United-ICAP
the technical advisory service
walter j. zimmermann jr. walterz@united-icap.com

Crude Oil Price Risks

Global crude glut, central bank currency price war, and Euro zone contagion

Walter J. Zimmermann Jr.
United-ICAP

18 Jan 2015

Refresh

In a report dated 13 November 2014 I targeted the following:

- Brent to $44.20
- WTI to the $43.00 to $41.00 range
- RBOB to $1.2040
- ULSD to $1.2875
- GasOil to $394.00

These targets were calculated by averaging the percentage loss in all the big dumps in these various markets, and then applying that percent loss to the recent highs in these various markets.

Update

As of last week the following lows were reached.

- Brent to $45.19
- WTI to $44.20
- RBOB to $1.2265
- ULSD to $1.5980
- GasOil to $453.75

Bearish Sentiment Extremes

The following lows were reached in the Market Vane Bullish Consensus

- Crude to 9% Bulls
- RBOB to 10% Bulls
- ULSD to 9% Bulls

Bearish Momentum Extremes

In the course of this decline the weekly RSI reached new all time lows

- Brent to 7.65%
- WTI to 9.30%
- RBOB to 12.27%
- ULSD to 9.01%
- GasOil to 7.03%

Welles Wilder called this a ***Relative*** Strength Index for a reason. It does not matter how high the RSI rallies or how low it falls. This index gives buy and sell signals from divergence. In a down trend this means the point where the price fall to a new low but the RSI fails to make a new low. And in major declines like this I long ago learned to ignore the daily RSI and track the weekly RSI. The point here is that, until last week, there were no bullish RSI divergence in any of these markets. There is now some bullish RSI divergence on the weekly in some of these markets.

- Brent - Tiny, just barely bullish divergence
- WTI - Ditto
- RBOB - Bullish RSI divergence
- ULSD - No RSI divergence
- GasOil - Definite and dramatic bullish RSI divergence

If these were more normal times bullish RSI divergence on a weekly chart, however marginal and from such an extremely oversold market, would be a ‘no brainer’ buy signal. However this is not a normal market. There is one very big and very significant extenuating circumstance.

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The Crude Price History

As per my 13 Nov 2014 Petro Complex report there have been five world class nose dives in the petroleum complex since 1985.

1. From 1985 to 1986 the Saudis took a brief vacation from the swing producer role as Sheik Yamani taught OPEC production cheaters a big lesson on the repercussions of cheating.
2. From 1990 into early 1994 crude oil prices first rallied on Iraq's invasion of Kuwait and then plunged at the end of that war and the onset of the highest OPEC production levels in a decade.
3. From 1996 to 1998 crude oil prices swung from discounting the risk of renewed problems in Iraq to the Asian contagion, a swing from the fear of scarcity to the reality of a glut. Again.
4. From 2000 to 2001 the price of crude oil swung from discounting strong global demand to the recession induced by the bursting of the Federal Reserve inflated Dot-com bubble.
5. The period 2007 to 2009 marked the on-going collapse phase of several bubbles that has been inflated by the Federal Reserve. The housing bubble burst, and that burst the credit bubble, and that burst the stock market bubble, and that burst the commodity bubble.

Of these five nose dives the most largest collapse in crude oil by far was from 2008 to 2009. The number one reason it was the largest collapse was because it was preceded by the largest advance. And for this we can thank the Federal Reserve. You cannot inject trillions of dollars into a financial system in an effort to re-ignite inflation and expect that there will be no consequences.

The Deflation Risk

Before the Federal initiated the largest manipulation of the financial markets in recorded history, crude oil prices were the result of a messy but self-regulating dynamic. Prices would rise with the fear of scarcity, then increased crude production would first calm those scarcity fears, but then replace them with the fear of a crude glut. Then decreased crude production would first calm those glut fears but then replace them with fears of scarcity. And that is how it went from the 1960s until the response of the Federal Reserve to the bursting of Dot-com bubble.

