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Supportive Fundamentals for Oil in 2010 and Beyond

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The price of crude oil has been extremely volatile over the past few years as a result of economic uncertainty and a near collapse of the financial system. The volatile price environment has been further accentuated by various supply issues, concerns about geopolitical risk, currency hedging, and general speculation on commodities. Over the first half of 2008, against a backdrop of a weakening economy, the price of crude oil shockingly rose beyond US\$140 per barrel. However, the commodity price plummeted by more than US\$100 per barrel in subsequent months as economic conditions worsened. In another demonstration of violent price swings, between 2000 and 2007, the price of crude oil would swing as much as \$2.50 per barrel on average each week; however, from 2008 to the present, price swings have averaged \$6.65 per barrel in any given week. Clearly, this is an extremely difficult and unpredictable environment for both traders and investors.

From a shorter-term perspective, we believe that the current price of crude has been supported by a weak U.S. dollar and speculative activity as opposed to reflecting an improvement in underlying fundamentals. We would not be surprised to see some price weakness over the near-term as a result of high inventories, moot economic outlook, the likelihood of lacklustre demand, and seasonality. Accordingly, we are slightly cautious on the energy sector over the next few months.

That said, we are of the view that if a pullback were to occur or if we consolidate at current levels until signs of an economic recovery strengthen, such a scenario would present an excellent long-term buying opportunity. This would allow investors to capitalize on the seasonally stronger spring period for energy stocks as well as the bullish longer-term supply fundamentals that are extremely supportive of the underlying commodity price going forward. We strongly believe that under-exploration over the past few years as a result of budget constraints, increasing reliance on unconventional resources that tend to be more costly to produce, and the eventual uptick in the economy all lend to the notion of higher crude prices over the longer term. To appropriately position a portfolio for this bullish trend, depending on risk tolerance and overall portfolio exposure, our preferred names in the sector are currently Suncor, Canadian Natural Resources, and Husky Energy.

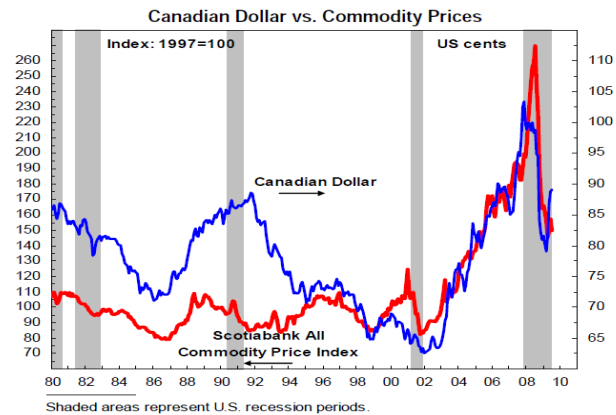
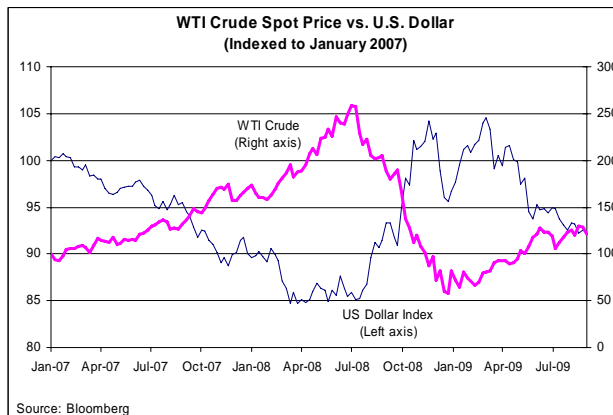
BACKGROUND

