TD Bank Financial Group

TD Economics

Special Report

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WITH ALL THE TALK ABOUT PEAK GLOBAL OIL SUPPLY, WHAT ABOUT PEAK OIL DEMAND?

Despite the pullback over the past two days, crude oil prices continue to trade about 50% above their recent levels of less than US$90 per barrel in February 2008. In addition to the falling U.S. dollar, the market has cast its attention on a host of supply-side factors, including slowing growth in non-OPEC supply, rising production costs, and fears about further output disruptions in Nigeria, Iran, Iraq and Venezuela. Meanwhile, the global push to develop alternative fuel sources has encountered some potholes, notably the "food versus fuel" debate surrounding ethanol.

Still, as prices move higher and higher, investors should be wary about trading patterns that resemble a proverbial hockey stick – especially at a time when market supply/demand fundamentals are visibly beginning to slacken. Put simply, as we move into the summer driving season, world crude supply growth is exceeding that of demand and U.S. and global inventories are healthy. Spare production capacity within the OPEC cartel increased to 3 million barrels per day in April, up from a low in 2005 of 1 million barrels per day.

HIGHLIGHTS

- **Concerns about peak world oil supply have been instrumental in fuelling the recent rally in crude oil markets**
- **While these concerns are well-founded, less attention has been given to the notion of peak world oil demand**
- **So far this year, global oil demand growth has virtually stalled, and will probably soon shift into reverse**
- **A shift in focus to emerging demand-side trends will act to cool the rally in the crude market**

GLOBAL CRUDE OIL MARKET

	06	07	08 YTD*
	Y/Y % change		
PRODUCTION GROWTH			
OPEC	-1.4	2.7	6.5
Non-OPEC	1.4	1.2	0.4
World	**0.6**	**2.0**	**3.2**
DEMAND GROWTH			
OECD	-0.7	-0.5	-1.6
Non-OECD	2.9	3.5	3.1
World	**0.8**	**1.2**	**0.4**
	Million b/d		
Supply-Demand Balance	0.6	-0.2	1.7

*YTD as of April
Source: Haver Analytics

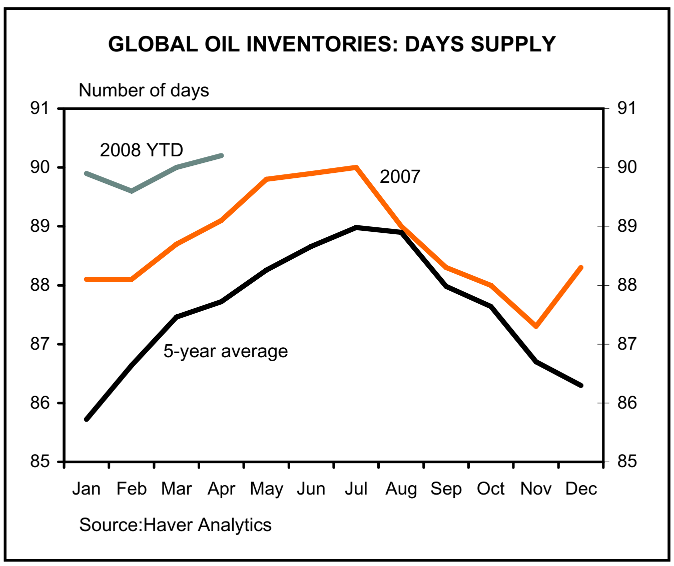
What about peak demand?

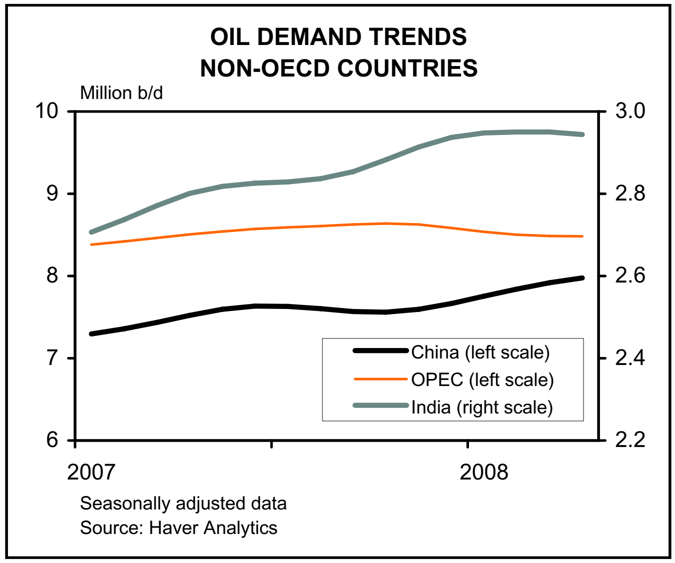
The market has recently rallied in large part on slowing growth in non-OPEC supply. These concerns are indeed well-founded. Despite the lure of high prices over the past few years, the global output response has been meagre, with non-OPEC supply essentially flat on a Y/Y basis in the first four months of 2008. This year's slowdown in non-OPEC output growth has added credence to the view that world oil production is set to peak earlier than some forecasters had projected.

That being said, there are two parts to the equation: supply and demand. And in our view, the market has largely been turning a blind eye to developments on the demand front. Overall, crude oil consumption so far in 2008 has softened to a paltry 0.4%, in line with non-OPEC supply gains and well below overall total world production growth. The culprit has been an outright decline in consumption within the OECD, led by a 3% drop in the United States and a 1% decline in Western Europe. This downtrend is almost certain to accelerate. In particular, stay tuned for data on summertime fuel consumption in the U.S. and Europe, which are likely to show high fuel prices putting a growing damper on driving activity.

The prevailing view in the crude oil market is that demand growth in the non-OECD countries (i.e., China, India, OPEC and other developing regions) has been taking up the slack. This is only partly true. So far this year, growth in non-OECD demand is up a solid 3.1%, spearheaded by a gain of more than 6% in China. However, in order to have kept overall world oil consumption growth running at last year's 1.2% rate so far this year, growth of 5% would have been required. Moreover, there are early signs that non-OECD consumption growth may have peaked (see chart).

Going forward, we would expect non-OECD demand growth to slacken further, as anemic U.S. demand increasingly weighs on emerging-market GDP growth through the export channel. A related downside risk to oil consumption is the likelihood that central banks around the world will need to tighten their monetary settings in response to rising inflation risks. There is also a growing number of countries





announcing reductions in fuel subsidies, which tend to weaken consumption. Recently, India, Malaysia, Taiwan, Sri Lanka and Thailand, have announced moves to raise retail gasoline prices. There is also speculation that China may follow suit, albeit after the hosting of the Summer Olympics.

The bottom line

The trends witnessed so far this year indicate that elevated prices are beginning to put a damper on global consumption of crude oil and refined products. And evidence of demand destruction is almost certain to become even more visible in the months ahead as the price spike this spring likely provokes an accelerated behavioural response. In our view, it is only a matter of time before these emerging fundamental trends begin to catch up to the crude oil market, sending prices substantially lower. Our current forecast profile has prices settling at about US$100 on average in 2009, although this assumes that prices have reached a peak. To the extent that crude oil prices continue to soar to new records in the coming weeks, next year's correction could be even more dramatic.

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