From the bursting of the Dot-Com bubble the Fed became increasingly frightened of the risk of deflation. So over the following years the Fed adopted increasingly desperate measures to fight deflation by attempting to re-ignite inflation. One of the unforeseen consequences of reckless Fed manipulation was the inflation of a titanic commodity bubble.

One of the great lessons of financial history is the deflation risk hidden within a commodity bubble. As commodity prices rise producers increase production. And the more drastically prices spike higher, the more dramatically the ensuing increases in production. Once the speculative bubble bursts prices quickly collapse. However it takes years from the decision to ramp up crude oil production until the new barrels come on-line. So as prices continue to collapse production continues to rise. This is the deflation risk of a burst speculative bubble. And deflation is the significant, extenuating circumstance that no crude market has ever had to face before now. But it gets worse.

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Global Currency Wars and Euro-zone Contagion

The currency war that continues to propel the US Dollar higher is the global blow-back from earlier attempts on the part of the Federal Reserve to drive the US Dollar lower to re-ignite inflation. The most recent battle in this currency war was the one that the SNB lost to the ECB last week. But there are many more battles yet to come. And two of them are set to arrive into the end of this week. The first of these two battles will erupt from Thursday if the ECB launches its own Quantitative Easing program. And the second of these two battles will erupt from Friday if Syriza wins the Greek election.

There are two big risks for crude oil prices in these coming battles. The crude oil market has been attempting to discount a million barrel per day of excess crude oil production. That has been the focus of the markets attempt at price discovery. And if that were the only bearish factor impacting crude oil prices then the recent price collapse (basis WTI) from 107.73 to 44.20 may well have been sufficient to discount the glut.

However a glut of crude production is not the only threat facing crude oil prices. There is also the risk that the currency wars will drive the Euro-fx to parity with the Greenback and even beyond. And then there is the risk that contagion from Greece will sweep across southern Europe. The remainder of this report will use price charts to highlight these additional risks for crude oil prices. However before we move onto these charts there is yet one last point we need to make about price oil prices for this coming week.

Potential Doji Star Bottom

Last weeks price action resulted in potential doji star bottom patterns on the weekly candlesticks of the following markets:

- Brent
- WTI
- RBOB
- GasOil - Due to the timing of a spot contract roll over that involved a spec change, GasOil has a bullish engulfing pattern for its weekly candlestick but a big, potential doji star bottom on its monthly candlestick.

As we detail in our tutorial on candlesticks, a doji star is a three candlestick pattern. It takes three weeks, three weekly candlesticks, to get a confirmed doji star bottom on a weekly chart. The first candlestick is a red bodies, sharp drop. The second candlestick is the doji pattern. The third and confirming candlestick must be a green bodies powerful rally. No confirming rally, no doji star bottom.

And as we just noted the week ahead is a huge week. So what do crude bulls really need to get confirmed doji star bottom patterns on the weekly chart? If the ECB launches a QE then crude bulls need that QE to be mild and unimpressive. And crude bulls really need Syriza to lose the Greek election. If this coming week can unfold this way then short covering in the petro complex has a shot of producing confirmed doji star bottoms.