Volatility in recent years partly reflects currency & inflation hedging

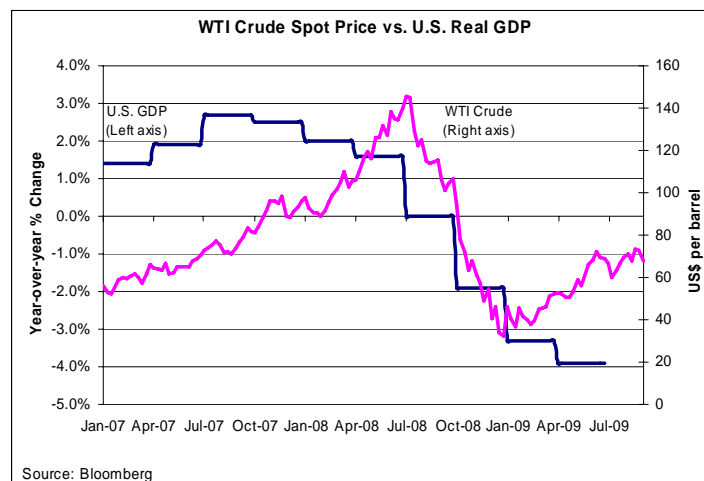
- Most commodities are priced in U.S. dollars (ie. oil, copper, gold, etc.)
- Weak domestic economy, soaring budget deficits, and accommodative monetary policies all have negative influences on the U.S. currency
- Depreciation of the U.S. currency makes the price of the commodities more attractive for foreign buyers, thereby providing some demand and price support
- Commodities also provide protection from the effects of inflation as the price of raw materials such as oil rise when inflation is accelerating
- Over the past two years, rampant speculation over the direction of the U.S. dollar, stagflation, and diversification of asset classes drove the price of oil to an unprecedented high of US\$145 per barrel

Market Observations

- Volumes of investment funds in commodity markets have risen from an estimated \$15 billion in 2003 to \$260 billion currently
- The price of oil spiked 51% over the first six months of 2008, despite the fragile economic outlook
- The desire to diversify assets due to the economic upheaval and pure speculation on the part of investment funds are the primary drivers behind this most recent commodity run



- Commodity price strength has been more about the dollar and diversification, than true underlying demand as GDP declined while crude prices soared in the first half of 2008
- In the second half of 2008, however, true fundamentals and commodity prices finally converged again

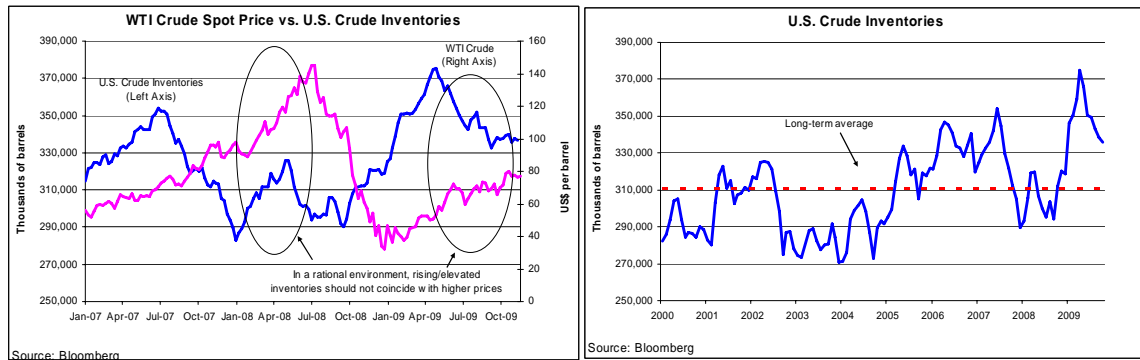


Misalignment – Inventories, Prices, Economy

- Not surprisingly, the sharp economic downturn has resulted in a significant rise in crude oil inventories
- Despite reductions in production and exploration by OPEC and other producing nations, inventories are at their highest levels in nearly a decade
- The last time inventories were this high in mid-2007, the price of oil was above US\$70 per barrel

Market Observations

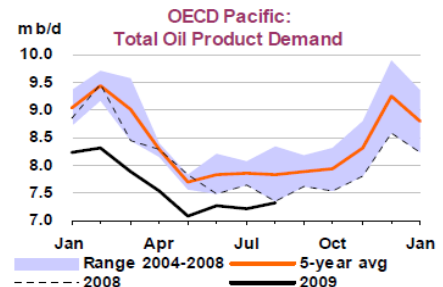
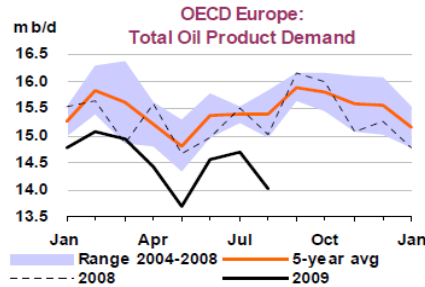
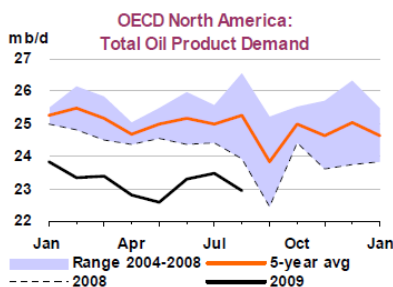
- However, economists at that time were forecasting global real-GDP to grow at a pace of 3%+ for both 2007 and 2008
- Currently, Scotiabank is forecasting global real-GDP to decline at a pace of 2.1% in 2009 before returning to growth of 2.9% in 2010



