**14** Hamas orders end of suicide bombings (lasts a month)

**15** Netanya Passover bombing

**16** Israel launches attack on Jenin

**17** Arafat forced to resign from his government

**18** Syria rejects Blair's invitation for Middle East peace

**19** US finally publishes its "Road Map", sends Powell in May to promote it

**20** UN declares Israel in violation of resolution on the security fence around the West

**21** Israel bombs Southern Lebanon

**22** Sharon reveals intention to withdraw completely

**23** Israel incursions in

**24** Arafat

**25** Gaza withdrawal begins

**26** Sharon suffers massive

**27** Olmert becomes Prime

**28** Israel bombs Lebanon "July War

**29** Ceasefire between Hezbollah and Israel's army

Source: ING

# The background

***Democracies give warning of an attack – and we have been given many such warnings***

Democracies don't start wars easily and usually give considerable guidance before they do. Our problem in analysing the likelihood and timing of any attack on Iran is that we have, if anything, been given too much warning. This has been on the agenda since the country was labelled "evil" by President George W Bush in 2002 – a batting back of "the Great Satan" label proffered by Iranian Ayatollah Khomenei in 1979. We wrote about the possibility of a US ground invasion of Iran in '*Persian Gulp'* on 28 January 2005[4] though it was not our base case, and more recently we wrote about the possibility of an Israeli aerial attack on Iran[5] sometime in 2007-08. That time may be very soon – but of course this could come much later, or perhaps not at all.

***Israel will want to act before Bush retires in Jan 2009***

The consensus view, both inside and outside the financial markets, remains that an attack is unlikely. Indeed, it is widely perceived that an attack is less likely than it was a year or two ago. It is not hard to see why. Both the US and Israeli administrations have been weakened by their recent respective military excursions in Iraq and Lebanon. There is certainly not general approval in the US among politicians, the public or the military for action against Iran. Robert Gates, the new US Defense Secretary, is notably less hawkish than his predecessor, Donald Rumsfeld, and has described military action against Iran as a "last resort". Confidence that an attack would succeed is low, bearing in mind that Iran has had ample time to disperse and conceal its facilities, and the uncertainty about the impact of Iranian retaliation is a major deterrent.

***US may hope for internal political change in Iran***

Meanwhile, the fact that President Ahmadinejad's popularity has also slumped could, ironically, be seen as another argument to wait. There is already talk that he may be replaced, and with Ayatollah Ali Khamenei's health failing, the possibility of a less hard-line leadership taking over in Iran might be worth waiting for. Moreover, to attack Iran soon would risk reviving Ahmadinejad's position, if the population rallied around its leader at a time of crisis. Indeed, for that reason, it could be argued that his radical anti-Zionist rhetoric may even be designed to bring such an attack on.

Although the Israelis have recently responded to Iranian threats with their own increasingly vitriolic rhetoric, the consensus is that Iran and Israel are essentially engaged in shadowboxing. The war of words is not expected to turn into physical conflict. But even if the probability of an attack on Iran remains low, investors need to prepare for the possibility that that expectation might be wrong, given the potentially dramatic economic consequences.

In what follows we consider the reasons why Israel might deliver on its bellicose rhetoric, when and how it might attack. We conclude by considering how Iran may respond.

## Why might Iran be attacked?

***The US and Israel are determined to prevent Iran from acquiring nuclear weapons***

If Iran is not persuaded by diplomatic means to desist from developing nuclear weapons, then a military attack is a prospect, such is the determination of the US and Israel to prevent Iran from acquiring them.

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[4] For extracts see p33 of *Directional Economics,* "Excessive Risk-Taking", March 2005

[5] See p14 of *Directional Economics,* "Thai with a Twist", November 2006

*Iran's president has threatened to destroy the Zionist state*

Particularly worrying for Israel is that President Ahmadinejad has suggested that the Zionist state be wiped from the pages of history, which is being interpreted as a genocidal threat by a leader who will remain Iranian president until August 2009. Meir Dogan, head of Mossad (Israel's intelligence service), said in December 2006 that Iran will be in a position to build a nuclear bomb in 2009. He has previously called the Iranian nuclear programme as the "greatest threat" to Israel since its founding in 1948 – which is a dramatic statement given the near destruction of Israel in 1973[6].

