

Iran war: more oil is flowing, but the risk of escalation is growing

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Key points

- Oil exports from the Middle East climbed back close to pre-war levels in September, buying markets more time before inventories run short
- CommBank still sees a diplomatic deal as the most likely outcome, but the timing is highly uncertain
- It puts a 45% chance on a limited exchange of fire between the US and Iran, and 15% on a major escalation
- Diesel supply from the Gulf remains squeezed, and Brent crude has struggled to fall below \$US100 a barrel

Oil is flowing out of the Middle East again, but that doesn't mean the Iran war is winding down.

That's the view of CommBank Senior Geo-Economics Analyst Madison Cartwright, who said in a research note that "the risk of military escalation is growing."

What changed in September

According to ship-tracking firm Kpler, total oil exports from the Middle East got close to their pre-war level in September.

Cartwright said that likely gives markets at least 10 to 15 weeks of oil and refined fuel before shortages bite in some regions, up from his earlier estimate of five to 10 weeks.

That takes some pressure off the US to act quickly, and weakens Iran's hand. But Cartwright said it's unclear whether the higher flows will last.

Iran has already responded by stepping up attacks on ships in the Strait of Hormuz, and Middle East oil exports fell meaningfully in the past week.

"As long as the war is unresolved, risks of future disruption will persist," he said.

Why oil prices haven't fallen far

Despite the extra supply, Brent oil futures struggled to fall below \$US100 a barrel. After the US-Iran agreement in June, they dropped as low as \$US70.

Cartwright said that suggests markets see the September recovery as temporary, and believe Iran still has significant control over Middle Eastern oil flows.

Diesel is under even more pressure. Fuels like diesel are riskier to ship through the Strait of Hormuz and can't use the pipelines that bypass it, so Gulf exports remain suppressed. The gap between oil and diesel prices has widened since the war began.

Shipping is dearer too. The cost of moving oil from the Persian Gulf to China on the largest tankers has jumped from \$US7 a barrel before the war to \$US36 a barrel.

What CommBank expects next

Cartwright said a deal similar to the agreement struck in June is still the most likely end point.

"A diplomatic settlement remains the most likely outcome, but the timing is highly uncertain," he said.

He gives a 45% chance to a limited escalation, a tit-for-tat exchange like the one seen between April and June. In most of those cases, higher oil prices would push the US back towards a deal. But in 10% of cases, Cartwright said, that limited escalation could spiral out of control.

A deal through diplomacy has a 40% chance, and a major escalation 15%.

Cartwright said a major US escalation remains unlikely, partly because US stockpiles of missile-defence interceptors are low. But he warned that "limited escalation can spiral out of control," as the conflict has now spread to Saudi Arabia, Yemen and the Red Sea.

What to watch

Two elections could shape the timing. Israel goes to the polls on 27 October and the US holds its midterm elections on 3 November.

Cartwright said Israel would likely prefer a return to bombing over a deal, while US President Donald Trump has publicly mused about whether to attack Iran before or after the midterms.

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