Diverging Trends

The Former Powerhouses

- According to the International Energy Agency (IEA), oil product demand in North America fell by 4.1% year-over-year in August. This marks the twentieth monthly contraction in a row for the continent
 - U.S. is gradually becoming a mature market for crude; additionally, recent changes in U.S. poses substantial uncertainties for growth
 - IEA is currently forecasting U.S. oil demand to fall 4.3% in 2009 and then rise by a modest 0.9% in 2010
- In Europe, oil product demand plummeted by 6.7% year-over-year in August
 - IEA is forecasting European oil demand to fall 4.4% in 2009 and then remain flat in 2010
- In the Pacific, oil product demand contracted for the fourteenth consecutive month, falling 0.4% year-over-year in August as its largest economy, Japan, continues to be in an economic lull
 - IEA is forecasting oil demand in the region to fall 5.9% and 2.4% in 2009 and 2010, respectively

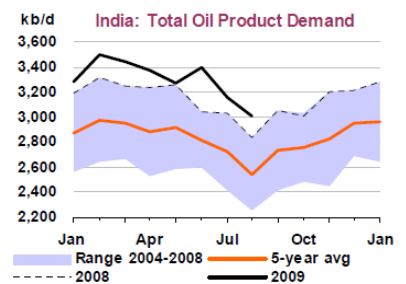
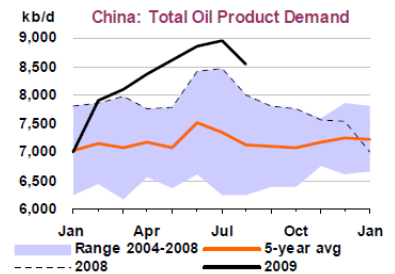


Source: International Energy Agency

Market Observations

Rise of the East

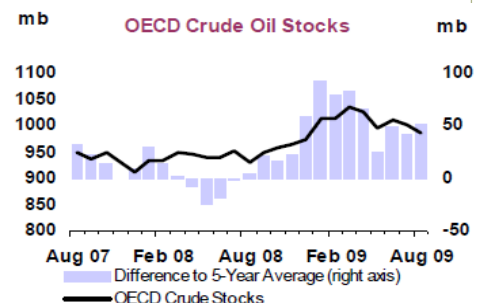
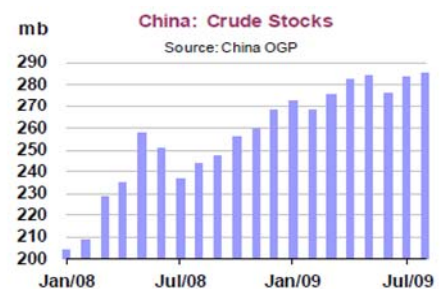
- China has averted the above trend as demand continues to remain strong, rising by 6.8% year-over-year in August
 - In sharp contrast to North America, the auto industry has helped to spur demand as car sales continue to be robust (up 48% in June); this trend may continue given increasing wealth and that only 2% of population owns automobiles
 - IEA expects Chinese oil demand to rise by 5.1% and 4.1% in 2009 and 2010, respectively
 - China's import of oil products has steadily increased as the country is now more dependent on foreign resources than the US
- India's oil product sales surged by 6.4% year-over-year in August
 - IEA expects Indian oil demand to rise by 4.2% and 3.7% in 2009 and 2010, respectively



Source: International Energy Agency

OVER THE NEAR TERM...