*The Begin doctrine demands that Israel acts to stop Iran*

Israel finds itself in a familiar position, because just such a threat existed in the 1970s. Iraq's Saddam Hussein was intent on building a nuclear bomb, which some estimated would be ready by 1985, and his deputy premier Tarik Aziz reportedly declared in 1978 this was for use against the Zionist enemy. After seven years of diplomatic, covert and overt actions, Israel resorted to bombing the nuclear reactor at Osiraq in the hope of delaying the programme by between 3-8 years. It is now perceived to have worked for 25 years. This action became known as the so-called Begin doctrine, named after the premier at the time, which states that no other belligerent power in the region is allowed a nuclear weapon.

*Israel will not accept the deterrence argument of the Cold War*

Israel is not prepared to accept the same doctrine of 'mutually assured destruction' that kept the peace during the Cold War. Israel is adamant that this is not an option for such a geographically small country. Feared scenarios include the delivery of a nuclear bomb to a terrorist organisation which would also make retaliation difficult to justify. So if Israel is convinced Iran is aiming to develop a nuclear weapon, it must presumably act at some point or hope that the US will do so.

**A diplomatic solution**

*As previously, Israel has tried diplomatic methods*

Israel has been waiting many years for the West to find a diplomatic solution. There have been frenzied diplomatic efforts – with visits to Moscow by Israel's premier and by Russian President Vladimir Putin to Israel – presumably in an attempt to dissuade Russia from continuing the support given in building Iran's nuclear reactor at Bushehr. They echo the efforts made in 1976-81 to dissuade France from supporting Iraq's nuclear programme[7]. However, Russia (as France did) has argued that its support is not contributing to the creation of a possible Iranian nuclear weapons programme.

*To prevent attack may require recognition of Israel and an end to Hizbollah support*

To remove the prospect of Israel attacking Iran, we believe that a diplomatic solution would need to involve:

1) Iranian recognition of Israel. This was withdrawn in 1979 – but reportedly in July 2003 Iran did offer recognition as part of a wide-ranging possible agreement to the US around 2003[8].

2) Iran to cease all support for Hizbollah and Hamas, and other terrorist organisations.

3) Iran to comply fully with UN and IAEA demands. Libya sets the precedent for a possible deal that would remove a threat to Israel's security.

*Iran is concerned about sanctions…*

Recent reports suggest Iran may be beginning to take the threat of UN sanctions more seriously. Financial sanctions are perceived to be particularly problematic. Indeed, the economic failures of President Ahmadinejad's administration might be behind the drop in his popularity which has sparked talk of his replacement.

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6 http://formerspook.blogspot.com/2006_12_01_formerspook_archive.html

7 See p27 of the report Israel's Attack on Osiraq http://www.usafa.af.mil/df/inss/OCP/ocp59.pdf

8 http://www.mideastweb.org/iranian_letter_of_2003.htm

***…BUT it may see little point in complying with the UN – it did not help Saddam Hussein***

However, this cannot be relied upon. The US is in no position to pursue regime change, and for Israel, there is the concern that even regime change in Iran would not deliver an end to its nuclear ambitions – after all, Israeli fears over Iran's nuclear programme existed even in the 1990s well before the current president came to power. Moreover, the consensus opinion in Iran appears to be that no attack is likely on Iran in the near term, so it sees no point in attempting to comply with UN resolutions. Iranian politicians believe it is better to show strength against this pressure and win support at the grass roots level across the Muslim world than waste time complying with the UN. All would highlight that occasional Iraqi compliance with the UN and IAEA, and the lack of WMD there, did not prevent the US invasion of Iraq.

# How might Iran be attacked?

***A ground invasion of Iran now looks most unlikely***

Two years ago it was plausible that the US might consider a ground invasion of Iran. Options may have included either a full-scale invasion, with US forces remaining in place for years, or an 'Iraq-lite' 20-30 day campaign in which the goals would be to remove the theocratic leadership and destroy the nuclear energy programme components, before withdrawing and watching to see what may emerge from the resultant political chaos. Since Iraq's descent into civil war, any ground invasion aimed at regime change looks most unlikely – though the use of ground forces cannot be entirely ruled out.

***Air attack looks preferable***

Instead the most likely option would appear to be an operation similar to the 1981 Israeli attack on the Osiraq reactor. In that attack some 14 F-16/F-15 aircraft dropped 16 bombs on the Iraqi reactor, destroying (as some have put it) five years of Iraqi nuclear work in 90 seconds.

