Though it has received little market attention, a series of deadly explosions at critical infrastructure and sensitive nuclear sites in Iran potentially signal the resurgence of the region’s dangerous shadow war.

The Iranian government, reeling from an unrelenting economic crisis and resurgence of COVID-19 cases, has tried to downplay the incidents by attributing most of them to human error. Nonetheless, government officials did indicate that there would be further investigations into last week’s blast at the Natanz nuclear facility.

While a new domestic anti-government group, the Homeland Cheetahs, has claimed credit for some of the incidents, several foreign intelligence officials have pointed their fingers at Israel. Though there has been no overt response to date from the Iranians, Israeli media reports indicate that the Netanyahu government is bracing for some type of retaliation, potentially in the form of a cyber attack.

After being implicated in a string of brazen oil infrastructure attacks in 2019, the Iranians have been relatively restrained since the January killing of the IRGC Quds force leader Qasem Soleimani. The Iranian leadership may very well continue on this less confrontational course, with the UN arms embargo set to expire in October and the November Presidential election and potential shift in US sanctions policy looming.

However, if the incidents continue to escalate, we cannot rule out a kinetic response from the Iranian leadership or hardline elements who remain opposed to any rapprochement with the west and restraints on its nuclear activities.

President Trump has made it clear that he has no appetite for Middle East military entanglements, but we believe that he would be much more amenable to aiding the Israelis in the event of an Iranian military reprisal. Hence, we highlight a potential Iran-Israel confrontation as one of the most underappreciated tail risks of H2 2020.

Figure 1: Timeline of relevant events

<table>
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<tr>
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<tbody>
<tr>
<td>Pompeo visits Israel</td>
<td>Iran-based hackers vandalize thousands of Israeli websites</td>
<td>Explosion at a medical clinic in Tehran - 19 people killed</td>
<td>Large fire in Shiraz</td>
<td>Blast at Sepahan Brash Factory, south of Tehran, leaves two dead</td>
</tr>
<tr>
<td>5th strike attributed to Israel against Iran-linked forces in Syria in a span of two weeks</td>
<td>Airstrikes near Albu Kamal kills seven Iranian proxy fighters</td>
<td>Blast at a liquid fuel production facility, near Tehran; Fire at power plant in Shiraz, causing a blackout</td>
<td>Explosion in power plant in Ahwaz; Chlorine gas leak at petrochemical plant</td>
<td>Blast and fire at Natanz nuclear site</td>
</tr>
</tbody>
</table>

Source: news sources, RBC Capital Markets

All values in USD unless otherwise noted.
Priced as of prior trading day’s market close, ET (unless otherwise stated).

For Required Conflicts Disclosures, please see page 6.
Random Acts or Dark Arts?

The past three months has seen a series of unexplained incidents that have done serious damage to some of Iran’s most important economic and military assets. Explosions have occurred at nuclear sites, oil refineries, power plants and major businesses across the country. The pace of these mysterious incidents has picked up in the past two weeks and include:

June 26: Blast at a liquid fuel production facility for ballistic missiles near the Parchin military base. US and Israeli officials have repeatedly called for curbs on Iranian ballistic missile activities. In addition, international inspectors have sought access to the Parchin base, where Iran is suspected of carrying out clandestine experiments with nuclear triggers and detonators. Within an hour of the Parchin explosion, a fire broke out at a power plant in Shiraz, causing a blackout. Shiraz is also home to several important military bases, including the 7th tactical airbase.

Figure 2: Key Iranian nuclear sites (Natanz and Parchin recently targeted)

June 30: Explosion at medical clinic in Tehran leaves 19 dead.

July 2: Blast and fire at the Natanz nuclear complex, which is home to the country’s centrifuge stockpile. The explosion, which is thought to have been caused by a bomb, caused serious damage to the facility and has reportedly set back the nuclear program by up to a year. The Homeland Cheetahs, which claims to be composed of dissidents from the Iranian military and security services, claimed credit for the Natanz explosion and reportedly gave advance warning of an impending attack to media outlets. The sophistication and target choice has led several intelligence officials to posit Israeli involvement. Israeli officials have not directly denied involvement in the blast and in recent days have doubled down on their warnings about the dangers of a nuclear-armed Iran. On Sunday, Foreign Minister Gabi Ashkenazi told reporters that “Iran cannot be allowed to have nuclear capabilities” and added “we take actions that are better left unsaid.” The Israelis and the US had previously targeted Iran’s centrifuge program with the 2010 Stuxnet virus that destroyed an estimated 984 devices at Natanz.

July 3: Large fire in Shiraz.
July 4: Explosion and fire in power plant in Ahwaz. Chlorine gas leak at Karoun petrochemical plant in Mahshahr.

July 7: Blast at Sepahan Brash Factory, south of Tehran, leaves two dead. The factory is owned by the automotive manufacturer SAIPA, which in turn reportedly has ties to the Iranian Ministry of Defense and the Iranian Revolutionary Guards Corp (IRGC).