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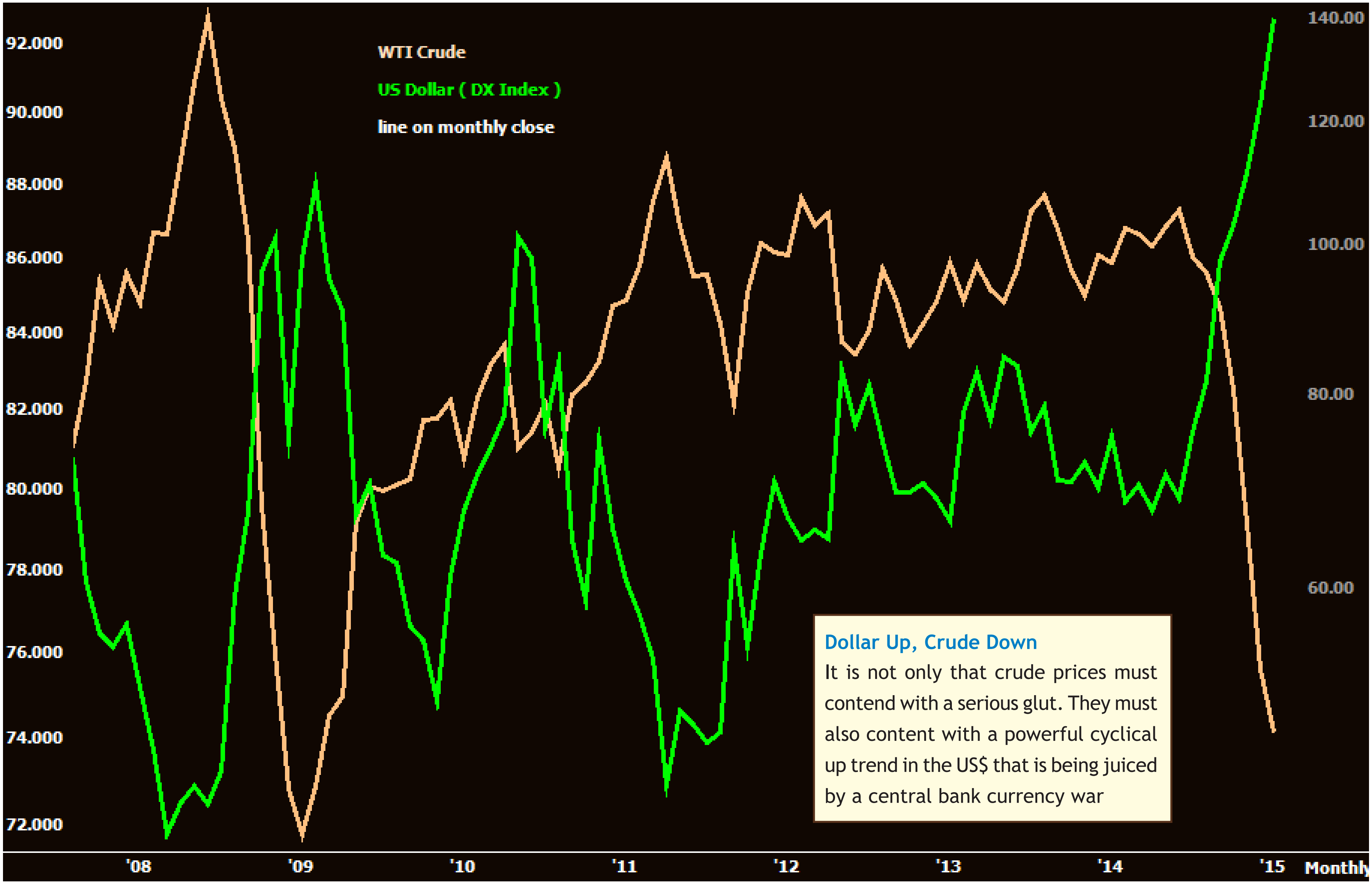

Dollar Up, Crude Down

It is not only that crude prices must contend with a serious glut. They must also content with a powerful cyclical up trend in the US$ that is being juiced by a central bank currency war

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DX Index (US Dollar) - monthly

Big Week Ahead for the US Dollar

If the DX Index fails to sustain a reversal lower from here then the implied target is parity with the Euro-fx and beyond. And as we saw on the previous page, it will be extremely difficult to crude to claw its way higher is the DX powers higher.

