TD Bank Financial Group

TD Economics

Special Report

April 18, 2008

CRUDE OIL PRICE RELIEF IS COMING, BUT NOT UNTIL LATER THIS YEAR

With gasoline prices at nosebleed levels, the spotlight has been turned up even higher on the key culprit – the price of crude oil, which has continued to set record after record. The following note provides an updated snapshot of the current oil market, and our view as to what's in store for the next 12-18 months. In short, look for some of the froth to come off crude oil and gasoline prices, but not to any meaningful extent until after the summer. At that time, we predict that the focus will shift to the global economic slowdown, the resulting moderate slippage in the supply/demand fundamentals underlying crude oil and some stabilization in the value of the U.S. dollar.

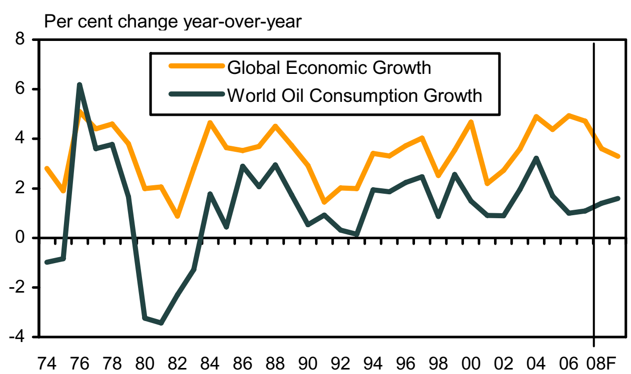
HIGHLIGHTS

- **U.S. oil demand to slow in 2008, but demand in developing countries will remain strong.**
- **Supply-demand balance to swing into a positive position in 2008 and to remain there in 2009.**
- **U.S. dollar and speculative buying to remain key drivers of oil prices in the near term, but should begin to recede later this year.**
- **Prices to drop to US$85-90 by Q4-08 and Q1-09, before a firming pattern takes shape starting in Q2-09.**

Crude oil prices continue to set records

The rally in the crude oil market, which has been underway since 2002, has accelerated since early 2007, with prices more than doubling. After peaking at a price of US$111 per barrel in March, prices began to retreat toward the US$100 per barrel threshold, stirring up chatter that the oil bubble was bursting. However, that notion was short-lived as prices shot right back up a week later. Currently prices are hovering around US$114 per barrel, and there may still be more gas in the tank over the very near term. It is interesting to note, that on average, bullish news has been generating greater upswings in prices than bearish news has been generating downswings, highlighting the fact that there remains quite a bit of optimism in the oil market.

GLOBAL CRUDE OIL CONSUMPTION GROWTH VS. GLOBAL ECONOMIC GROWTH



Source: Energy Information Administration
Forecast by TD Economics as at February 2008

While supply and demand fundamentals have certainly played a role in driving up prices, it is clear that there have been other factors at play as well. Geopolitical events, a slumping U.S. dollar and a flood of speculative buying have had a significant impact on crude oil prices. Indeed, the boost to prices purely from recent speculation has been estimated at US$20-30 alone. As a result, these non-fundamental/investment factors must be taken into account when considering the future of oil prices.

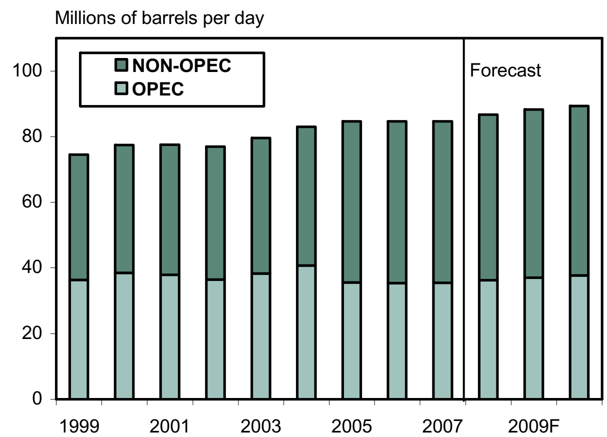
Little risk of crashing oil demand

Global consumption trends have remained quite robust in spite of the current weakened state of the U.S. economy. However, the economic slump south of the border will eventually spill over into the global market. As such, we have downgraded our global growth forecast from 3.8% to 3.6% for 2008 and from 3.7% to 3.3% for 2009 in the latest edition of the *TD Quarterly Economic Forecast*. Given that oil consumption is closely tied to world economic growth, the global slowdown forecast is likely to soon show up in the demand equation.