## Israeli capability and likely targets

***Israel has forces available to achieve this***

Israel does have the weaponry to repeat this achievement in Iran. F-15/F-16 aircraft equipped with bunker-busting bombs, have the range to strike the 5 or 6 key targets, including the Bushehr nuclear reactor, the heavy water plant at Arak, the Natanz enrichment plans and facilities around Teheran and Isfahan[9]. Submarine-launched cruise-missiles can target the east of the country. Lastly reports in late 2005 suggested that Israel might use a Special Forces brigade (Unit 262) to achieve its goals. Ground attack was also considered against Osiraq.[10] Reportedly even tactical nuclear weapons have been considered though their actual use would be very surprising.[11]

## Duration and risks

***A strike may well not be as successful as Osiraq***

Lessons taken from the Osiraq strike were that any future attack on nuclear facilities would be less likely to be as successful, as countries would deny their nuclear ambitions (making attacks harder to justify) and would disperse facilities (making attacks harder to coordinate). One report concluded that a "future strike may hinder nuclear plans temporarily, [but] the time will not be measured in years unless followed with more strikes"[12].

***There may need to be days of strikes, hiking casualty levels***

If a single strike is insufficient, Israel may need to be prepared to continue this for some days or (less preferably from their perspective) even weeks. The ideal would be to achieve all goals in a very short period of time. The greater scale of the attack compared to 1981 means the immediate costs to Israel may be higher, potentially

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[9] *Der Spiegel*, October 2004, cited in http://www.globalsecurity.org/military/world/israel/iran.htm

[10] www.opendemocracy.net

[11] *Sunday Times*, 7 January 2007

[12] www.usafa.af.mil/df/inss/OCP/ocp59.pdf

involving the capture of aircrew and loss of equipment. But note that one former head of the Israeli Air Force argues that while there are more targets than in 1981, there is also more that must be defended, which may help the Israeli assault. Iran's air defence capacity does not appear strong enough to make the costs of any attack prohibitive.

There is a high risk of civilian casualties.

## The goal of an aerial strike

***The goal will be to delay the programme, not to destroy it***

It is worth emphasising that the expectation of any aerial strike would not be to permanently destroy Iran's nuclear programme. Rather it would be to delay it, as was the goal in 1981 against Iraq, and this might not even require all targets to be destroyed. A delay of 3-4 years would:

1) create an opportunity of political upheaval in Iran, although there is a risk that it could at least temporarily boost the hard-liners;
2) perhaps encourage Iran to reconsider the expense of re-starting the nuclear programme; and
3) at the least ensure that President Ahmadinejad would not hold the bomb before his presidential term ends in 2009.

## Who may attack?

***Israel is determined, but the US could also act***

Israel has repeated many times that it might consider an attack on Iran but the US has also declared that a military option is still on the table as a possible tool to force Iranian compliance with regards to the nuclear weapons programme.

***The Lebanon experience may encourage a surgical rather than mass strike***

A US aerial campaign against Iran carries the military advantages of overwhelming force. Seymour Hersh, a columnist for *The New Yorker* who has written more than most on this issue, said the US was particularly interested in the anti-Hizbollah campaign by Israel in the summer of 2006, as a possible test-run for a similar US assault on Iran. Hersh wrote "[Vice-President Dick] Cheney's point, the former senior intelligence official said, was 'What if the Israelis execute their part of this first, and it's really successful? It'd be great. We can learn what to do in Iran by watching what the Israelis do in Lebanon.' "[13]

***This would enable the US to avoid some of the worst diplomatic repercussions***

There are three significant problems for the US in taking action. First, the broad campaign in Lebanon was considerably less successful than the targeted action against Osiraq in 1981 – so arguably there is no need for the mass assault that the US is capable of. Second, Israel's actions in Lebanon were perceived to be disproportionate to the provocation, and the US would bear a high diplomatic cost if it emulated it by attacking Iranian infrastructure (eg, electricity generators), destroying all air defence capabilities and so on. Third, if Israel acts against Iran, rather than the US directly, then the US can avoid some of the worst diplomatic repercussions (see below).

