



Geopolitical risks in the Middle East: +5% for gold and oil prices

The world faces a new organization, the Islamic State in Iraq and Syria (ISIS), which is causing a return to the forefront of the risks of oil supplies.

Key Points:

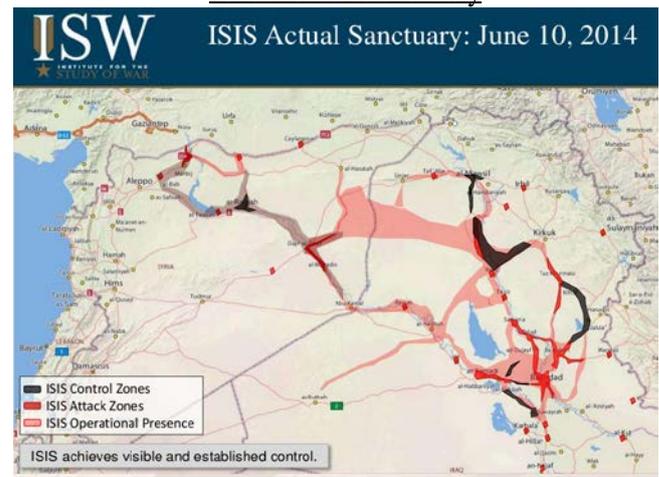
- ISIS alters the political boundaries and redraws the map of the region
- Iraqi government retreats in front of the ISIS
- The Shiite Iraqi Prime Minister sectarianism has led to the radicalization of the Sunni minority
- Dismantling of the Shiite Crescent Iraqi-Syrian border
- Iran is interfering in the Iraqi conflict and warned it will intervene to protect the Shiite community and the holy shrines of the Shiite imams in Iraq
- A civil war between Sunni and Shiites could pose a threat to all countries in the Middle East
- Oil supply risks are still underestimated
- Increase in oil and gold prices

Many cities have already fallen into the ISIS control. For instance, the cities of Mosul and Tigris in north and central Iraq have already been seized; there is growing concern over Baghdad for the security and stability in the entire region.

According to the *New York Times*, ISIS has cash reserves seized from Mosul banks and possibly the reserves of the Mosul Central Bank which are estimated at \$400 million. The organization can also count on the military equipment from seized military and police bases and the release of fighters out of local jails. The forces which are now available to jihadists are estimated at 15,000-20,000 men.

The map below, from the Institute for the Study of War shows the ISIS control zones, operational presence and attack zones.

ISIS Actual Sanctuary



Source: ISW

The world faces a new organization (ISIS) whose strategy is poised to redraw the region's political map

In just a few weeks, the fighters of the Islamic State of Iraq and Syria (ISIS also known as ISIL) have moved into Iraq and Syria and are approaching Baghdad, a situation which has literally surprised observers.

Since the beginning of the offensive in June, the ISIS popularity seems to have gained momentum through its recent military conquests. Approximately 10,000 men have joined the organization in the last weeks. The organization seems to be composed of a broad coalition of Sunni representing different ideologies, and aims to establish an Islamic caliphate, or state, which would stretch from the Mediterranean Sea to Mount Zagros in Iran.

Major cities in northern Iraq (Mosul) and Syria are now under ISIS control causing intense population movements. For instance, an estimated 500,000 people have fled Mosul, while a large number of civilians who have left Syria to take refuge in camps in Iraq are now in areas threatened by ISIS control.

The mobilization of Kurdish Peshmerga forces and Iraqi Kurds led to the recovery of Kirkuk, an important city located in the oil rich region of northern Iraq. But the offensive to take control of Iraq's biggest oil refinery (Baiji) at 200 km north of Baghdad, which is responsible for turning the country's crude into useful petroleum, continued and further threatens oil interests. If the Baiji refinery makes product for domestic consumption and does not export oil out of the country, its impact will be limited on global oil prices in the short term. However, it could improve the ISIS oil supply which could be crucial in the next combat phase against the Iraqi army.

In Baghdad, recruiting stations are enlisting Shiite volunteers who have flocked to fight against the jihadist movement of the Islamic State of Iraq and Syria (ISIS). Iraqis volunteers decided to join and to help the 350,000 men of the Iraqi security forces and 600,000 police men. The contingent of ISIS fighters who seized Mosul had only 800 to 3,000 men according to local sources, which were enough to rout two divisions of the Iraqi security forces (30,000 men). Since the beginning of the offensive, the Sunni faced little opposition from Iraqi troops which also abandoned their equipment. The striking imbalance between the two sides, should theoretically be sufficient to contain the advance of the ISIS.