- Price of crude oil reached a 4-year low of approximately US\$32 per barrel in late-2008 as the market panic reached a pinnacle but has since rebounded more than 100%
 - Concerns of demand destruction and a near meltdown of the financial system brought prices down from triple-digit territory
 - Prices began to recover in the spring of 2009 as a result of improving sentiment, signs of stabilization in the rate of economic deterioration, and stockpiling by countries such as China
 - In our opinion, one major factor that has supported near-term prices relates to stockpiling
 - According to the IEA, "Reports continued to emerge over developments in China's Phase 2 strategic crude oil stockpiling. With the recent reported completion of the filling of 102 million barrels of Phase 1, China is in the midst of constructing a series of eight storage sites for Phase 2 totaling about 170 million barrels, some of which may reportedly be completed before end-2009."
- An indication that recent price strength relates more to stockpiling (meant to be stored to meet future demand) as opposed to meeting true underlying demand was that global oil consumption was actually down by 3.1 million barrels per day in the first half of 2009
 - Inventory levels in major industrialized countries can sustain current consumption levels for roughly 60.7 days if production and imports were halted (3.7 days higher than a year ago)



Source: International Energy Agency

Market Observations

- Analysts have suggested that crude oil and refined products held in floating storage, which are not included in certain inventory totals, have recently increased to 140 million barrels; speculators and producers are essentially waiting for a higher price
- Therefore the sustainability of any upward price movements will require a pick-up in current consumption and a coincidental decline in inventories
- **The primary market focus over the near term will be on inventories as well as underlying demand**

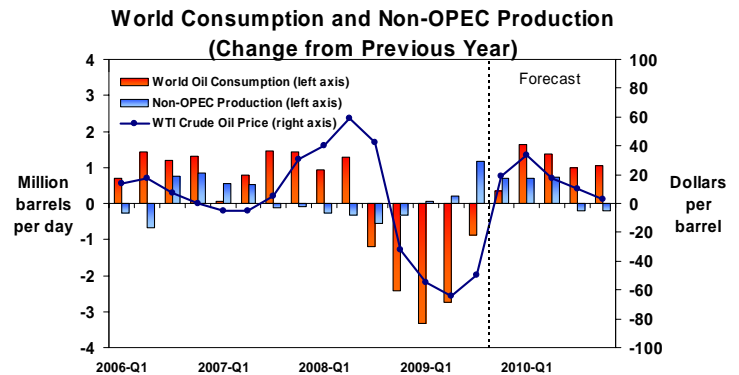
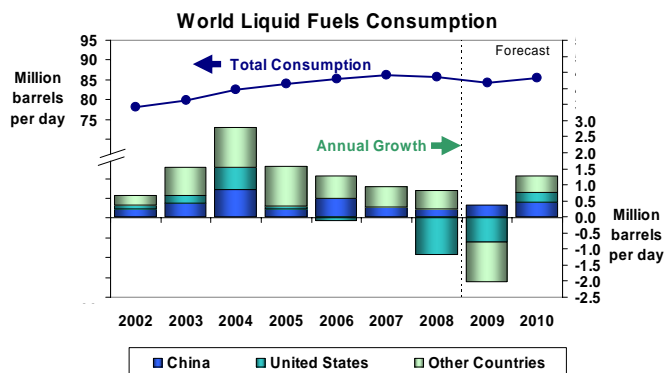
LOOKING FURTHER AHEAD...

- Over the longer-term horizon, once the economy stabilizes, inventory levels will begin to decline and economic growth resumes, **the primary market focus will quickly shift to supply issues**
- During the last two years, low prices and lack of available credit have limited the amount of exploration and production investment necessary to maintain and increase production
 - The issue for supply over the longer term is that much of the world's growth in production now comes from long-lead, and arguably higher cost, projects such as oil sands and offshore developments
 - Deferred and/or cancelled exploration programs will have a negative impact on supply growth; particularly at a time when the global economy is recovering and demand growth is resuming
 - Earlier this year, the International Energy Agency estimated that \$100 billion of worldwide oil production capacity expansion projects have been cancelled or postponed
 - OPEC members have postponed a total of 35 oil-drilling projects due to the effect of the financial crisis and low crude prices
 - Saudi Arabia has cancelled the development of several fields such as the Manifa and Dammam oil field, which would have added about 1 million barrels per day of capacity
 - China cut its investment in domestic oil and gas exploration by 13.8% in the first two months of 2009
 - In Canada, investment in mining and oil and gas exploration fell by over 25% this year

