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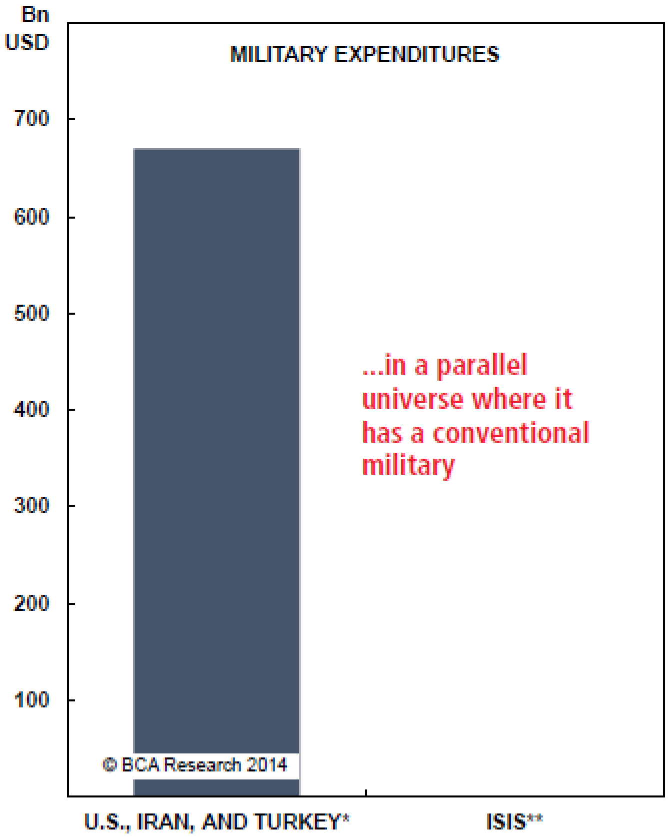
Islamic State is irrelevant - Libya is relevant

Marko Papic | BCA Research | 10 November 2014

The media's coverage of the Middle East continues to obsess about the Islamic State (IS), despite the fact that the extremist group has been unable to expand its territory significantly since August. The news coverage is reflective of IS's brutality and media savvy, not its investment or geopolitical relevance.

In our view, IS will soon cease to be relevant beyond its penchant for terrorist activity in the Middle East and potentially further abroad. The militants have managed to unite the US, Iran, and Saudi Arabia, which is quite a feat. Turkey may soon become involved with ground troops due to IS activity on the Syrian-Turkish border, pitting the militants, who lack experience in conventional warfare, against a coalition of formidable foes (Figure 1). News reports also suggest that various Sunni tribes are beginning to abandon IS. This will sound the death knell for IS, since their ability to claim territory, especially in western Iraq, is based on their alliances with other Sunni militant forces who themselves have been in a state of insurgency against the Shia-dominated government in Baghdad since late 2012. We believe that as the international coalition presses on with air strikes against IS, more Sunni militants will abandon the flamboyant terrorists for fear of being targeted themselves.

Figure 1: IS is a conventional military threat



Sources: SIPRI. ** Assuming that ISIS generates US$12 Million per month from extortion and US$2 Million per day from oil revenue. * 2013 military expenditures, shown in current U.S. Dollars.

The far more investment-relevant geopolitical development from the Middle East is the sudden return of approximately 925,000 barrels of Libyan crude into a well-supplied market, and the reluctance of the Saudis to fully offset that increased Libyan production. The Saudis may be hesitant to significantly cut production, after cutting 408,000 barrels per day in August, due to the unsustainability of the recent surprise increase in Libyan supply.