## When might Iran be attacked?

As noted above, the timing of an attack has been very difficult to predict, as forecasts about when Iran may 'get the bomb' have consistently been too bearish.[14,15] Both Israel and the CIA suggested Iran may get the bomb by 2000 but by 2003 the suggestion

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[13] http://www.newyorker.com/printables/fact/060821fa_fact
[14] The Military Balance 1995/96 – International Institute for Strategic Studies
[15] http://www.fas.org/irp/congress/1992_hr/h920327g.htm

was an Iranian bomb by 2006. In terms of an attack, reports 13 months ago suggested Israel may strike Iran by March 2006, as this would be the 'point of no return' in its nuclear programme – yet this did not happen.[16]

***Iran will have bomb in 3-4 years and "technological independence" in 6 months***

So some may be sceptical about any urgent need for action, despite the most recent statements by Mossad's chief that Iran may develop a bomb by 2009-10, that Iran may have 25kg of enriched uranium by 2008 (Iraq had this already in 1980-81) and that it is six months away from achieving technological independence in its quest to develop a nuclear bomb.

***Israel will want to act before Bush retires in Jan 2009***

However, we can be fairly sure that if Israel is going to act, it will be keen to do so while Bush and Cheney are in the White House. President George W Bush knows his predecessor left it too late to stop North Korea becoming a nuclear power and his personal legacy will not be improved if Iran becomes a nuclear power. Note if Israel did attack Iran, it may receive support from Democrats and Republicans, as the Democrat leader in the House of Representatives, Nancy Pelosi, is seen as a strong supporter of Israel.

However, three factors have prompted us to consider this scenario in which an attack may occur in February-March 2007.

## 1. The Osiraq precedent

One of the most useful single documents on this issue was produced for the United States Air Force's Institute for National Security Studies in July 2005[17]. It outlined the timetable and events surrounding the Osiraq attack in 1981, and there are uncanny similarities to what has occurred recently.

***Israel's decision to attack Osiraq was preceded by diplomatic and media campaigns***

Israel spent years warning about Iraq's nuclear programme, and then in 1980 it changed its tactics. In July 1980 the Israeli cabinet approved a global media campaign to highlight the Iranian threat. Just three months later, in October 1980 the cabinet took the decision to bomb Osiraq – though it then delayed the actual event to 7 June 1981 – partly for domestic political reasons. It is curious to note that PM Menachem Begin was at risk of losing the October 1981 elections and the Osiraq attack certainly lifted his support (he always denied politics played a role in the decision to attack) – PM Ehud Olmert currently has just 9% support from his own supporters. The report highlighted the importance of having political leaders with military backgrounds, which might have a bearing on whether Olmert aims to change his defence minister whose lack of military experience is seen as being one factor behind the failures of the Lebanon campaign.

***We have seen the same in recent years***

Israeli efforts to highlight the Iranian threat are already well-known but we can see from documentaries such as "Will Israel bomb Iran" shown on UK television in October 2006[18] and other examples[19] that the cabinet has most likely given the authorisation for a global media campaign.

## 2. The UN timetable

***The UN deadline of 20/21 February could be the trigger for an attack***

If Israel does attack Iran, it will want to minimise the inevitable diplomatic fallout that will emerge from this. We believe it may have been waiting for diplomatic efforts to show their evident failure. On 22/23 December 2006 the UN Security Council approved

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[16] *Sunday Times*, 11 December 2005 and the *Sunday Times* carried another story on 7 January 2007 but without mentioning timing

[18] see *Directional Economics* "Thai with a Twist", November 2006

[19] see *Prophet* of 8 December 2006, citing a *Jerusalem Post* mailing sourced from www.theisraelproject.org, and the Sunday Times of 7 January 2007

Resolution 1737 which Iran was swift to reject in the following days.[20] The Security Council has threatened to increase the sanctions applying to Iran if the country does not comply within 60 days – which takes us to around 20 February 2007. Assuming Iran continues to ignore the UN, and assuming that China, Russia and others refuse to back harsh sanctions against Iran, Israel may use the UN's failure to act as justification for an attack in late February or March.

## 3. US military deployments

It is curious that this UN timetable also fits with announced US military deployments to the Persian Gulf region. The build-up of Navy, Marine and Army units – Air Force units would not need to deploy until much closer to possible hostilities – will give the US much greater ability to:

1) directly support Israeli attacks on Iran;
2) help deter Iranian retaliation in the region in the event of an Israeli attack; or
3) to give extra credibility to force Iran to the negotiating table.

***Two US carrier groups will be in the Gulf in February/March 2007…***

In December, the US moved the Eisenhower aircraft carrier strike group into the Persian Gulf where it is due to remain into March. Later in December it also brought forward the deployment of the John Stennis aircraft carrier strike group to the Persian Gulf, which may now happen by the end of January 2007[21]. Four other carriers, Kitty Hawk, Enterprise, the Nimitz and Ronald Reagan are all reportedly available for deployment to the Gulf if necessary[22].

