

OBSERVATION

TD Economics



July 6, 2012

CRUDE OIL'S REPEAT PERFORMANCE TO COME TO AN END

Highlights

- The trend in crude oil prices during the first half of this year closely resembles the trend seen in 2011, as many of the drivers underpinning price movements have followed a similar pattern as last year.
- One key difference is in the supply-demand dynamics, as surplus production has allowed inventories to mount this year, compared to a supply deficit winding down stocks last year.
- Last year, oil prices bounced back to US\$100 per barrel by the end of the year. However, while oil prices bounced back recently, we suspect that the fundamental backdrop will keep prices in their current US\$80-90 per barrel range in the near term, before drifting back up to US\$100 per barrel by the end of 2013.

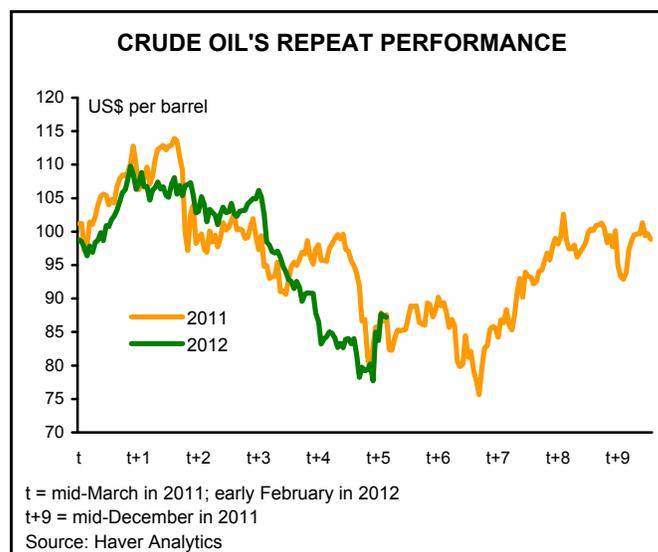
In uncanny fashion, oil price movements this year have been tracking those of a year ago almost dollar for dollar, with WTI prices rallying to a peak of around US\$110 per barrel through the first quarter, only to plummet to around US\$80 per barrel at mid-year. Likewise, the hefty rebound in WTI prices observed over the past week is raising hopes within oil industry circles that the second half of 2012 will also mark an encore performance to that in 2011, where prices rallied back up to US\$100 per barrel by year end.

While nothing can be ruled out given the high degree of volatility that persists in the marketplace, a closer look suggests that a surge back up to the triple digit mark over the next six months will be a very tall order. Notably, a key difference that distinguishes current market conditions over those of a year ago is a considerably slower growing global economy and the high amount of slack that has accumulated in the oil market.

Similarities abound...

The accompanying chart illustrates how closely oil price movements this year resemble those seen last year. The ups and downs in both years have largely been a function of the broader risk appetite prevailing in financial markets. Similar to last year, investors began 2012 feeling more optimistic about Europe, China and the United States. Meanwhile, geopolitical tensions in the Middle East – the civil war in Libya last year and concerns over Iran's nuclear program this year – sparked fears of supply shortages, also attracting investors to oil.

But by the spring, the sanguinity turned into pessimism. Last year, it was a combination of worries about the European debt crisis, the uncertain U.S. political situation and the potential for a debt downgrade, and a slower pace of global economic growth



that shifted sentiment. This year, the downward pressure has stemmed largely from the European woes and lower global growth prospects, but political uncertainty in the U.S. remains a key risk. These factors combined have pulled investors out of riskier asset classes such as commodities and equities and into the safety of government bonds. This change in sentiment is reflected in the non-commercial net long positions on the NYMEX, which shot up by 75% during the first two months of the year, before plunging by 45% in May and June.

Recent rebound may be short lived

Some optimism has crept back into the oil market recently, driven largely by market expectations for further monetary stimulus around the globe and some worries seeping back into the market regarding Iran and potential disruptions to the Strait of Hormuz. Developments at the June European Union Summit also played a role, as progress was made in establishing a banking union among other measures. However, there appears to be more market skepticism than was the case a year ago that the actions agreed upon mark a major step forward to resolving the European situation. So while we see potential for prices to gain further traction –

particularly if the situation with Iran intensifies – the recent rebound could prove to be short lived.

Indeed, while one can be mesmerized by the abundance of similarities, there is one important difference between this year and last that could keep prices from rallying back to the US\$100 per barrel mark in the near term: the supply-demand dynamics, which are highlighted in Table 1.

Last year, demand outpaced supply, leading to an average deficit of 800,000 barrels per day for the year as a whole. Global inventories were falling, although they were still high relative to historical norms. In reality, the release of oil from the Strategic Petroleum Reserve last June was not actually needed to meet demand – it was more to calm markets and temper prices. And it had only a temporary impact on prices.

