How Wall Street Missed the Biggest Dump in Crude Oil Prices...

since the last big dump which they also missed

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If Wall Street's track record of accurately predicting crude oil prices could be recorded on an archery target one would have a target unsullied by any arrow hits.

US Dollar Time Cycle: background and update

1. Over the past thirty plus years my work in time cycles have focused on two primary cycles

- The 16 year cycle in the US Dollar, 8 years up and 8 years down.
- The 15 year cycle in the commodity sector, a major low every 15 years

2. Basis the US Dollar a cycle high was ideally due into October of 2000
3. The DX made a slightly higher high in July 2001 then keeled over.
4. As we are talking 8 years up and then 8 years down that is an entirely acceptable slippage from the ideal.
5. Calculating 8 years forward from the midpoint of October 2000 and July 2001 indicated February - March 2008 for the next 16 year cycle low in the US Dollar.
6. The DX Index bottomed at 70.698 on 17 March 2008 with a dramatic doji star bottom.
7. There was also massive bullish RSI divergence on the weekly chart and very significant sentiment divergence from only 16% Bulls.
8. Calculating forward 16 years from the 121.02 high of July 2001 and 8 years from the 70.698 low of March 2008 suggests a timing window for the next cycle high into the timing window March 2016 to July 2017
9. The epicenter of that timing window would be **November 2016**
10. Also relevant here are the 4 year and an 8 year Euro-fx cycles.

- The next 8 year cycle low in the Euro-fx is ideally due **October 2016**
- The next four year cycle low is due **July 2016**

Commodity Time Cycle: background and update

1. The usual method of measuring time cycles is low to low. The timing interval between cycle lows are always more precise than between cycle highs. I ascribe this to fear being more powerful than hope.
2. From the year 1165 until 1897 there were a total of thirteen major cycle lows in the commodity sector.
3. The average duration between these lows was 56 years. This is one of the historical components behind the eponymous Kondratieff wave.
4. However the long depression that finally bottomed out in 1897 was a huge shock to the global markets.
5. Since 1897 the 56 year cycle has been abbreviated a 34 year cycle whose next major low is due into 2033
6. However since 1960 evidence has emerged for an even shorter term 15 year cycle in commodities whose next major low is due into **2016**.
7. I have my own theories for why the commodity cycle has been trending toward shorter and shorter durations since 1897 but that is the subject for another report entirely.
8. The bottom line is that the Commodity Cycle, the US Dollar Cycle, and the Euro-fx Cycles have been all aligned for a **2016 - 2017** timing window. And this alignment has been evident for decades.
9. Time cycles do not predict actual events. They predict the severity of events and the bullish or bearish nature of that severity.
10. Without any way to forecast the timing of severity one is at a fatal disadvantage to anyone with a handle on the time cycles.

Crude Oil Report dated 24 Feb 2011

1. A report that I sent to clients on 24 Feb 2011 strongly urged crude oil producers to launch a major hedge program.
2. The Libyan crisis had jacked up crude oil prices and I detailed the case for that rally in crude as a gift to crude oil producers.
3. That report targeted WTI to $47.00 and Brent to $45.00 by 2016
4. My 2014 outlook for crude oil prices was extremely bearish.

From that 24 Feb 2011 report I found no interest in hedging on the part of producers. Crude producers are infamous for getting bullish at major peaks and for then getting hedged into the lows after the next major down trend. Yet what I encountered from March 2011 was much more than the usual reluctance to hedge. What I heard over and over again was how bullish Wall Street was on crude oil prices. And what I heard again and again was that Wall Street was long term bullish on crude oil prices. In this report I will review why Crude Oil prices have been predictable, but not for Wall Street analysts.

US Dollar Price Targets: background and update

1. Using Elliott wave analysis and ratio retracements my minimum 2016 - 2017 cycle high target for the DX Index from the 70.698 low of March 2008 was the 91.90 - 92.90 range.
2. The DX just reached a 92.528 high and is extremely overbought with a historic bullish sentiment extreme.
3. However we are nowhere near 2016. So on a decisive weekly close above 92.900 my next step up targets the 103.00 to 109.00 range.

Euro-fx Price Targets: background and update

1. Using Elliott wave analysis and ratio retracements my minimum 2016 - 2017 cycle low target for the Euro-fx from the 1.6038 high of July 2008 has been the 1.1200 to 1.0800 range.
2. With 1.1728 the most recent low the Euro-fx looks set to reach my minimum downside target well before the time cycle low is due.
3. So on a decisive weekly close below 1.0700 my next step down targets .9900 minimum with .7500 the most bearish case objective.