Consumption to outpace production growth

- Energy Information Administration (EIA) forecasts global oil consumption to decline by 1.7 million barrels per day in 2009 (-1.9% year-over-year) and then rise by 1.3 million barrels per day in 2010 (+1.5% year-over-year)
- By comparison, in terms of production:
 - Non-OPEC crude oil and other liquid fuels is expected to rise by 533,000 barrels per day in 2009 and 253,000 barrels per day in 2010 as higher output from Brazil, the US and the former Soviet Union is expected to offset falling production in Mexico and North Sea.
 - OPEC crude oil production is expected to decline by more than 1.5 million barrels per day in 2009 and then rise by approximately 1 million barrels per day in 2010

Market Observations



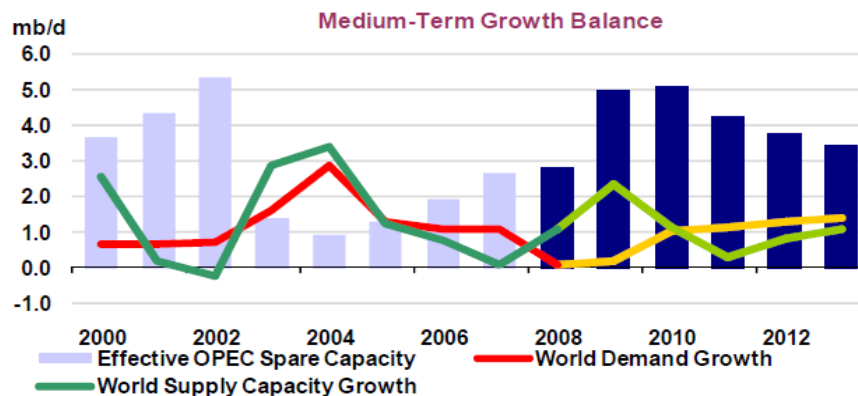
Short-Term Energy Outlook, November 2009



Short-Term Energy Outlook, November 2009



- In addition to consumption growth outpacing production growth, other factors impacting long term supply include:
 - Analysts estimate that to offset decline rates of current reservoirs, over 3.5 million barrels per day of new production is needed each year, just to hold world production steady
 - A number of conventional oilfields in developed nations are showing little growth, if any at all
 - Therefore, there will likely be growing reliance on unconventional resources and OPEC
 - For OPEC, however, spare capacity is expected to decline to a mere 1 million barrel per day by 2013 (equivalent to approximately 1.1% of global demand)



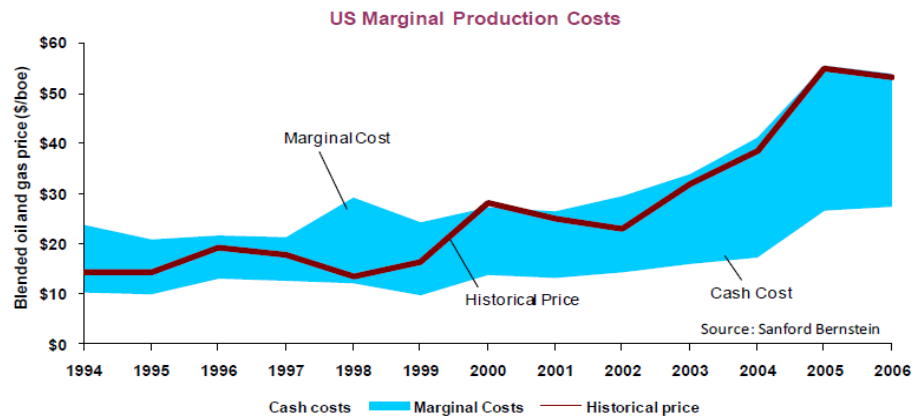
Source: International Energy Agency

- Economic theory suggests that over the long-term, commodities tend to revert back to marginal cost of production as competitive pressures should serve to drive costs close to market prices or vice versa
 - Low prices eventually force production cuts and eliminates some unprofitable and/or underperforming companies and/or assets – this eventually results in lack of supply when demand eventually picks up
 - High prices attract new entrants into the industry, thereby increasing supply and driving up costs; this eventually reaches a point where supply exceeds demand with resulting downward pressure on prices
 - IEA previously estimated that the marginal cost of production is approximately US\$60 to US\$70 per barrel
 - Marginal costs have risen sharply since 2003, reflecting tightness in the service sector; together with limited access to