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Petro Complex
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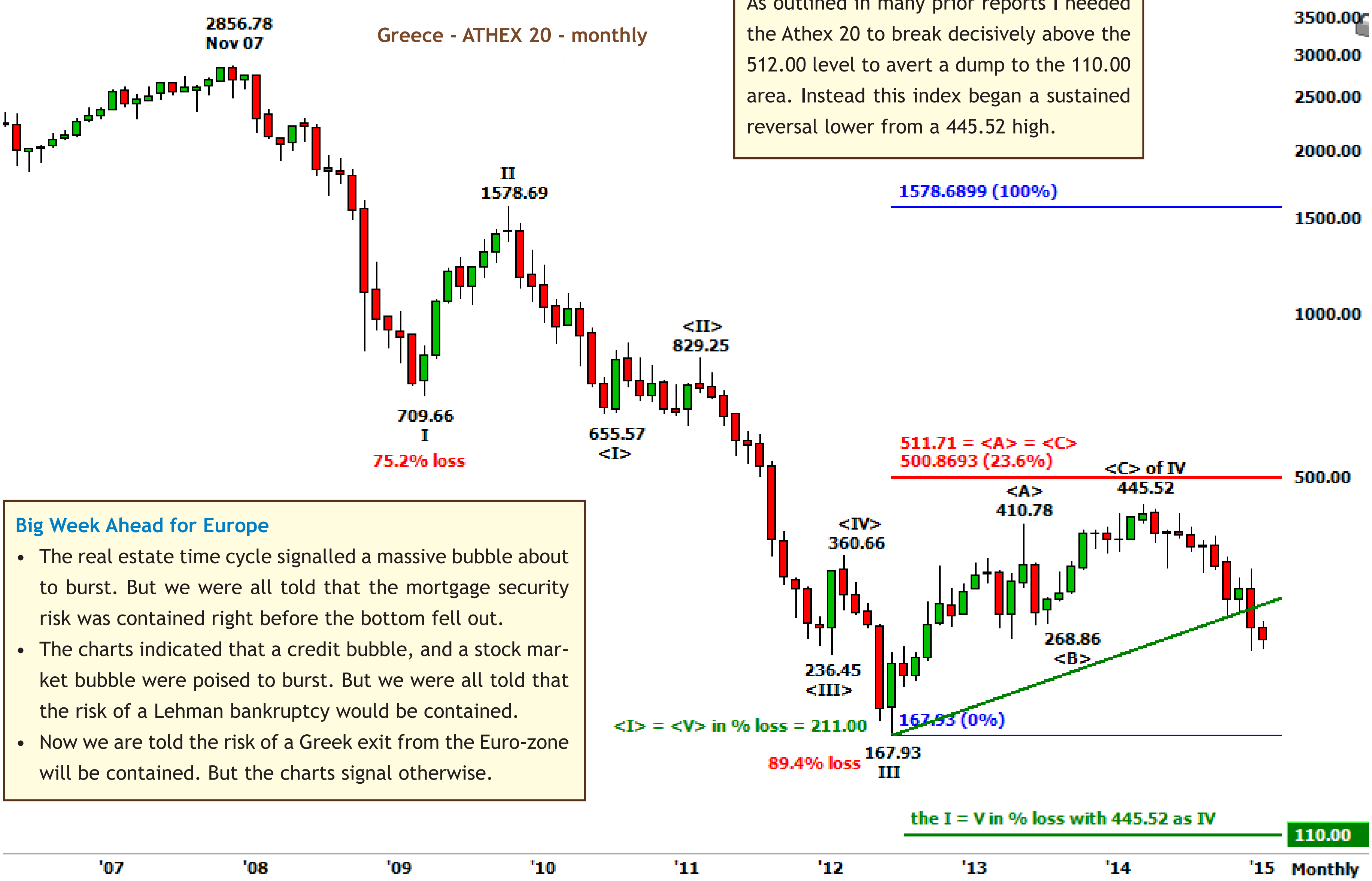
Break down

As outlined in many prior reports I needed the Athex 20 to break decisively above the 512.00 level to avert a dump to the 110.00 area. Instead this index began a sustained reversal lower from a 445.52 high.



Big Week Ahead for Europe

- The real estate time cycle signalled a massive bubble about to burst. But we were all told that the mortgage security risk was contained right before the bottom fell out.
- The charts indicated that a credit bubble, and a stock market bubble were poised to burst. But we were all told that the risk of a Lehman bankruptcy would be contained.
- Now we are told the risk of a Greek exit from the Euro-zone will be contained. But the charts signal otherwise.