Commodity Sector Price Targets: background and update

1. Using Elliott wave analysis and ratio retracements, from the cycle high at 238.52 (Bloomberg Commodity Index), my minimum downside target since the 175.68 high of April 2011 has been the 91.00 level.
2. With 99.95 the most recent low this commodity index looks set to reach my minimum downside target well before the time cycle low.
3. On a decisive weekly close below 89.50 my target becomes the 74.65 area for a double bottom against the 74.241 low of Feb 1999

Crude Oil (WTI) Price Targets: background and update

1. WTI prices fell an average of 65.4% over the course of the last two fifteen year commodity cycle declines.
2. The average of all five major dumps in WTI prices since 1985 was a 64.4% loss in value.
3. A 64.4% loss in value from 147.27 at 52.43 has already been decisively exceeded. A 64.4% loss from 114.83 targets the 41.12 level. Ratio analysis still suggests 30.00 is pivotal, longer term support.

Top 5 Reasons Why Wall Street Cannot Forecast Crude Prices

#1. Wall Street has not yet figured out how crude oil is priced

Wall Street investment banks have no clue as to how crude oil is actually priced by the markets. Crude analysts at investment banks spend most of their time trying to explain how the myriad forces of physical supply and demand result in today's price for crude. The unthinking assumption is that, because the markets are rational and efficient, today's price must make sense. Today's price must be the efficient result of all available information. The further implication is that any deviations in supply and demand will likely produce only minor adjustments from today's price. Stability will reign because the markets are rational. I think we can already see how this approach weaves a cocoon of complacency around the analysts that then blinds them to the risks ahead.

So how does the market set the price for crude oil? In a tight market crude oil demand is seen to exceed supply. From this bullish vantage point refiners will not be able to buy that last barrel of crude that they need. As cutting runs is anathema to refiners they will get into a price war over that last barrel of crude before they cut runs. So prices spike higher. When demand is seen to exceed supply the market price of crude blasts higher to reflect that last barrel that refiners cannot get unless they out-bidding all other refiners. In a bull market for crude oil the price of crude reflects that last barrel that only the highest bidder will get. Everyone else will not get enough crude. So prices spike higher.

In a bear market crude supply is seen to exceed demand. From this bearish vantage point refiners will not need that last barrel of crude the market offers them. When you are already running flat out that last barrel of crude can only be stored. It cannot be refined. And who in their right mind would store something that no one wants? So when supply is seen to exceed demand the market price of crude oil reflects that last barrel that no one needs. What is something worth that no one needs, that no one wants, that no one can use? So prices collapse.

Collective Opinions and Emotional Content

The market price is nothing more and nothing less than the collective opinion of where prices should be at that moment. As everyone has an opinion, and opinions are fickle things, as opinions shift the price fluctuates. Market participants vote their opinion with either buy orders or sell orders. And as opinions are not facts there is always an emotional content to these opinions. The more volatile the market, the greater the emotional content. The collective emotional content of the market peaks into major lows and major highs. This is not theory. This is the reality that sentiment indicators reveal. See next page. Into a bull market the price of that last barrel of crude that no one can get is the collective result of highly emotionally charged opinions. And into a bear market the price for that last barrel of crude that no one wants is the collective result of even more highly emotionally charged opinions. Hopes and fears rule such markets. So prices always rally way beyond and way below the price assumptions generated by fundamental analysis.

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WTI monthly chart with sentiment history - log scale

The real systemic risk

I will never forget the day I fist plotted sentiment history on a price chart. It was 1983 and I was working with the #2Oil weekly chart. I was absolutely gobsmacked. I discovered that as prices fall more and more analysts get bearish until, at the final lows of a major down trend, virtually everyone is bearish. I saw that prices advance once everyone is caught short. And I discovered that as prices rise in an up trend more and more analysts get bullish. By the final highs virtually everyone is bullish. And I saw that prices collapse once everyone is caught long. The real systemic risk in the market is that everyone is bullish at the top and bearish by the final lows. This is what drives price trends. This herding behavior is the reality of the markets.

