NATCAN WEEKLY MARKER

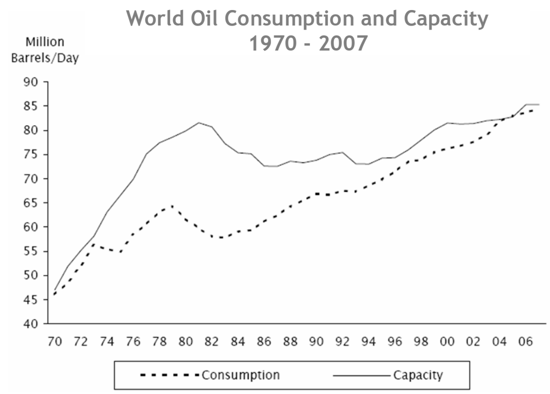
May 20, 2008

SUPPLY AND DEMAND: THE CASE OF OIL

The most important law of economics may well be summarized as "supply meets demand at a clearing price". Oil recently set new record highs, and respected analysts have been calling for a price *superspike* that might lead the barrel to as much as $200 within a year. This week's Marker sheds some light on how investors should factor in high prices for oil in their investment strategies.

WHEN DEMAND LEADS AND SUPPLY TRIES TO KEEP UP

The strongest determinant of growth in demand for oil is world economic growth. Recent trends in this area are telling. Global GDP growth in the 5 years ended 2007 was at a historical high (4.9% per annum). What may be overlooked is the fact that growth was distributed in one of the broadest ways in history, with billions of world citizens in the developing world benefiting from the expansion. This is a significant development insofar as government policies pertaining to the price of oil in developing countries are often at 180 degrees from that of the developed world. Whereas oil in its crude and refined forms (gasoline, heating oil, jet fuel) is taxed in the Western world, it is more often than not subsidized in emerging countries. Such subsidies combined with currencies pegged to a falling U.S. dollar contribute to strong growth in demand from the emerging world. In fact, the International Monetary Fund (IMF) recently confirmed that China and emerging countries account for over 90% of world growth in demand for oil.

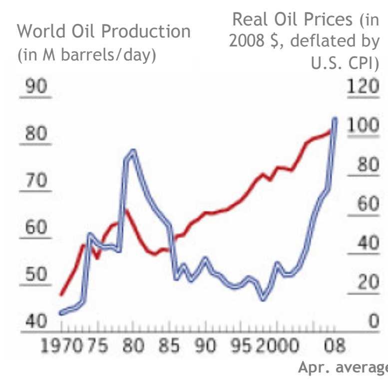


Sources: BP Statistical Review, Energy Information Administration

As the above chart illustrates, this strength in demand has occurred as oil producers the world over have struggled in bringing important net new production on line. One of the key contributing factors to current elevated prices is the perceived lack of excess supply in the global oil system. We definitely are in a situation where supply and demand are balanced, and demand is at risk of running ahead. The prevailing high prices for oil are thus fundamentally justified at present.

COULD A HIGH PRICE LEAD TO A LOW PRICE?

Contrary to the dot com bubble during which people were paying for fuzzy concepts, oil is a real commodity with a true underlying value. As such, a high price alone will not lead to a downdraft. For oil prices to drop, demand growth will have to slow, allowing for a restocking of spare capacity. With emerging country growth continuing, it is unlikely the trend in oil prices will reverse its course in the short term. A more likely course of development is for a combination of new supplies coming on stream as well as adjustments in consumption resulting from demand destruction to lead the market toward lower prices over the medium and longer terms.



Sources: BP, IMF, Goldman Sachs, Thomson Datastream

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The global market for oil is in a tight balance between supply and demand. Excess capacity is below historical norms. These facts combined with a healthy global economy and strong growth in demand from emerging countries render the current high price fundamentally justifiable. Investors need to consider the fact that the pricing environment of the past 12 to 24 months - high by historical standards - is likely to be with us for some time.

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FINANCIAL MARKETS

RETURNS AS AT MAY 16, 2008 (%)	MTD	QTD	YTD
S&P/TSX	7.62	12.57	9.37
S&P 500	2.28	5.24	-1.57
S&P/TSX Small Cap	4.60	6.71	2.39
Russell 2000	2.79	5.08	-2.21
MSCI EAFE	1.92	5.47	-0.11
MSCI World	2.34	5.73	-0.04
DEX Universe Bond	0.47	-0.05	2.90

	RATES AS AT MAY 16, 2008
CAD/USD	1.00
CAD/Euro	1.55
US Treasuries yield 10-yr/30-yr	3.85/4.58
GOC bond yield 10-yr/30-yr	3.58/4.04
Fed Fund Rate (target)	2.00

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc.

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