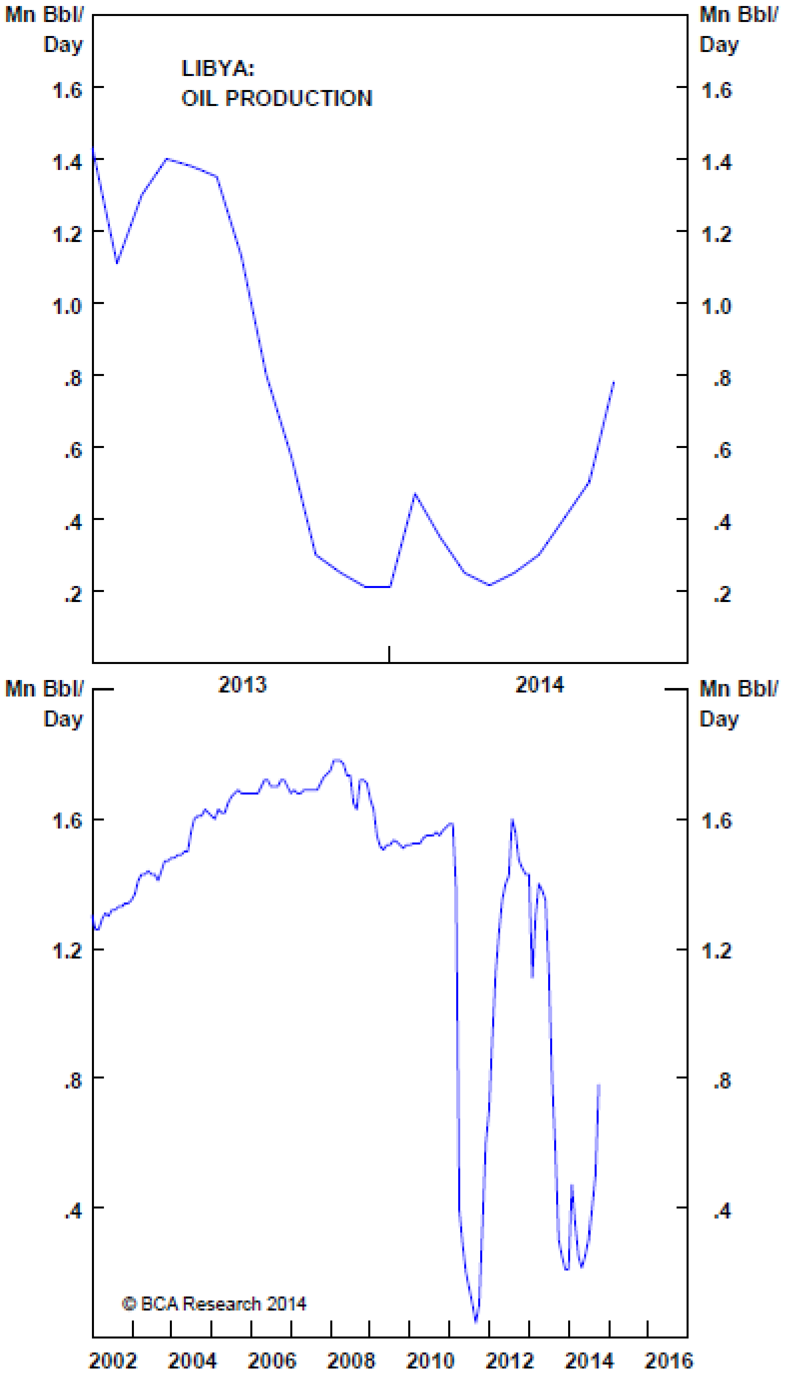
BCA's Commodity & Energy Strategy does not believe that the current weakness in the price of oil is sustainable. Eventually, OPEC will defend its US$100 floor, provided that there is no significant deterioration in the global economy. Furthermore, US shale oil production does not pose a risk for long-term oil prices since the marginal cost of oil production in the US is around US$80-85 (long-term WTI future prices are barely above this level already). High well decline rates will also be an impediment to production growth.

Bottom Line: Oil prices may be reaching a bottom, provided that there is no further global growth disappointment. OPEC has the ability to defend its US$100 floor and we expect prices to go up even as the US dollar continues to strengthen.

LIBYA: A RISK TO PRODUCTION

Our pessimism regarding production in Libya has clearly been wrong, with considerable gains throughout late 2014 (Figure 2). However, the tensions in Libya between the warring factions are boiling over into a nascent civil war. In the short term, rising tensions could undermine the recent revival of oil production but, in the long term, an international intervention may stabilise the security situation long enough to bring oil production back to the levels seen under Gadhafi.

Figure 2: Libyan Production: Near-term risk, long-term support?



Sources: BCA Research 2014

The violence in Libya has forced the country's nationalist- and liberal-dominated House of Representatives elected in June to move to Tobruk, where it is sheltered in the stronghold of the self-declared leader of the Libyan National Army, General Khaifa Haftar. The capital city, Tripoli, and the country's second-largest city, Benghazi, remain occupied by Islamist-allied militias who have installed the country's outgoing General National Congress as the official government. General Haftar and the Tobruk parliament are in favor of an international intervention in Libya, as they seem unable to counter the Islamist militias on their own.

The internal dynamics in Libya are grafted on to a proxy war between Arab countries supporting secularists and nationalists - Egypt, UAE and, to a certain extent, Saudi Arabia - and those supporting Islamist forces aligned with the Muslim Brotherhood - Qatar and Turkey, in particular. The situation is further complicated by the fact that moderate Islamist militias aligned with the Muslim Brotherhood are invariably allied with radical Islamist forces.

For investors thinking about Libya's global relevance, the weedy details of the emerging civil war overwhelm the main issue. Libya produces a particularly 'sweet' type of crude, favored by Europe's refineries. Who runs Libya and how is therefore secondary to the question of whether oil production can increase in the short term and potentially go back to levels seen prior to Gadhafi's ousting.

At the moment, the risks to production are to the downside, and it would be overly-optimistic to expect production to increase much beyond the recent gains made this year. While all the warring sides have an incentive to get oil to the global market for the sake of funding, they also have an incentive to undermine production that is undertaken in hostile territory.

In the long term, however, production is likely to accelerate in one of the following three scenarios:

1. One of the two warring factions wins;
2. Both factions become exhausted and seek terms via negotiations; and,
3. International intervention stabilises production.

The first two options are unlikely. Both sides are receiving material support from abroad in the form of financing and weapons, and are therefore unlikely to win outright or yield to pressures to undertake negotiations. The two sides are not yet at an equilibrium where the best alternative to the conflict becomes more lucrative than continuing the war. In fact, the Islamist militants appear to have the initiative and therefore will seek better negotiating terms only after their military efforts are exhausted.

An intervention by external forces, on the other hand, could either bring the Islamist militants to the table via airstrikes, or could stabilise the security situation with troops on the ground. In our September Monthly Report, we posited that Algeria and Egypt may decide to intervene militarily and split the country into their own spheres of influence. The two North African states have more than enough military resources to get the job done and would be able to count on Gulf state resources to finance the expedition against the Islamists.

Bottom Line: Risks to the recent increase in Libyan production are to the downside in the short term. However, an intervention from Algeria and Egypt could considerably accelerate production gains in the medium and long term.

Read the full Geopolitcal Strategy Report

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