Sentiment from Market Vane
www.marketvane.net

#2. Wall Street analysts treat the market as a mechanical machine

Wall Street does not do Technical Analysis. Wall Street does Fundamental analysis. Fundamental analysis operates in a very Newtonian sphere. In fundamental analysis the forces of supply and demand are seen as mechanical - as if the market were one big machine. Shifts in supply and demand are expected to have a linear and rational effect on prices. News is expected to be quickly and thoroughly discounted in the price. According to the efficient market hypothesis prices can never be cheap or expensive as prices are always efficiently reflecting all available information. So bubbles are impossible. And whatever the emotional content of the market might be, it is irrelevant to the forces of supply and demand that mechanically set prices with minimal human intervention.

To say that this approach to the markets is deeply flawed is to make a very serious understatement. The fundamental analysis approach to the markets is completely and utterly incapable of forecasting peaks and troughs. The emotional content of the markets ensures that shifts in supply and demand have a dramatically non-liner effect on prices. Market prices are driven by herding behavior, not by rational assessments and logic. And news is never quickly and efficiently reflected in the market price because bulls refuse to believe bearish news and bears refuse to believe bullish news. The collective emotional mood of the market drives prices down to dirt cheap, under-valued levels, and then up to wildly expensive, over-valued levels, and then back down again. Speculative bubbles are a common feature of the markets.

The collective mood of the market sets prices

The price of crude oil is never the result of mechanical forces of supply and demand. Prices are set by the highly emotional collective mood of the market. And prices are driven to trend by highly emotional herding behavior. So the true subject of study in the field of economics are not mechanical forces of supply and demand. The true subject of study is human nature and collective behavior. Any system of market analysis that ignores this emotional content of markets is doomed to fail.

Fundamental analysis is an essential tool for traders and hedgers who must deal with physical supplies and physical demand. However fundamental analysis is not capable of accurately forecasting prices. Why? Fundamental analysis has no way to assess the emotional content of the markets. That is the specialty of technical analysis.

As fundamental analysis is incapable of forecasting the extent of price peaks and troughs, there is no way it can possibly succeed at forecasting an average price outlook. All such efforts are exercises in futility. If your market model is critically flawed, and if you do not understand how the market prices a barrel of crude oil, then you have no business making price forecasts. The only solace of these Wall Street analysts is that all of their colleagues at the other investment banks are making equally misguided and inept price forecasts. This would be comical if the forecasts did not do such serious financial damage to those who place trust in Wall Street forecasts and plan accordingly.

#3. Wall Street analysts have no use for crude oil price action

For fundamental analysts like Wall Street investment bankers, crude oil price forecasts begin and end with a scenario that consists entirely and exclusively of supply and demand factors. This approach is extremely complicated and prone to a very high failure rate. The number one problem is that one can never be certain whether the supply and demand factors that one has selected for their forecasting value have already been fully discounted in the price. This critical uncertainty is the number one source of failure for fundamental analysis based price forecasts.

This discounting issue is not a problem for technical analysis because technical analysis studies the price action directly. The founding principle of technical analysis is that all one needs to know about the forces of supply and demand are already reflected in the price action. So the study of the price action is a far more direct study of the forces of supply and demand than is ever possible using the tools of fundamental analysis. This price action centered critical difference between technical and fundamental analysis reveals another element that helps to cripple the ability of Wall Street to forecast crude oil prices.

The study of the price action reveals many levels of pattern repetition. Patterns that repeat themselves in the price action are revealed by chart patterns like the bearish rising wedge. Patterns that repeat themselves in the collective mood of the market are revealed by sentiment indicators like the Market Vane Bullish consensus, and the so-called 'news.'

Patterns that repeat themselves in the velocity of the price action are revealed by momentum indicators like the RSI. And patterns that repeat themselves over time are revealed by time cycle analysis. Truth be told, time cycle analysis was my number one tip-off that there were big problems ahead for crude oil bulls. As fundamental analysts never pay any attention to the price action they will never uncover time cycles.

At this point I think a tangent to some auto-biographical details may be useful in understanding my time cycle work. It seems that I am a bit of an odd ball. Some of my earliest memories relate to a fascination with cyclical behavior. When I was about four years old my grandparents gave me what is known as an 'Irish Mail' pedal car. I remember turning it upside down to find out how a back and forth lever motion became forward motion. I discovered that via a geared cog the 'back and forth' became forward motion. It fascinated me that 'back and forth' became cyclical, and cycical became forward motion.