***…a naval deployment that echoes that before the 1991, 1996, 1998 and 2003 bombing of Iraq***

This naval deployment may be the largest since the 2003 Gulf War and is a signal that military action may be closer. It is officially aimed at 'deterring' Iran or perhaps assisting in imposing stronger sanctions against Iran, but it clearly gives the US more aggressive options. Previous deployments of two carrier groups to the Persian Gulf – aside from the 1991 and 2003 Gulf wars – include the deployment before Operation Desert Strike in 1996 (a two-day bombing campaign), and Operation Desert Fox in 1998 (a three-day bombing campaign). One deployment in May 1998 occurred without bombing – the threat temporarily brought Iraq back into compliance with the UN.

***The second US carrier has run exercises involving a state's "nuclear ambitions"***

It is also curious to note that the last exercise by the John Stennis was scheduled to run from 11-16 November 2006 and was based on the following Joint Task Force Exercise scenario "conducting operations to support a newly elected government against an ongoing insurgency. The operations are placed against a backdrop of increasing civil unrest and rising global tension resulting from a neighbouring country's nuclear ambitions".[23]

***A Marines unit will deploy to Bahrain in February 2007***

February 2007 will also see Expeditionary Strike Group (ESG) 2, a Marines-based unit, culminate nearly a year of preparation and deploy to Bahrain. Rear Admiral Garry Hall, Commander of ESG 2 has said, "Any time an ESG, an amphibious squadron or a MEU deploys, they are used in a multitude of events. *They should expect the unexpected and be prepared for any mission to come their way*" (our italics).

***UK to deploy minesweepers***

Even the UK is acting, albeit in a far more modest manner, sending two Royal Navy minesweepers to the Persian Gulf. Iran used mines in the Persian Gulf during the 1980-88 war with Iraq in an attempt to limit Arab oil supplies to the rest of the world.

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[20] http://www.un.org/News/Press/docs//2006/sc8928.doc.htm
[21] http://www.worldtribune.com/worldtribune/06/front2454092.063888889.html
[22] http://www.navytimes.com/story.php?f=1-292925-2438831.php
[23] http://www.cvn74.navy.mil/layer2/news/frontpagestorys/Prepare%20for%20JTFX.html

Although Prime Minister Blair's popularity has plunged in the wake of the problems in Iraq, he is generally expected to step down by mid-year.

***The US also may deploy up to 20,000 troops to the region***

Also US President George W Bush on 10 January is expected to announce the "surge" deployment of perhaps as many as 20,000 additional troops to Iraq. This is being reported as purely related to Iraq, but may be a prescient move to deal with a potential surge in 'insurgent' activity in the wake of an Israeli assault on Iran.

***New US commander in region is naval, not an army man***

It has also been suggested that General John Abizaid's retirement as Commander of Central Command (in charge of all US forces in the Middle East) – announced in December 2006 – was because he objects to the prospect of US action against Iran.[24] More compelling to us was his replacement on 7 January by Admiral William Fallon. To have an Admiral in charge of Central Command when US military operations in the region have been dominated by the Army in Iraq might look odd. However Fallon's background is in the US Naval Aviation service and he led airwings from one US aircraft carrier in the Desert Storm operation against Iraq in 1991 and was in charge of a carrier battle group during Nato's combat missions over Bosnia in 1995. This fits with the scenario of near-term action using carrier groups in the Persian Gulf.

# And then what happens?

Iran has promised to retaliate if it is attacked militarily.

## Retaliating against Israel – and only Israel

***Iran might retaliate against Israel with missiles while Hizbollah could also attack Israel***

Attacks on Israel could be done in five ways:

1) Ballistic missile attacks – Iran has developed Shahab-3 missiles that are capable of hitting Israel. Air defence systems may offer some protection to Israel, but a re-run of the 1991 Scud attacks by Iraq is likely.

2) Hizbollah/Hamas attacks into Israel. Hamas leader Khaled Meshaal has said "If Israel launches an attack against Iran, we will expand the battlefield" and Hizbollah would react too. It is possible Hizbollah may be more constrained now that 10-15,000 UN troops are deployed in southern Lebanon.

3) Terrorist attacks on Israeli targets abroad.