Market Observations

low-cost oil reserves, there is an increasing need to produce oil in ever-challenging regions and the need for more expensive technology

- Ultimately, rising marginal costs of production helps to provide a floor price
- Scotia Capital believes that the minimum price required for deepwater and oil sands projects is in the US\$75-100 per barrel range



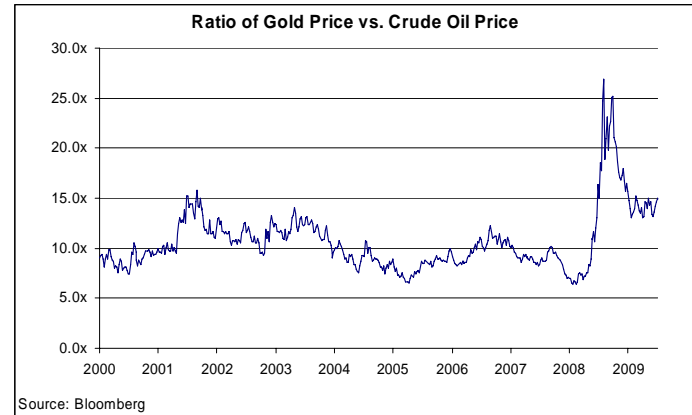
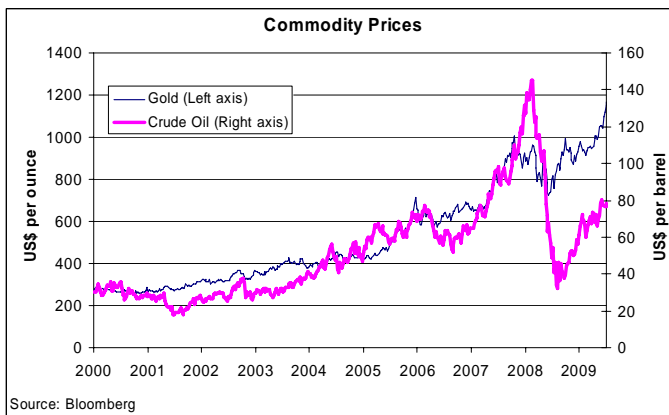
Source: International Energy Agency

PRICE OF CRUDE OIL RELATIVE TO GOLD

- Price of gold continues to reach new highs, rising over 33% on a year-to-date basis and recently surpassing US\$1170 per oz. Scotia Capital's Gold research team has attributed some of the rise to the following factors:
 - Fabrication demand may pick up as economies recover in 2010.
 - The U.S. dollar will continue to be weak and commodity prices including gold will continue to rise as speculative safe havens from the falling U.S. dollar. This weak U.S. dollar assumption is supported by the U.S. budget deficit now being nearly 10% of GDP and some economists forecast it will reach 12.5% of GDP.
 - Gold may also be seen as an alternative currency to the falling USD or, although unlikely, as a potential replacement reserve currency. In any case, the speculation should be good for gold.
 - The rising commodity prices (oil, copper, zinc, lead, gold, and silver) should continue along with the falling U.S. dollar. The massive financial stimulus around the globe, and in particular in the U.S., should start to breed inflation in mid- to late 2010. Investors typically flock to gold as an inflation hedge at the threat of inflation and reciprocally, they would look to sell gold when inflation declines.
 - U.S. and global economies continue to attempt to "spend themselves" out of the economic melt-down that started last year. We believe this action should continue to buoy gold higher.

