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CRUDE OIL SQUEEZE TO EASE IN 2006, SAY TD ECONOMISTS

- Although crude oil prices could set new record highs later this year, prices are likely to fall back to US$45 per barrel by early 2007.
- Souring prospects for the U.S. economy next year to be the main culprit for halting the rally.
- While little relief for consumers and businesses is likely this winter, prices for gasoline and natural gas should fall in lockstep in 2006-07.
- Beyond 2007, supportive underlying fundamentals – notably, strong crude oil demand from developing markets, limited prospects for supply gains, and inadequate refining capacity – should help to push crude oil prices back above US$50 per barrel.

TORONTO – After this year's dramatic run-up, crude oil prices are likely to fall back toward US$45 by early 2007, say TD economists in a special report entitled *Crude Oil Squeeze to Ease Next Year: But Era of High Prices Here to Stay.* The report is available at www.td.com/economics. "A significant slowdown in the U.S. economy, which will become apparent once rebuilding efforts related to Hurricane Katrina are largely completed by mid-2006, is likely to be the major catalyst for the price decline," remarked Derek Burleton, an Associate Vice President and Senior Economist with TD Bank Financial Group. "A weaker U.S. performance will lead to some slackening in the tight global supply-demand balance for crude oil and refined products, which in turn, will ease the massive fear premium currently embedded in prices."

No near-term relief seen

The short term direction of crude oil prices is anybody's guess, especially as investors continue to evaluate the progress in restoring damaged energy infrastructure in the Gulf of Mexico, and the prospect of further hurricane activity. "While we have set a year-end target of US$60 per barrel, we don't rule out prices moving above US$75 or even US$80 if further unanticipated supply disruptions occur," argues Burleton. "At the same time, the more oil prices increase in the short run, the more significant the downward adjustment is likely to be over the next 12-18 months."

Prices to hit US$45 by 2007, then rebound

Unlike past shocks in the early 1970s and 1980s when supply cutbacks by OPEC led to price spikes, current robust demand for crude oil globally has been a major factor behind the recent rally. Regardless, TD Economics believes that a slowdown in U.S. GDP growth from current 3.5-4 per cent annual rates to just over 2 per cent by the second half of 2006 will take a major bite out of the global expansion. Weaker international growth, combined with some limited conservation efforts by consumers and businesses in major industrialized countries, will shave growth in world crude oil consumption from its recent rate of more than 2 per cent per year to about 1 per cent in 2006-07. "The weaker demand picture will help to greatly alleviate some of the fears that have been instrumental in pushing up prices through the roof this year."

Fundamental price has increased

While the next 12-18 months should serve up a reminder that the laws of the oil price cycle are far from being repealed, TD Economics does see merit behind the hypothesis that the world has entered a new era of high crude oil prices. "Many factors that have helped to prop up crude oil prices in recent years, such as strong demand from developing economies, limited prospects for gains in production by OPEC and non-OPEC, and a lack of refining capacity, will remain in place at least to some extent." Boosted by these structural factors, the fundamental price – or the price that can be justified by supply and demand drivers alone over the long run – has probably increased to about US$40 per barrel from the historical level of about US$30 (in real terms).

The fundamental price doesn't include the risk premium. "There is a good case to be made, that when the U.S. economy gets back on track by 2008 and the oil market tightens again, investors will once again get nervous about inadequate supply. Accordingly, prices are likely to move back over US$50 per barrel by 2008 and to remain there in 2009-10.

Gasoline and natural gas prices to follow in lockstep

In line with the likely path of the price of crude oil prices, TD Economics expects some easing in current stratospheric gasoline and natural gas prices over the next 12-18 months. A US$45-50 price of crude oil is consistent with gasoline prices in the range of 70-80 cents Canadian per litre. Furthermore, natural gas prices are expected to drop to about US$8 per MMBtu on average in 2007 from their current level of US$12. However, any meaningful relief in retail prices likely remains several months away. In the meantime, Canadians, who are faced with elevated gasoline and heating bills through the fall of 2005 and winter of 2006, are not likely to take much comfort.

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Crude Oil Squeeze to Ease Next Year: But Era of High Prices Here to Stay (including charts and detailed tables), is available in PDF format on TD Economics' Home Page at: www.td.com/economics.