4) Retaliation against the 35,000 Jews estimated to be living in Iran.

5) Using chemical weapons.[25] It is unclear whether these – if they exist – can be loaded onto missiles. Iran's suffering at the hands of Iraqi chemical weapons may be sufficient to prevent this option, if it exists.

***Israel has faced such attacks before***

In terms of options 1-3, Israel has faced them all before and is likely to accept the trade-off in return for greater security on the more important nuclear issue.

***Israel can expect international condemnation***

As with the 1981 Osiraq attack, Israel can anticipate international condemnation for any attack on Iran. After the Osiraq attack, the UN passed a resolution condemning Israel, but Iraq did not attempt to push a UN vote to expel Israel from the UN because it still needed US support in Iraq's own war against Iran at the time. US President Ronald Reagan criticised Israel's actions, suspended the delivery of four F-16s, and the US officially investigated the legality of the raid. Note international condemnation of Israel could very significant if tactical nuclear weapons were used, and their use would be very surprising.

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[24] http://www.larouchepub.com/other/2007/3401chickenhawk2.htmlthe Spring

[25] http://en.wikipedia.org/wiki/Chemical_weapon_proliferation#Iran

## Retaliating more widely

***Greater market reaction would occur if Iran retaliates more widely***

Beyond attacking Israel, Iran has a range of options. Everyone believes, Iran included, that any Israeli action against it would have received at least tacit approval from the US. Therefore, the fear is that Iran may react by:

1) Cutting off oil supplies to the global economy – by closing the Straits of Hormuz, attacking oil installations in GCC countries or even cutting off its own oil supplies – so pushing up oil prices to beyond US$100/bbl. In practice, it could achieve such an effect, at least in the short run, by merely threatening such actions.

2) Boosting military supplies to Iraqi Shias to intensify the civil war there, or Afghan forces fighting the US, or even send in hundreds of thousands of troops to Iraq – as China did in North Korea during that war.

3) Supplying terrorist forces in the Gulf region and attempting to provoke revolution among the pro-US governments in the GCC.

4) Encouraging terrorist actions globally against the US and other Western interests.

We shall attempt to address these issues in turn.

**Closing the Straits of Hormuz**

***20% of world oil supply flows via the Straits of Hormuz***

The Iranian navy learnt the tactics of asymmetric warfare in the Iran-Iraq war, and with missile boats, mine-laying facilities and land-based missiles, it may aim to close the Straits of Hormuz, through which roughly 20% of the world's oil supplies and 90% of Gulf oil supplies flow. In 2006, Supreme leader Ayatollah Ali Khamanei threatened to disrupt energy shipments from the Persian Gulf if Iran was attacked[26]. There are three reasons why we think this would be unlikely.

***Sinking tankers would hurt Iran's reputation***

First, the diplomatic cost of this could be immense. Using mines to sink tankers destined for countries such as China or Japan (8-11% of their oil comes from Iran) might provoke the UN to act more firmly against Iran. US and UK minesweepers may limit the impact.

***Also closing the straits may not be possible***

Second, Iran failed to close the straits during the 1980-88 war (except – one source suggests – for 17 hours one night) so it is unlikely to be successful.

***US may capture Iranian islands and retaliate hard against such Iranian actions***

Third, this would invite massive retaliation from the US forces now being deployed to the Gulf. In 1987-88 the US responded by destroying Iranian oil facilities and warships. The Iranian military would probably not be able to prevent the US capturing Iranian islands in the region that have been disputed since Iran took them from the UAE in the early 1970s – and Iran may lose them permanently to the UAE as a result. Reinforcing defeat with further defeats may be counter-productive.

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[26] http://www.theodoresworld.net/archives/2006/06/ayatollah_ali_khamenei_say_wha.html, ""If you make any mistake [punish or attack Iran], definitely shipment of energy from this region will be seriously jeopardized,.. You will never be able to protect the energy supply in this region. You will not be able to do it," "

**Fig 15 Straits of Hormuz**


Source: http://www.willisms.com/archives/2006/04/flashpoint_stra.html

**Attacking GCC states' US bases or oil installations via missiles/terrorism**

*A second credible threat is attacks on oil installations or US bases in the GCC*

With US forces based in Qatar, Bahrain, Kuwait and using docking facilities in Dubai and Muscat, there is a significant chance that Iran might respond against these targets, or indeed against the far larger and easier to damage oil depots, refineries and pipelines in the region.