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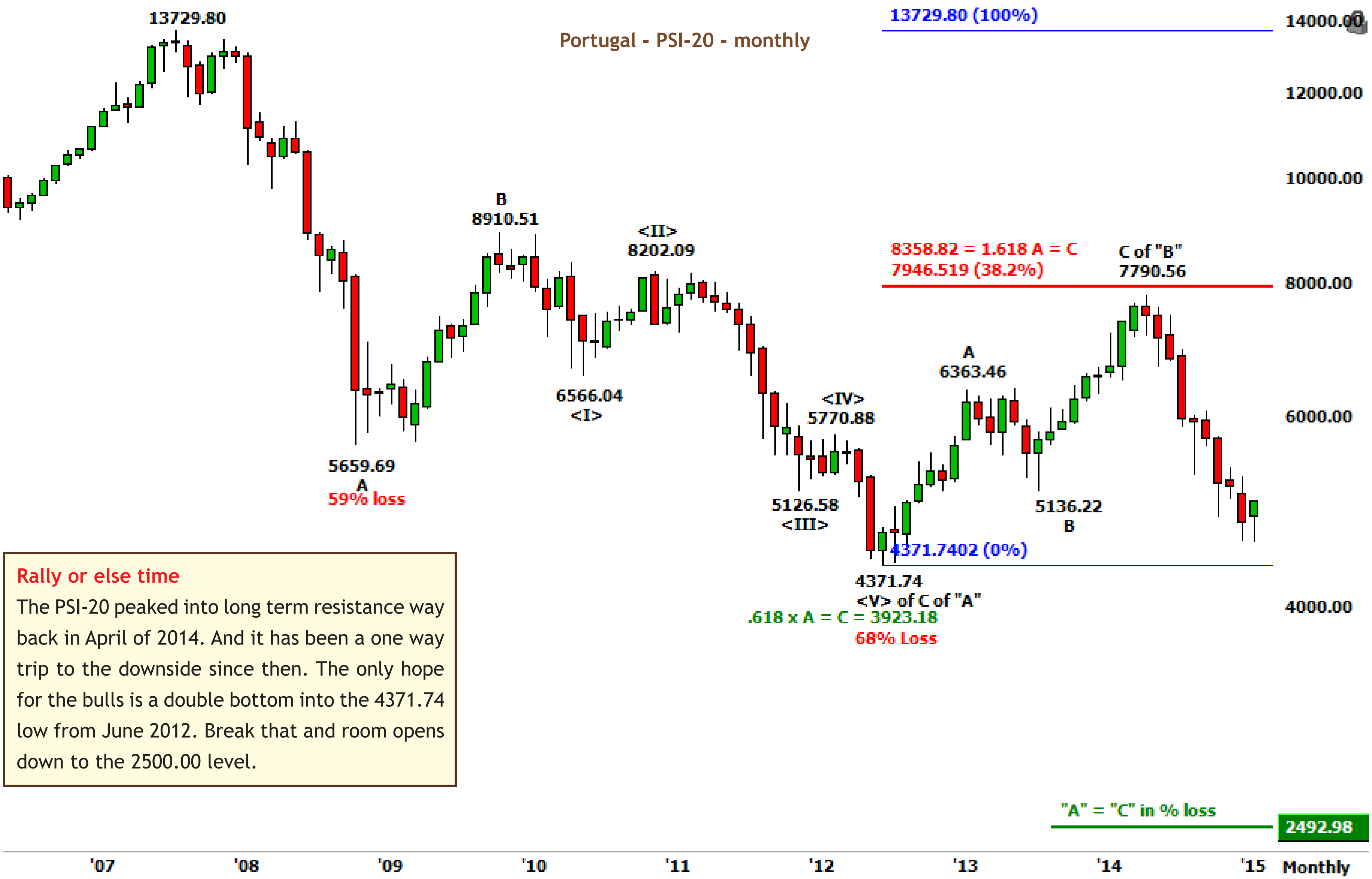

Rally or else time

The PSI-20 peaked into long term resistance way back in April of 2014. And it has been a one way trip to the downside since then. The only hope for the bulls is a double bottom into the 4371.74 low from June 2012. Break that and room opens down to the 2500.00 level.

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