ISIS and Iraqi Sunnis

ISIS is currently a large Sunni militant alliance which integrates ideologies and interests which are at times difficult to reconcile.

Former Ba'athists and loyalists of Saddam Hussein and officers of the armed forces have fought alongside with ISIS, after the U.S. invasion of Iraq in 2003, and have staged a comeback since the withdrawal of troops in December 2011.

ISIS has made alliances with Islamist groups, some of whom participated in the creation of Sunni militias, which were supported by the United States to fight Shiite jihadists. The numerous Sunni groups of Baathist or Islamist trend and tribal leaders who have developed in revolutionary military councils in almost all Sunni Iraqi cities were part of insurrections in 2013. They denounced the policies pursued by Prime Minister Nouri al-Maliki which have alienated the Sunni minority and fueled widespread resentment of the central government.

If this seems to be a motley coalition, it is however, mainly composed of Sunnis which are united by a common aim against the actions of the Shiite-dominated Iraqi government backed by Iran.

Even if the insurgents are united in the interest of regaining power in Iraq, the alliance has few chances of surviving in the long-run. Worst case scenario could spiral the country into a civil war, and force each religious community to take sides.

After the first stage of their offensive, the ISIS will certainly need the help of former Baathist officers to effectively handle the seized military equipment for the next stage of their offensive. There are reports which indicate that the militants are driving closer to Baghdad, before heading south where most of the Iraqi oil fields are located.

This reconquest of Sunni territory was an exceptional event which was triggered by the atypical geopolitical situation in the region. The ISIS could breakdown if the movement were restricted to Iraq, had the goal of bringing a change to the actual government which has marginalized the Sunni minority and end the jihad against the Shiites.

A report by the International Crisis Group (ICG) suggested that many Iraqi Sunni fear the ISIS, but believe they have no other choice to restore their rights within the country.

The Iraqi community was caught in a vise between the Iraqi government, which is dominated by a Shiite majority, and a Syrian leader decided to fight Sunnis in Syria, had little choice but to become radicalized.

The ISIS strategy could embroil in a civil war

In just a few weeks, ISIS is poised to implement a key phase of its strategy by redrawing Middle Eastern boundaries.

This strategy went almost unnoticed in the media, which mostly covered fightings and war reports in Iraq. Nevertheless, this outcome is crucial for the future of the region.

The organization removed frontier posts between Iraq and Syria, which had been negotiated by France and the United Kingdom in 1916, and which the ISIS considers as the borders of shame.

The fall of the border between Syria and Iraq is already an exceptional event in the regionalization of the conflict in Iraq.

But even more important is the consequence of the swift advance of the ISIS through northern and central Iraq, as well as the occupation of a few bordering towns.

These developments now break the Shiite Crescent which stretches from Iran to Syria via the pro-Iranian government in Iraq. This has forced Iran to engage more openly on the side of the Iraqi Prime Minister in the country's domestic policy, by not hesitating to mention a possible future intervention of Iran in this conflict.

The ISIS strategy differs from that of Al Qaeda (which focuses its strengths in the fight against the US and its Western allies), in the sense that it considers that since the departure of U.S. troops from Iraq, the priority is to fight "the Iranian expansion."

Denouncing what it calls the "Safavid project" (1501-1736 Safavid dynasty who converted the majority of the Iranian population), the ISIS attacks Arab regimes and members of the Shiite expansionism.

Thus, currently the ISIS has a more regional and international ambition. Its strategy is essentially to gain power in Iraq and to settle in Syria, Lebanon, Jordan and Palestine.

The current strategy of the ISIS must be understood as part of a long-term development of the organization.

The situation is particularly complex today because it causes the rise of extremism in both the Sunni community, the Shiite community and the risk of an all-out civil war.

In this situation, the Western world has difficulty in understanding the extension of such a situation.

What is happening today in Iraq reflects the failure of the United States intervention which were not able to establish a viable political system and respect the fragile political, economic and religious interests in Iraq. Ironically, is perhaps the fact that Baghdad has called upon the United States military intervention in the form of air strikes to defend the integrity of the country. This places the United States on the same axis as Tehran, an alliance which is extremely contradictory and difficult to put into perspective.