'Irish Mail' Pedal Car

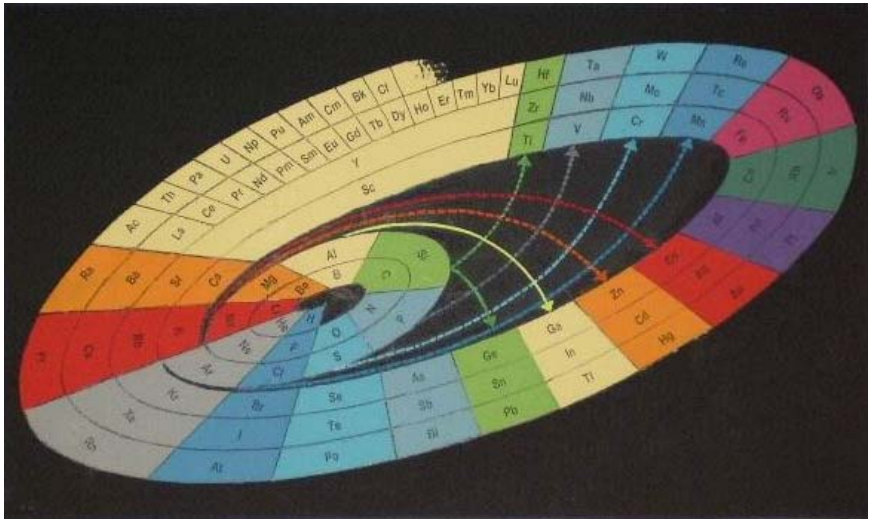
Cycles

My parents saved all the art I brought home from school for kindergarten through 2nd grade. We found this stash during a major house cleaning when I was in high school. Every single drawing was of a wheel with spokes. Some were like simple bicycle wheels. Others were wheels within wheels. Later in life I found they were all variations of the wheel of dharma symbol on the flag of India. At the time my parents wondered whether there was actually something wrong with me. They remember asking my kindergarten teacher during PTA about all these wheels.

In middle school I remember being disappointed that the Pearl River public library had no books on historical cycles. I remember my father asking me why I wanted books like that. My answer was that I just did.

In the first day of chemistry class we broke into small groups to observe and take notes on a burning candle. I found a thermal cycle within the melted pool of wax around the burning wick. The teacher thought I was nuts but I showed him it was really there. That same day the teacher introduced the periodic table. As he was explaining to the class how the table was structured it immediately struck me that the table was cyclical in nature, that the distribution of the qualities of the elements was cyclical. I asked my teacher about this and he did not really have much of a comment. But in graduate school I found that cyclical graphs of the periodic table dated back to 1862. After all, periodic means recurring and recurring means cyclical. To my eye it seemed self-evident at first glance.

Periodic Table of the Elements - Edgar Longman - 1951



In my 12th grade high school English class we read 'Passage to India' by E.M. Forester. My teacher was an older British lady. I remember only one particular class in great detail. She filled up a double blackboard with her theories of the cyclical nature of time. She introduced the Vedic concept of Yugas and of cycles within cycles. I remember every detail of this class like it was yesterday. My only other memory of a high school class was the just noted first day of chemistry in 11th grade.

I could go on but I think this is already enough of a tangent to make my point. I have always had a thing about cycles. So I spent my first month as an analyst at Amerex Petroleum researching time cycles in crude oil prices.

#4. Wall Street analysts begin by explaining today

For Wall Street, in order to forecast the future the present must first make sense. In order to use supply and demand factors to predict future prices those same supply and demand factors must first fully explain today's prices. Because these investment bankers feel compelled to present the markets as efficient and rational, they are forced to completely explain why prices are where they are today. When you begin your analysis by explaining that everything today makes perfect sense, you are unconsciously giving too much weight to the forces of stability. When you have today all figured out you are inadvertently giving way too much probability to the case that today's prices will persist into tomorrow and beyond. You unwittingly come to assume that steadiness will prevail over volatility. And when this is how you analyze the markets your forecasts risk becoming mere assertions that present conditions and current prices will invariably persist into the future.

Wall Street oil analysts might have been able to get away with this approach in the 1950's, but their methods have been an unmitigated disaster for the past fifty-five years. And the Wall Street track record on forecasting year ahead average crude oil prices just since January 2014 is a perfect microcosm for their longer term problems. I became more aware of this issue in January 2014 when various subscribers started e-mailing me a Reuters page that listed Wall Street analyst changes in their forecasted crude price. The list was a who's who of investment banks and their forecasts ranged from the clueless to the comical.