There has been some evidence emerge that consumers in the U.S. are beginning to adjust their behaviour in order to minimize the pinch being felt on their wallets. Over the past year, there has been a more than 2 percentage point swing in the market share from light trucks towards smaller, more fuel efficient vehicles. Moreover, during the first quarter of the year, total oil product demand in the U.S. (i.e., crude oil and refined products) declined by 3%. That said, we see a limit to how far demand will slacken, since with few available alternatives, oil consumption is relatively price inelastic.

Regardless, the impact of a global slowdown on oil demand will be more muted than usual given that the energy-hungry nations of China, India, the Middle Eastern and other developing markets will account for an even bigger share of energy consumption growth in 2008 and 2009. For one, economic growth in these regions is expected to ease only moderately. Second, many of the countries continue to heavily subsidize fuel prices. In particular, China, as the number two seed in global crude oil consumption, will continue to widen its domestic supply deficit. Overall, we expect global demand to grow 1.4% in 2008 and 1.2% in 2009, compared to the 1.8% annual average advance of the past 5 years.

WORLD OIL PRODUCTION

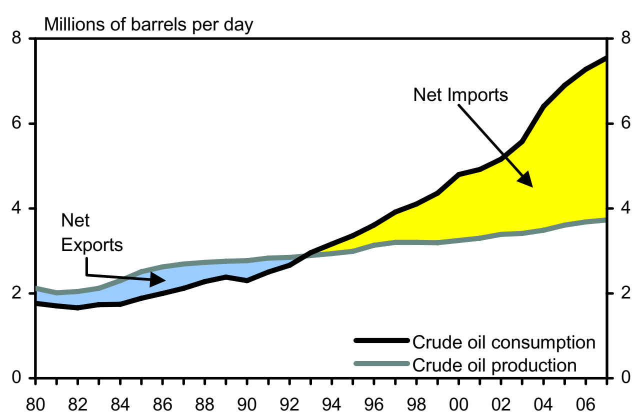


Source: Energy Informaion Administration, TD Economics

Global supply growth to outpace demand

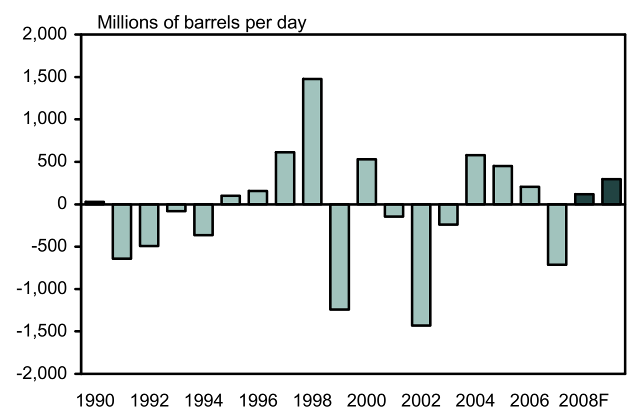
Meanwhile, supplies remain quite tight as evidenced by the 2% drop in OECD inventories so far this year. In the U.S., where inventories have been building for 11 of the past 14 weeks and are right in line with their five-year average, they still remain over 5% below year-ago levels, keeping concerns about inadequate supplies at the fore-

GROWING CHINESE OIL DEMANDS



Source: U.S. Energy Information Administration

SUPPLY-DEMAND BALANCE



Source: Energy Information Administration
Forecast by TD Economics as at February 2008

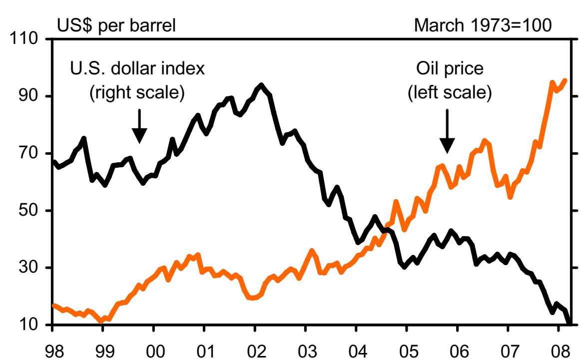
front. Despite calls from U.S. officials for OPEC to boost output in order to alleviate supply concerns and bring prices down, OPEC has instead been focused on the non-fundamental factors that are lifting prices and therefore decided to leave production levels unchanged at each of their last three meetings.