Response Mechanisms...
How Iran responds to these increasingly destructive incidents will have important implications for regional stability and also potentially for the country’s ability to secure sanctions relief. At first glance, the Iranian leadership seemingly has a lot to lose if it does launch a reprisal attack on Israel, especially an overt one or one that could be easily tied to its armed proxies. The UN weapons embargo is set to expire in October and Israel and the United States have thus far been unsuccessful in their attempts to get members of the UN Security Council to extend the punitive measures. A kinetic response, akin to what was witnessed in 2019, could potentially cause the Europeans to rethink their position on the expiration of the ban, especially as Iran has continued to back away from its JCPOA commitments. In addition, depending on the outcome of the US election, a direct military retaliation could also cause an incoming Biden administration to reconsider any near-term rapprochement with Iran that could bring the country’s oil barrels back on the market. Senior members of Biden’s foreign policy team have already indicated that sanctions relief would be conditioned on Iran becoming compliant with the 2015 JCPOA nuclear deal. A direct military response would further complicate a relationship reset given that Biden has pledged strong support for Israel. Several media reports have suggested that the Iranian leadership is increasingly looking beyond the Trump presidency and is focused on preparing for a Biden White House.

That said, a covert/cyber response certainly cannot be discounted because it affords greater deniability and may not be publicized for some time. In fact, Iran may be already deploying such asymmetric tactics. Last month Ze’ev Elkin, an Israeli security cabinet member, claimed that Iran had attempted a cyber attack on the Israeli water system in April. If such reports are indeed accurate it would suggest to us that the risk of an unintended, escalation through miscalculation remains ever present and underappreciated by market participants. Moreover, we cannot rule out a more direct response in the event that the pace of the destructive incidents accelerates and become increasingly embarrassing for the Iranian leadership. There is a hardline element in the country that remains opposed to the JCPOA agreement and is dissatisfied with the relatively muted official response to the Soleimani killing. On Sunday...

Figure 3 & 4: Iran defense expenditure, Iran monthly crude exports

Source: Defense Intelligence Agency, Petro-Logistics SA, RBC Capital Markets
Iran’s newly elected, conservative, parliament subjected Foreign Minister Javad Zarif to a combative grilling, accusing him of selling out the country by negotiating the 2015 nuclear accord. Finally, we do not think President Trump will remain on the sidelines in the event that there is a more direct confrontation between Iran and Israel. Despite his strong antipathy for being dragged into Middle Eastern conflicts, he might find it politically expedient to show strength and provide fulsome support for this important ally. For now, this remains a tail risk scenario, but given what has transpired in the past two weeks (and frankly the last 12 months), we do not believe it is in the black swan category. Just because it is under the radar does not mean that it is off the table.

Figure 5: Map of Iranian ballistic missile ranges

According to the US Defense Intelligence Agency “Iran has the largest and most diverse ballistic missile arsenal in the Middle East, with a substantial inventory of close-range ballistic missiles (CRBMs), short-range ballistic missiles (SRBMs), and medium-range ballistic missiles (MRBMs) that can strike targets throughout the region up to 2,000 kilometers from Iran’s borders.”

Source: Defense Intelligence Agency, RBC Capital Markets
The five-year international arms embargo under 2015 United Nations Security Council Resolution (UNSCR) 2231 effectively bans the transfer of arms to or from Iran – unless approved by the UNSC on a case-by-case basis. It applies largely to “battle tanks, armored combat vehicles, large caliber artillery systems, combat aircraft, attack helicopters, warships, missiles or missile systems, as defined for the purpose of the United Nations Register of Conventional Arms, or related material, including spare parts” (UNSC). However, UNSC members have broadly construed the restriction as inapplicable to systems used only for defense (FAS). This unanimously passed resolution, which originated with the 2015 Joint Comprehensive Plan of Action (JCPOA) deal to abate Iran’s nuclear program, superseded previous resolutions pertaining to arms transfer to Iran. This embargo is scheduled to expire on October 18, 2020 (five years after the enacting of JCPOA). Notably, US Secretary of State Mike Pompeo called for an indefinite extension of the arms embargo on June 30th, which Russia and China (UNSC veto powers) directly opposed. Washington added that if the call for an extension were unsuccessful, then the US would summon a “snapback” provision of the 2015 nuclear accord to re-enact all UN sanctions on Iran. Some European countries voiced concern of lifting the arms embargo on Tehran, though they stated they would not support Washington’s efforts to individually invoke the return of all UN sanctions on Iran – arguing that the Trump administration’s decision to withdraw from the 2015 JCPOA nullifies any US capability to use the snapback provision. Another restriction from UNSCR 2231 applies to supplying equipment that could be used to develop ballistic missiles with nuclear capabilities, and this provision is not set to expire until October 2023.

Source: UNSCR, FAS, SIPRI, Reuters, Bloomberg, RBC Capital Markets

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