Asserting stability in volatile times

The year 2014 began with Brent crude opening at 111.00 and Wall Street analysts targeting a 2015 average crude price in the 115.00 to 120.00 range. My 2014 outlook targeted a world class collapse in crude oil prices. I had cited the case for $45.00 by 2016 in my 2014 year ahead outlook.

By October 2014 Brent had fallen to $90.00 and there was a predictable wave of Wall Street analyst crude price downgrades. Their new average price forecast for the year ahead ranged from $100.00 to $90.00 per barrel. By mid November 2014 Brent was pushing $80.00 per barrel. There was another predictable wave of Wall Street analyst crude downgrades. Their new average price forecasts for the year ahead ranged from $90.00 to $80.00 per barrel. By end November 2014 Brent was pushing $70.00 per barrel. There was yet another predictable wave of Wall Street analyst downgrades. Their new average price forecasts for the year ahead ranged from $80.00 to $70.00 per barrel. And on and on. Most recently on 12 January 2015 with Brent trading $49.00 Goldman Sachs, in a bold move, cut their three month forecast for Brent from $80.00 to $42.00

Sorry, but I cannot help but find all this rather comical. Wall Street forecasts of year ahead prices have continued on as mere assertions that current prices will persists into the future, even in the midst of a world class collapse in prices. Any objective observer would be forced to quickly conclude that Wall Street cannot forecast crude oil prices. They can only insist that today's prices will persist into the foreseeable future.

#5. Wall Street analysts suffer from severe herding behavior

Let us begin this topic by taking another look at the page 5 chart of Crude Oil sentiment. These sentiment numbers are the percentage bullish among over a hundred Wall Street analysts. These analysts vote daily on whether they are bulls or bears on the various markets. It is rather obvious from this page 5 chart and others like it that these analysts are all bullish into the major peaks and all bearish into the major lows. And it is not only in crude oil that Wall Street analysts have such a consistent track record of getting it wrong. Over the last fifty plus years the Market Vane Bullish Consensus service has proven itself as an equally invaluable contrarian indicator for the softs, grains and livestock, the metals, currencies, interest rates, and for diesel, gasoline, and natural gas. See next page.

These investment bank analysts all have the same models and methods. They all read the same headlines. They all read each others fundamental reports. They all start with the same data. And they all follow each others bullish and bearish trend outlooks like sheep. They herd like cattle. People are fond of accusing investors of herding behavior, but that herding behavior begins with Wall Street analysts. And really for them there is safety in numbers. If one of them is wrong then at least all of them are equally wrong. Their modus operandi seems to be that it is too risky to go out on a limb with a forecast that diverges from everyone else on Wall Street. The perceived risk of a divergent outlook is evidently that everyone else could be right and they would be wrong.

Mechanical Facts versus Market Wisdom

One of the first things that I learned in my analyst career is that one can excel at having a good grasp of the physical forces of supply and demand but be inept at actually trading the petroleum markets. And this gap between expertise in physical forces and expertise in market forces is not some recent result of our modern age of specialization. As the page 12 chart attests, one can be an absolute genius at predicting physical forces and yet completely useless and even dangerous trading market forces. There is probably no better instance of this truth that the experience of Sir Issac Newton with the South Sea bubble. See page 12.

Newton was a towering genius in optics, mathematics, astronomy, and physics. He discovered and mathematically explained the nature of light, gravity, and motion. He invented the field of calculus, the binomial theorem, and what later became infinitesimal calculus. He solved many current problems in analytical geometry, cubic plane curves, and coordinate geometry. During his tenure as Mater of the Mint he reformed the British currency and moved it from a silver standard to a gold standard.

However he went bankrupt trading the South Sea bubble. And it may be apocryphal but he is alleged to have said “I can calculate the movement of stars but not the madness of men.” Whether we are geniuses, really smart, or just average, at some point in our lives we must all figure out what we most enjoy doing, what we are really good at, and stick to that. Feigning the ability to forecast crude prices does no one any good.

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Long Bond - Monthly Chart

How Wall Street Misses
14 Jan 2015

Long Bond and Wall Street Sentiment

So Wall Street analysts are terrible at forecasting crude oil prices. It is not their field of expertise. As Wall Street analysts are supposed financial experts they should excel at forecasting things like bond prices. Not.
Same dismal track record as for crude oil.

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South Sea Company Stock Price, December 1718 to December 1722, log scale