While we assume that OPEC will leave quotas unchanged in the coming quarter, increased production from non-OPEC countries will provide a modest boost to supplies later this year. As a result, we project overall global output to grow 2.5% in 2008, pushing the global supply-demand balance into moderate positive territory (see chart on previous page). The majority of this new capacity is expected to come from Brazil, which alone will nearly offset declines in the U.K., Mexico and Norway combined. Of course, new projects are always susceptible to delays, which presents a downside risk to supply growth. OPEC's spare production capacity is expected to increase moderately in 2008, with the bulk of it stemming from Saudi Arabia. This easing in the global oil balance this year is one good reason to expect prices to fall off their recent highs.

Geopolitical factors remain a risk

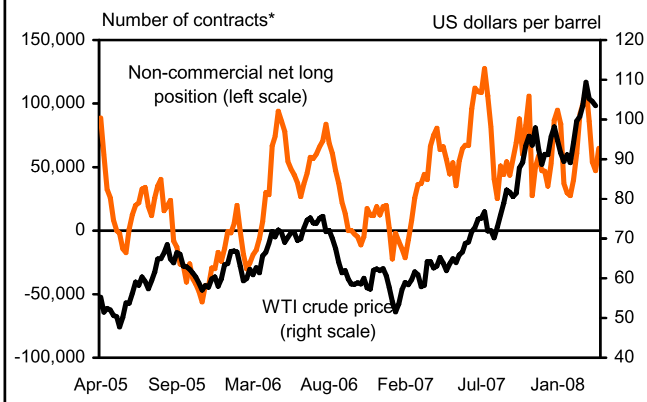
On the flip side, the potential for unrest in the supply nations of Nigeria, Venezuela and Iraq has contributed to higher oil prices recently, and concern of further supply disruptions in these major producing countries has led to a desire for a higher level of commercial inventories. Although the risk of supply developments in these countries is unlikely to abate, the moderate easing in the tightness in the market later this year should result in a somewhat smaller risk premium being factored into prices.

OIL PRICES AND U.S. DOLLAR INDEX (AGAINST MAJOR CURRENCIES)



