TD Bank Financial Group

TD Economics

Observation

May 28, 2009

DESPITE SUPPLY GLUT, OPEC LEAVES OUTPUT QUOTAS AS IS

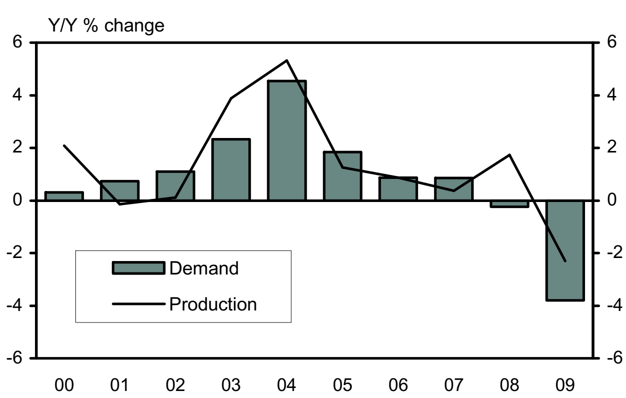
As widely expected by the markets, OPEC, at their 153rd (Extraordinary) meeting today, agreed to leave output quotas unchanged, despite a still-yawning gap in the supply-demand balance. With prices already breaching the US$60 per barrel mark (+65% from February lows), a further reduction in OPEC output quotas could have sent prices higher, potentially offsetting some of the improvements seen in the economy. As such, member countries agreed to adhere to current production quotas – compliance is currently about 80% – and the cartel will continue to monitor developments in the market. At the meeting, the cartel did acknowledge the fact that despite some of the so-called 'green shoots' emerging around the globe, the world is still battling very weak industrial production, high unemployment and declining world trade. And while production has been curbed, global oil demand has deteriorated even more, contracting for the first time since the early 1980s.

HIGHLIGHTS

- **OPEC leaves output quotas unchanged**
- **Supply glut to persist**
- **USD to be supportive of prices in the near term**

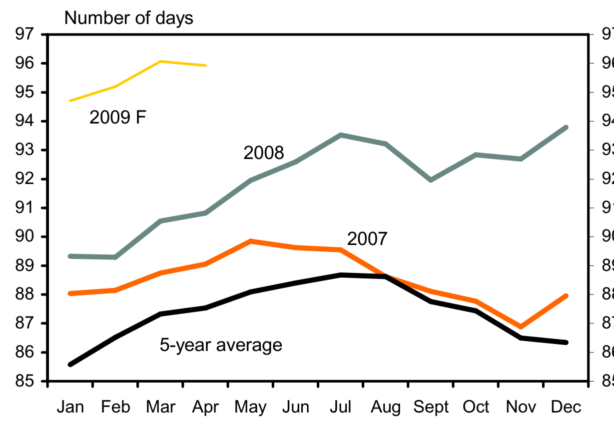
Accordingly, the world remains awash in oil. While OPEC has slashed output by 9% since the start of this year, this impact has been partially muted by a 3% increase in production in non-OPEC countries. As a result, total global production declined by only 2.3% during the first four months of the year. Meanwhile, the drop in demand has been even greater, leaving the market in a position of excess supply. Including April's data, year-to-date global demand has dropped 3.8%. As a result, the supply-demand balance has averaged 1.6 million barrels per day since January. What's more, global inventories, measured

GLOBAL CONSUMPTION GROWTH VS PRODUCTION GROWTH



Source: Energy Intelligence Group
2009 data for Jan-April 2009

GLOBAL OIL INVENTORIES: DAYS SUPPLY



Source: Energy Intelligence Group,

in days supply, remained well above (+8.4 days or 10%) their 5-year average in April, and are likely to stay quite elevated for at least the next two quarters. In the U.S., even with the larger-than-expected reduction in stockpiles seen over the past few weeks, inventories are also sitting well above their 5-year average, at a 19-year high. Looking ahead, with the global economy expected to ramp up only slowly, we expect to see the supply glut persist through 2009, with a surplus holding in the 1-1.5 million barrel per day range.

While the fundamentals will be unsupportive, the U.S. dollar is likely to remain a positive influence on prices in the near term. Indeed, after showing some disconnect early in the year, the (negative) correlation between crude oil prices and the greenback has strengthened considerably over the past few months. We expect the U.S. dollar to continue to slide against the euro and other major currencies through the end of this year (USD/EUR to hit 1.50 by year end), adding further upward pressure on oil prices.

Overall, we suspect that the tug-of-war between the weak fundamental picture and a further depreciation in the greenback will persist over then next few quarters. As such, we forecast crude oil prices to trade around their current level (about US$60-65 per barrel) throughout the second half of 2009, though we do highlight that downside risks remain should the economic recovery be slower than expected. Next year, while the U.S. dollar is likely to stabilize, prices are projected to head towards US$75 per barrel in tandem with the moderate economic recovery.

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