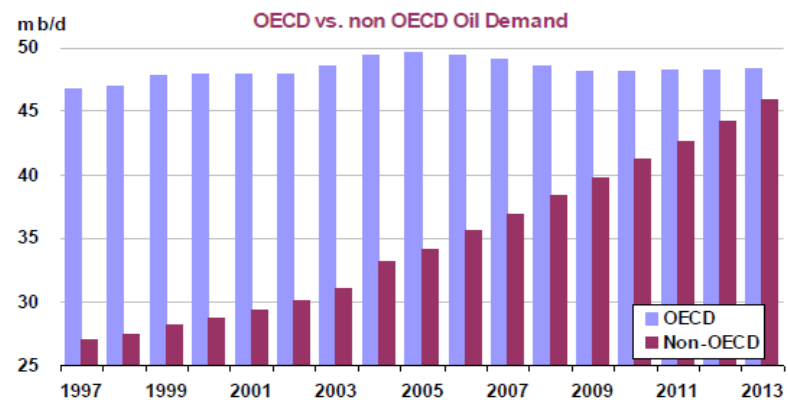
Market Observations

- In our opinion, many of these factors that have helped to drive the outperformance of the bullion can also be attributed to the price of crude oil. The attempt to diversify reserves at central banks, hedge for inflation, and positioning for an economic recovery are all supportive factors for the price of crude oil.
 - On a relative basis, the price of crude has underperformed the price of bullion since mid-2008. This arguably relates to the more economically-sensitive nature of crude oil and the safe-haven appeal of gold. However, with economic conditions now starting to stabilize and as investors look forward to the eventual economic recovery, a case can be made for this trend to reverse. The ratio of the gold price versus the price of crude oil currently stands at 15x, well above the historical average of 10x.



SUMMARY & RECOMMENDATIONS

- Near-term headwinds: Barring any unexpected major supply disruptions, economic uncertainty and high inventory levels will likely limit near term gains in the price of oil
- Supply issues on the horizon: Over the longer-term, however, a major consideration is that consumption will outpace production growth; there will be greater reliance on unconventional resources
- Emerging markets, shifting paradigm: With increasing wealth and accelerating energy use in high-population countries, oil demand will likely remain concentrated in developing economies
 - 90% of growth spread between Asia, South America, and the Middle East;
 - China and India account for almost half of the increase
 - Total consumption is expected to reach parity with mature economies by 2015



Market Observations

- For the longer-term, fundamentally-focused investors:
 - We continue to favor the fundamentals of oil over natural gas
 - Demand will invariably recover alongside the economic cycle but excess natural gas supply will take a longer time to work through
 - We recommend holding names in large-cap companies that are well-positioned to benefit from the evolving trends in the aforementioned sections; our preferred names include:
 - **Canadian Natural Resources (CNQ)**: 1-Sector Outperform, one-year target \$80
 - **Suncor (SU)**: 2-Sector Perform, one-year target of \$38
 - **Husky Energy (HSE)**: 2-Sector Perform, one-year target \$32

For more information on these names, please contact your ScotiaMcLeod Wealth Advisor.

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Our risk ranking system provides transparency as to the underlying financial and operational risk of each stock covered. Statistical and judgmental factors considered are: historical financial results, share price volatility, liquidity of the shares, credit ratings, analyst forecasts, consistency and predictability of earnings, EPS growth, dividends, cash flow from operations, and strength of balance sheet. The Director of Research and the Supervisory Analyst jointly make the final determination of all risk rankings.

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Medium

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High

High financial and/or operational risk, low predictability of financial results, high stock volatility.

Caution Warranted

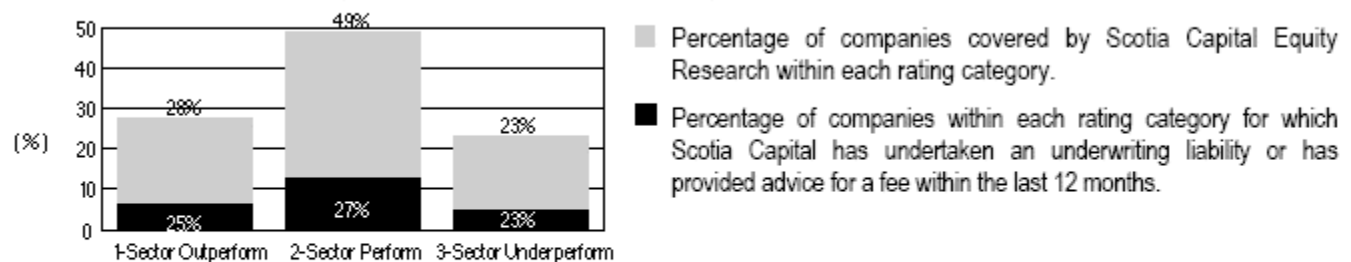
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Venture

Risk and return consistent with Venture Capital. For risk-tolerant investors only.

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