Last month plotted: March, 2008
Source: Haver Analytics

CRUDE OIL PRICE AND CFTC NON-COMMERCIAL NET POSITIONS ON NYMEX CRUDE OIL FUTURES

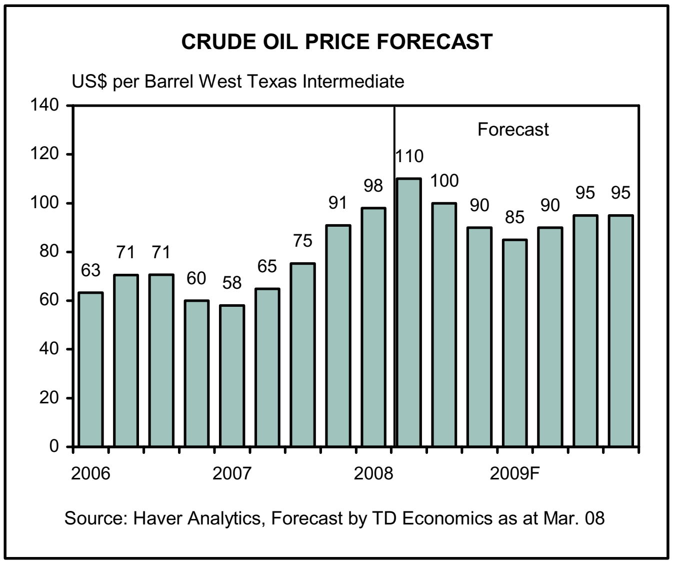


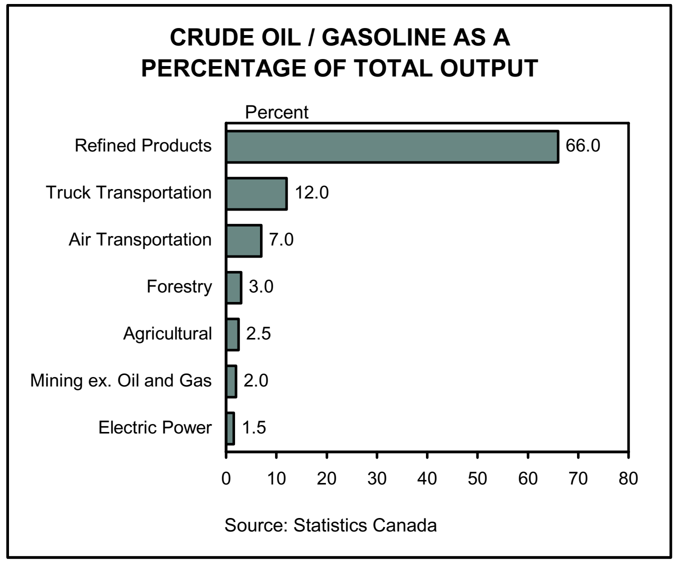
* Each contract is 1000 barrels; Last data plotted: Apr. 8th, 2008
Source: CFTC

U.S. dollar a key driver of oil prices

An even more significant driver of oil prices of late is the massive slump of the U.S. dollar against the euro and other major currencies. In addition to the fact that crude oil is priced in U.S. dollars and is therefore cheaper for stronger-currency countries to buy when the greenback is weak, there has been an influx of investment flows into commodities, and oil in particular, as investors turn to hard assets as a hedge against inflation. Indeed, over the past year, there has been a strikingly near-perfect (negative) correlation between daily movements in the trade-weighted U.S. dollar and oil prices. While correlation does not necessarily imply causality, it appears as though swings in the U.S. dollar have been an underlying driver of oil price movements, as any signs of further deterioration in the U.S. economy or of the Fed continuing its rate-cutting cycle have driven crude oil prices higher. Furthermore, this relationship has also induced a high degree of speculative buying, as evidenced by the number of non-commercial net long positions on the NYMEX exchange, which are in significant positive territory.

Predicting a shift in the direction of currency markets is never an easy task. Still, we believe there is a good case to be made that the U.S. dollar, which continues to trade at record lows against the euro, will begin to stabilize once the Fed is finished cutting interest rates in the third quarter of 2008. A gradual recovery in the greenback from these





very low levels is then expected in 2009. And with inflation pressures expected to ease in the United States as spare economic capacity gets built up, the attractiveness of holding crude oil as a hedge against both a falling U.S. dollar and inflation will decline.

Implications

Overall, the strong influence of investors in the recent surge in crude oil prices has led to greater-than-usual uncertainty surrounding the oil price outlook. While most of these drivers will likely remain rather bullish, the outlook for a moderation in global demand growth is likely to pull prices back to US$90 by year-end. Some further easing in early 2009 – to about US$85 – appears to be a good bet, before prices firm later next year in line with a recovery in the U.S. economy. Even with this outcome, prices will still be more than 50% higher than their 2004-2007 average.

The expected pull-back in crude oil prices from current levels will come as some good news to energy-intensive industries and oil-importing regions. As shown in the accompanying chart, crude oil, gasoline and other refined products account for a significant portion of gross output in a number of industries, including refineries, truck and air transportation, forestry, agricultural, mining and electric power. In terms of implications for gasoline prices, our projected profile for crude oil prices implies little relief at the pumps this summer. Indeed, the price of unleaded gasoline on average in Canada could rise even further, to within $1.25-$1.35. (Prices could jump even higher in B.C., Quebec, Newfoundland & Labrador, Saskatchewan and Nova Scotia, where prices tend to be above the national benchmark.) Although this further increase may appear at odds with our call for a drop in crude oil prices in the third quarter, to US$100 per barrel on average, refining spreads tend to widen during the peak driving season, pushing gasoline prices higher. However, by year-end, pump prices should pull-back to a more palatable level of about $1.00.

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