

An Assessment of a Nuclear Iran

Iran's recent boasts of progress in harnessing nuclear power have heightened existing tension in the Middle East, giving investors a reason to consider the probabilities, risks, and potential economic impact of a nuclear-capable Iran. As Ronald Blue & Co. sifts through news reports and considers the possible impacts, we find that four questions should be considered:

- How close is Iran to developing nuclear capabilities?
- Is the public's current perception of the risk reflective of actual risk levels?
- Will there be a military strike against Iran?
- What are the investment implications of a military strike?

How close is Iran to developing nuclear capabilities?

In short, no one outside of Iran really knows. The International Atomic Energy Agency (IAEA) report published in November 2011¹ indicates that there are currently 15 nuclear sites in Iran and that the country has only developed "low-enriched uranium." Low-enriched uranium has an enrichment level below 20% and is typically used for power generation and other non-weapon uses.² Unfortunately, most of the information contained in the report is submitted by Iran itself, so the reliability of these statistics is questionable. However, in the report, the IAEA did speculate on undisclosed areas of development, including:

- Acquisition of nuclear weapons development information
- Development of underground pathways for production of nuclear material
- Testing components of a nuclear weapon (the tests in question are unrelated to peaceful applications)

The IAEA goes on to note that the activities listed above were already occurring prior to 2003 and go back to the 1970s. Since 2003, much of Iran's nuclear activity has been shrouded in mystery, leaving their current nuclear capabilities mostly unknown to the outside world.

Is the public's current perception of the risk reflective of actual risk levels?

Possibly. But we should also recognize that several major players in the conflict have incentive to create uncertainty and alarm about Iran's nuclear capabilities:

- **Iran seems to benefit greatly from positioning the international perception of itself somewhere between full development and no development at all.**

If Iran were to claim to have a workable nuclear weapon, it would gain bargaining power in both the Middle East and globally but would possibly invite pre-emptive strikes. If it were to claim to have no nuclear weapon development, it would be perceived as militarily weak and would lose bargaining power. By existing under a cloud of secrecy, Iran holds the world at arm's length. Other countries are aware of the potential risk but uncertain as to the specifics of Iran's nuclear development.

By operating amid this global uncertainty, Iran maintains bargaining power and clout, can continue its program without external military conflict, and can use high oil prices to fund both nuclear research and to support the governing regime. Further, it seems that Iran has been purposely fueling international apprehension, as seen in Ahmadinejad's public visit to a nuclear facility on February 25, 2012. While Iran's ultimate intentions remain uncertain, its Middle East power has clearly expanded in recent years.

- **Israel is another entity that has an incentive to keep the international community on alert about Iran's nuclear status.**

While Israel clearly is one of the region's most developed military powers and benefits from strong alliances, it is surrounded by a Middle East that is hostile to its existence as a nation. Israel is obviously vulnerable to possible attack by any of its neighbors possessing the capability of launching a substantive offensive strike.

As Iran is an enemy of the state of Israel, Israel clearly has an incentive to use the current focus on Iran's nuclear ambitions to foster international furor and secure sanctions against Iran in an attempt to weaken the regime. The risks Israel faces are quite real, and by sharing that fear with the international community, it can push for a coordinated international response.

(Also, as many analysts have noted: In a previous episode of nuclear fear when Israel had the capability to stop a country's nuclear development, it did so by conducting a military strike against Syria – Operation Orchard in 2007 -- without engaging in substantial preexisting rhetoric.)³

Will there be a military strike against Iran?

Of course, no one can predict this with accuracy. However, we can evaluate the situation by exploring the perspectives of the various military powers. The situation in the Middle East has never been simple, and this time is no exception.

Clear **disincentives** to a military strike on Iran include:

- Iran's position has clearly weakened, with Syria, its main Middle Eastern ally, facing internal unrest.
- The risk of alienating international cooperation, as Iran could then portray itself as a victim of an unwarranted strike and begin to unravel its growing isolation.
- Oil Prices: Iran is the #5 oil producer in the world, accounting for 5% of global oil production, and it can disrupt trade in the important Strait of Hormuz, through which 20% of the world's oil travels. While any military conflict could boost the price of oil, history has not shown price increases to be inevitable in every situation. In the current environment, however, we believe that higher oil prices would likely be one result of a military strike.
- Current sanctions appear to be having some effect, as Iran has indicated a willingness to engage in talks. (On the other hand, this could very well just be a delay tactic).
- An American electorate that has grown tired of conflict in the Middle East.

