MENA REGION

An Emerging Markets View of US/Iranian Tensions

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As US-Iranian tensions rumble on, Franklin Templeton Emerging Markets Equity's Manraj Sekhon, Bassel Khatoun and Salah Shamma weigh in on the potential market impact.

The US assassination of Qassem Suleimani, commander of the QUDS Force in Iran's Revolutionary Guard Corps (IRGC), is the boldest US action against any senior Iranian political leader since the founding of the Islamic Republic. General Suleimani was a senior official of the Islamic Republic of Iran, and openly targeting him was a serious and credible shift in the rules of engagement in the region. Suleimani's killing raised a number of serious questions as he represented the military, and Iran saw this as an action that required some form of retaliation.

It is important to note that US President Donald Trump's administration took the unusual step of officially designating the Islamic Revolutionary Guard Corps (IRGC) as a terrorist group even though it is an arm of the Iranian state (and thus not a non-state actor), unlike most of the entities on the US list of terrorist organizations. Suleimani had been the architect of many of Iran's most contentious foreign policy issues. The QUDS Force provides training, weapons, organizational guidance and other support to a range of pro-Iran groups.

The US attack comes on the back of more recent military and terrorist events in the region. Tensions between both countries have been increasing since the recent oil tanker attacks to the drone attacks on Aramco oil installations, and the violent escalations against US interests in Iraq. The US administration has clearly signaled the objective of targeting Suleimani was to forestall further attacks and to push back with clear red lines against a wave of Iranian regional pressure seen over the past year in Iraq, Syria and the Gulf. We believe the recent action represents a change in US policy aimed at introducing a credible military deterrence strategy in the region.

In retaliation, Iran has launched missile strikes against two Iraqi military bases housing US forces. US and Iraqi sources have said there were no known casualties as a result of the strikes, although there are investigations underway in regard to a commercial plane that may have been shot down amid the strikes. Iranian foreign minister Javad Zarif was quick to announce that his country "concluded proportionate measures in self-defense."

We continue to believe there is a low probability of seeing further escalation in tensions that could lead to an all-out direct confrontation between the two countries. Iran is likely to continue with its low-intensity warfare, especially as its economy remains under pressure from choking economic sanctions, most likely using proxy assets to target the United States or its interests in Iraq, Lebanon or the Strait of Hormuz.

It is worth noting that other global powers—notably France, Britain and Germany, key signatories of the 2015 Joint Comprehensive Plan of Action nuclear deal—have expressed positions that are supportive of near-term de-escalation of current tensions. This opens the door to a possible diplomatic breakthrough that could alter the current impasse.

Both China and Russia also appear likely to strongly dissuade Iran from taking more significant action. Both countries' growing influence in the region, and also Iran's increasing political and economic reliance on them, means that this is likely to provide a key deterrent for Iran.

In terms of positioning, we continue to operate in an elevated risk environment similar to what we've seen over the past couple of years—granted, tail event risk looks heightened. However, we currently don't expect significant risk escalation that could derail the global growth outlook. We expect the market to digest the recent developments and the overall risk profile to normalize in the coming months.

Short of any event that threatens to block the Strait of Hormuz, we expect the usual oil market dynamics to prevail. Additional supply in 2020 continues to be balanced by OPEC+ members. We think oil prices could be range-bound, hovering between US$60-$70 for 2020.[1]

While the US and Iran have signaled an interest in avoiding military escalation, we believe this issue will likely continue to dog the region for some time.

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