Iran is obviously taking advantage of the situation to try to convince the West in the fight against the ISIS.

Regarding Iran, the country said it would spare no effort to protect the Shiite majority and safeguard the Shiite holy shrines in the Iraqi cities of Karbala, Najaf, Kadhimiya, and Samarra. Iran is said to support the Syrian regime and Iraqi Prime Minister Nouri al-Maliki.

Iran's intervention in Iraq's political scene is now very likely. Iran's President Hassan Rouhani made the clearest declaration that Iranian troops were prepared to mobilize to protect the holy shrines from ISIS takeover.

The United States are back in a critical position, as when Syria waived the ban of the use of chemical weapons set by President Obama. Those circumstances should have triggered a military intervention. But, it seems impossible to foresee another U.S. military intervention in Iraq. Meanwhile, the U.S. increased security at its embassy in Baghdad and ordered that one of its aircraft carriers be moved to the Persian Gulf in case Washington decides to use military force in the region.

In eight years in power, Iraq's Prime Minister has laid back almost a third of the country's population which accuses him of authoritarian drift. However, ISIS could easily lose some of its support if a change to the government were to restore the rights of the Sunni minority. This is always an option, as there are more insistent requests in the U.S. for the Iraqi Prime Minister to surrender power and for Iraq's political parties to form a new government which would include the country's Sunni, Shiite and Kurdish communities.

There is also increasing concern in the Gulf states about the potential impact in the Middle East of a civil war in Iraq between Sunni and Shiites.

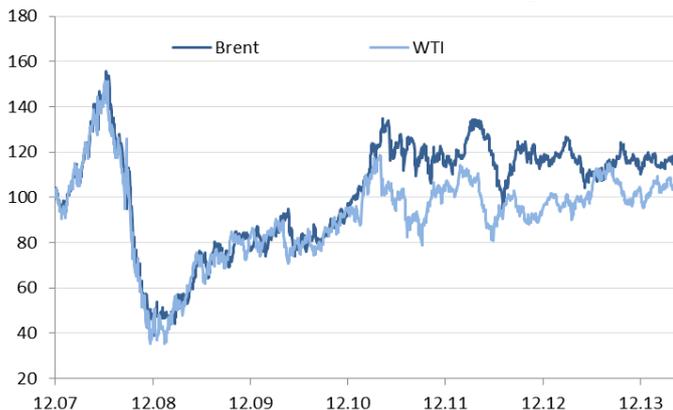
The ISIS rising power is in large part the product of the international community's inaction to the crisis in Syria.

The Iraqi-Syrian border has been dismantled and ISIS is marching as a threat to Baghdad. The risk of civil war and intervention by Iran has risen sharply. In this context, Iraq could be partitioned into three sectarian states: a Kurdish state in the north, Sunni center and a Shiite state in the South.

No major concern on the financial markets for now: moderate increase (+5%) of oil and gold prices

Financial markets have only slightly reacted to the possible developments of the crisis in Iraq. In the light of the on-going internal conflict in Iraq, The fact that the oil fields are situated well away from the conflict zone is certainly the main reason for the mild investors' anxiety, which has only been measured by the moderate increases in oil and gold prices.

WTI Crude Oil (USA), Brent Oil (Europe) Prices



Sources: Bloomberg, BBGI Group S.A

We must highlight the fact that since the media covered the ISIS offensive in early June, oil prices have increased by +5% to \$107 for WTI (West Texas Intermediate). Oil prices were well above their peak levels of \$105/barrel. In Europe, Brent crude oil was close \$116/barrel, as it exceeded its 2014 high (\$112).

The price of gold has risen by +5% since the beginning of the year and has benefited from a +5% additional rebound.

Gold Price



Sources: Bloomberg, BBGI Group S.A

Conclusion

The Iraqi government retreats when facing ISIS fighters which are redrawing the region's political map.

The dismantling of the Shiite Crescent and the Iraqi-Syrian border will push for Iran's intervention.

A civil war between Sunni and Shiite Iraqis could destabilize all the Middle East.

The risks concerning oil supplies are still underestimated, being Iraq the 2nd largest OPEC producer.

There are numerous potential effects on oil prices, gold prices, inflation, interest rates and the financial markets. This increase in global risk should seriously be taken into consideration in the future.

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