On the other hand, there are **incentives** for military action against Iran, whether by Israel or others:

- The risk that Iran has created or will quickly complete a nuclear weapon is real enough to warrant action now.
- Although sanctions have increased and seem to be having some effect, Iran still appears to be conducting research.
- Delaying a strike gives Iran the time to create underground facilities and move closer to developing a weapon itself.

To many in the investment community, it is entirely conceivable that a strike could occur within the next year. Intrade, an online trading exchange where participants bid on outcomes of world events, has estimated the risk of a military strike by the end of the year at 29% (as of April 2, 2012).⁴

What are the *investment implications* of a military strike?

From an investment perspective, this means the range of possible outcomes is wide. If a military strike involving Iran occurs, it is **our opinion** that some or all of the following investments **could benefit** on a relative basis:

- **Treasury Bonds** could benefit from a flight to safety, with investor demand increasing valuations and keeping rates low.
- **The U. S. Dollar** should continue to be strong and should remain the world's reserve currency. It is also likely that other strong currencies such as the Canadian Dollar, the Swiss Franc, and the Japanese Yen would do better than other, weaker currencies.
- **Gold** would benefit from uncertainty and fear, as it typically does during systemic risk events.
- **Lower-Risk Stocks** could remain a viable investment option. While one should expect most stocks (aside from military-related) to go down in the event of a military strike on Iran, lower-risk stocks would allow continued investment in equities but with less downside than traditional equities. (Examples of lower-risk stocks include utilities, healthcare, and some alternative strategies such as covered calls.)
- **Oil** would likely spike in price should a Middle Eastern military strike occur. We believe that current conditions would strongly affect oil prices, even though the historical precedent of military strikes has not always translated into higher prices.

Alternatively, it is **our opinion** that some or all of the following investments **could be affected negatively** by a military strike:

- **Currency Exposure:** International stocks and bonds would likely suffer due to currency risks, and depending on the country's credit rating and relationship to the Middle East, could suffer from credit risks as well.
- **Credit Exposure: Corporate bonds** – except for the highest rated bonds, anything with credit risk will likely see prices go down.
- **Growth Exposure:**
Stocks would likely perform poorly amid higher oil prices and a more uncertain investment context.

Industrial Commodities would likely go down in value, as they are highly sensitive to growth trends. (Studies have indicated that for every \$10 increase in a barrel of oil, there is a drop of approximately 0.2% in GDP.)

The possible repercussions from a nuclear-capable Iran are among the systemic risks that Ronald Blue & Co. monitors. We have recognized for some time that financial markets are susceptible to the generally elevated systemic risk environment that exists around the globe, and we have therefore chosen to implement limited systemic risk hedges within some of our investment strategies.

While no investment advisor can foresee and protect client assets from all dangers, the hedges we utilize are designed to provide their portfolios with some degree of protection should a systemic risk event occur. However, history has shown that trying to time the market to avoid real or perceived risks (often inherent in a globally-connected and sometimes extremely dangerous world) is rarely successful. For most investors, the most prudent approach is to stay well-diversified and to allocate assets in a way that recognizes the investors' short, intermediate, and long-term needs for their capital.

April 3, 2012

¹IAEA. (2011). *Implementation of the NPT Safeguards Agreement and relevant provisions of Security Council resolutions in the Islamic Republic of Iran*. Retrieved March 16, 2012, from <http://iaea.org/Publications/Documents/Board/2011/gov2011-65.pdf>

² Weapons-grade uranium generally requires about 85% enrichment.

³BBC. (2012). *How Iran might respond to Israeli attack*. Retrieved March 16, 2012, from <http://www.bbc.co.uk/new/world-middle-east-17115643>

⁴Intrade (2012). USA and/or Israel to execute an overt Air Strike against Iran before midnight ET 31 Dec 2012. Retrieved April 2, 2012, from <http://www.intrade.com/v4/markets/contract/?contractId=750356>