This year has seen the opposite, with an average surplus of 1.9 million barrels per day during the first five months of the year. In fact, crude oil inventories in the U.S. are currently sitting around a 22-year high, while global inventories rose to 96 days supply in May – the highest level seen in more than two years. Production in North America has ramped up this year, with the U.S. and Canada both posting significant gains of 8% and 11%, respectively, during

TABLE 1: OIL MARKET TRENDS IN 2011 & 2012

	2011		2012	
	April/May Peak [^]	August Low [^]	Feb/March Peak [^]	June Low [^]
Crude Oil Prices (US\$/b)				
WTI	113.93	79.30	109.77	78.77
Western Canada Select	98.18	66.05	80.99	49.69
Spreads	15.75	13.25	28.78	29.08
Oil Market Indicators				
Non-commercial Net Long Positions	258,068	131,234	254,559	123,908
U.S. real GDP Growth (quarterly Y/Y % change)	0.4	0.4	0.5	0.5e
China real GDP Growth (quarterly Y/Y % change)	9.5	9.1	8.1	7.9e
Oil Supply/Demand* (3-month moving average, Y/Y % chg)				
Global oil supply growth	0.9	1.1	2.8	4.7
OPEC	2.3	4.0	5.9	9.4
Non-OPEC	-0.1	-0.8	0.6	1.4
Canada	6.1	2.7	7.0	12.8
Global oil demand growth	1.4	0.6	0.7	0.7
China	9.5	4.0	3.8	2.2
U.S.	-0.1	-1.1	-2.7	-1.8
Supply-demand balance (mb/d)	-1.2	-1.0	0.8	3.2
[^] Peak of various indicators were at end of April/beginning of May in 2011 and end of February/beginning of March in 2012; indicators hit a low point in August 2011/June 2012 e TD Economics' estimate for Q2 growth *May is the latest data available Source: Haver Analytics, Energy Intelligence				

the first five months of the year. Some OPEC countries, particularly in Saudi Arabia, have also boosted production this year, which combined with the rise in non-OPEC output, has more than offset declines in Iran and a few other producing countries. At the same time, demand growth around the world – particularly in China and the U.S. – has been weaker than last year, leaving the market much looser than was the case a year ago.

Where to from here?

With recent economic indicators in the U.S., China and Europe all pointing to slower growth, demand for crude oil will likely soften in the near term. Meanwhile, supply will remain ample. Production in North America is expected to continue to grow over the next 18 months, despite the inventory accumulation that has taken place Stateside. Likewise, output from OPEC countries is likely to continue to overshoot the cartel's target, even with an expected drop in Iranian production. While some member countries who rely heavily on oil revenues would like to see output decline in to order to bring prices back up to levels they are more comfortable with, other members are in favour of lower prices given the weak economic backdrop around the globe. Lower oil prices can help rather than hinder growth, by putting more disposable income in consumer pockets and reducing the amount that governments have to spend on subsidies in countries such as China, leaving more room for stimulus spending. The recent drop in prices has also helped to put the brakes on inflation. Recognizing this, Saudi Arabia – which is commonly referred to as OPEC's swing producer since it is the largest producer and has enough spare capacity that it can increase or reduce production as

necessary to balance the market – has indicated that it would prefer to see lower prices while global economic growth is weak. Hence, it is expected to continue to produce oil at (or very close to) the highest rate seen in 30 years. That said, a full blown Iranian production shutdown would stretch Saudi Arabia's capacity to its limits.

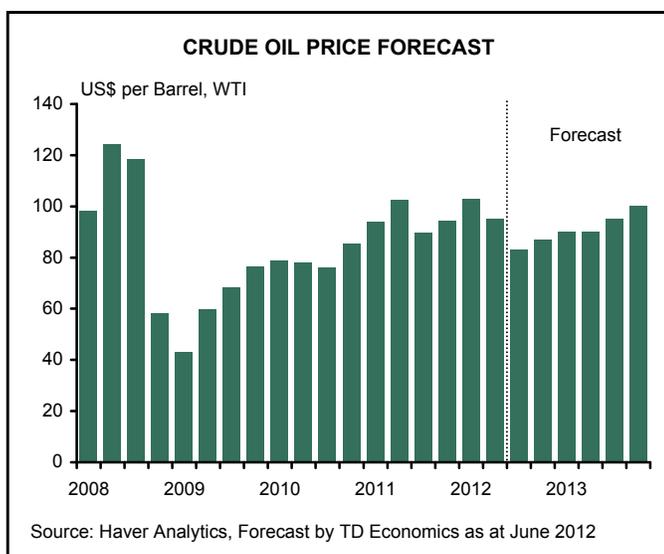
Given the fundamental backdrop, we suspect that prices will remain in their current US\$80-90 per barrel range through the second half of this year. Next year, oil market conditions should firm up as growth in China and around the globe stabilizes, lifting demand for oil. This will allow OPEC to lower production somewhat, though the improvement in the supply-demand balance will not likely be fast enough to address the excesses currently in the market. As such, we expect prices to rise gradually over the year, hitting the US\$100 per barrel mark by year-end.

Implications for the Canadian oil patch

For Canadian oil producers, another distinct difference between this year and last is the price differential between WTI and Western Canada Select (WCS), which is now almost double what it was in 2011. While a gap in the two prices is expected given that oil produced in the oil sands is 'heavy sour' versus the 'light sweet' oil that WTI is priced on and thus needs to be refined more, it is the increase in the gap that is worrisome for Canadian producers. This widening of the gap is largely due to the glut that has built up in the U.S. – where a significant chunk of Canadian oil is sent – along with refinery and pipeline constraints. Still, output in Canada is expected to continue to grow over the remainder of this year and next, albeit at a slower pace than has been seen thus far.

While the outlook for prices is more important than the current price level when assessing capital expenditures, the latter can impact cash flows and profits, particularly among the smaller players in the industry. Nonetheless, while some projects could get delayed, we don't anticipate widespread cancellations given that prices are expected to drift back up next year. That said, while we expect the spread between WTI and WCS prices to narrow somewhat over the next few years, it is unlikely to return to 2011 levels. Moreover, if the price that Canadian producers receive remains depressed for a sustained period of time, future supply growth could be constrained.

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