*This would carry benefits for Iran and hurt the US and its allies*

The benefits for Iran could be significant. First, it would damage the rulers of these GCC states who would have less money with which to maintain popular support. Second, it would drive up the price of oil, making Iranian exports more revenue-generating for Iran. Third, higher oil prices would hurt the US economy.

*GCC and US forces have trained to prevent this*

However, this would wreck Iran's previous strategy of trying to woo the GCC away from the US sphere of influence and build up its regional power base. Moreover, it is precisely this threat which GCC armed forces have been training to stop in recent years, and which US forces are being deployed to the Gulf region to prevent. We do accept this is a significant risk, however, for the markets.

The worst form of attack could be on the de-salination facilities in the region, but this would lose Iran support from the man on the street.

**Cutting off Iran's own oil supplies**

*The world could stop exports of refined products to Iran if it cut off its own supplies*

This would be aimed at driving up global oil prices and hurting the US, but it does not look a sensible policy for Iran to follow. First, the Iranian president is already being criticised for the economic problems Iran is facing, his budget has overshot, and cutting off oil revenues might not be politically popular, particularly if an expensive nuclear programme is lying in ruins. Second, one-third of Iranian gasoline is imported, and if Iran shuts off crude exports, then it will face fuel shortages in retaliation. Third the threat may lack credibility – given that the Iranian president reportedly said Iran would cut off oil supplies if Iran was referred to the Security Council.[27]

**Intensifying support for anti-US forces in Iraq/Afghanistan**

***A surge in violence in Iraq is possible***

Although the US and Iran are aligned in their support for the Shia government in Baghdad, Iran may well decide to strongly support forces that would work to worsen the civil war there and intensify attacks on US forces.

***Iranian military would lose if it intervened***

Actual intervention by the Iranian army looks less plausible. While Iranian suicide waves were an infamous feature of the Iran-Iraq war, it would be unfortunate if another generation were prepared to accept this fate.

***Market reaction may be limited***

A worsening of the civil war in Iraq in 2006 has coincided with a decline in oil prices through the later stages of the year, so the market impact of a worsening is not certain.

In Afghanistan, Iran is very much opposed to the narcotics trade and may be loathe to support any groups that may support this, even if they did oppose the US and UK forces in the country.

**Fomenting revolution in the GCC**

***Revolution in GCC states would be hard to foment, given Sunni majorities***

This is a longer-term threat. It is less feasible while oil prices are high and governments are flush with oil revenues. Also there is the natural problem of Sunni majorities generally not wanting to be ruled by Shia minorities or by those linked to Shia Iran. Problems in Iraq today stem from the fact that the Shia are in the majority – but were historically ruled by the Sunnis. Aside from Bahrain, there is no other Arab state where the Shia are in the majority. Shia minorities may be able to start civil wars, but they might need more than anger against Israel bombing Iran to be provoked into doing this.

**Terrorist attacks in the West**

***Terrorist actions may be more likely***

Some do suggest that terrorist attacks would become more likely in Western countries, but market reaction to such atrocities has generally been extremely short-lived. Moreover, attacks that were clearly supported by the Iranian state would clearly invite direct military action by the US against it.

# Conclusion

The financial markets are assuming that an attack on Iran by Israel or the US is unlikely. However, bellicose rhetoric from Israel and an imminent build-up of US forces in the Gulf suggest that they could be in for a shock.

Israel is concerned that Iran may have acquired nuclear weapons capability by the time the Bush administration leaves office at the end of 2008, and is determined to prevent this. With a diplomatic solution apparently still far off, Israel may take the opportunity to attack with the cover of two US aircraft carrier strike groups due to be in place in the Persian Gulf within weeks.

Given that risk assets are currently richly priced, they would suffer a dramatic reversal in the event of such an attack. This would involve sharp falls for stocks, corporate and emerging debt and emerging currencies. Safe havens such as government bonds, the euro, gold and oil would benefit. How long these effects would persist would depend on the extent of any Iranian retaliation. The threat of a massive US military counter-strike might persuade the Iranians to limit their reprisals, in which case the financial market effects might quickly reverse their initial panic reactions.

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[27] *Financial Times*, 3 October 2005

This report incorporates input from members of our financial markets and equity research teams. We would particularly like to thank our FX Strategy team led by Chris Turner, our Developed Rates Strategy team led by Padhraic Garvey and our Emerging Debt Strategist Luis Costa.

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