A Turn in Crude Oil

By Dr Alexander Elder

In 2008 oil prices reached $200 per barrel. After coming down from those highs, for years oil stayed in a trading range between $110 and $85 per barrel. This year oil traded at below $50 per barrel. Why?

The latest changes are driven by a revolution in the methods of extracting oil, which are hugely increasing its supply.

Organic fuels (coal, oil, gas) are produced by "cooking" organic remains deep underground for millions of years. The closer to the center of the Earth, the hotter it gets: temperatures increase by 25 degrees Celsius for every kilometer of drilling down. Organic remains cooked at lower temperatures produce coal, at medium temperatures oil, and at very high levels gas.

Because of that, oil is produced in a relatively narrow subterranean level (which is occasionally moved by seismic shifts). That level has been so extensively explored in recent decades that the number of new discoveries has diminished – while the demand for oil kept going up. The resulting discrepancy between supply and demand trends gave rise to the "Peak Oil Theory" which stated that as demand grew faster than supply oil prices could go only way – up. A decade ago, I referred to Peak Oil Theory in some of my presentations. What has changed?

It used to be that to pump up oil from the ground you had to find huge underground lakes of oil, which could form only in specific geological structures: essentially huge rock caves. No cave – no lake – nothing to pump.

Most oil exists not in caves but in soft structures, permeating them like a sponge. A new technology called hydraulic fracturing (fracking) allows companies to squeeze those sponges and pump oil out of them. This vastly increases the available supplies. Peak Oil theory is out the window. With fracking, the US is on its way to become the world's largest oil producer, outstripping Saudi Arabia.

In the 2nd half of 2014, as the world demand for oil slightly softened, Saudis decided to drive frackers out of business by continuing to pump oil at a steady rate despite lower demand. Saudis' production costs are around $12-14/bbl, while for frackers those costs are $40-50/bbl. That's what drove oil from above $100/bbl to below $50/bbl.

What's next?

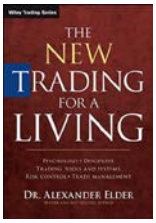
I think that American businessmen and inventors, in the environment of free enterprise, will find how to reduce costs and continue to pump at a profit. This reminds me of a quote from J.P. Morgan, a great late American financier: "A bear on America will die broke."

In a geopolitical sense, cheaper oil is good for democracy. It amounts to a huge tax cut. Low oil prices hurt countries that rely on oil for the bulk of their income, such as Venezuela, Russia, and some Gulf states. Remember, the Soviet Union fell apart when oil dropped to $5/bbl.

Looking at a monthly chart of crude, covering 9 years, we see that oil is trading at levels not seen in a decade. While the media is full of forecasts of $40, $30 and even $15 per barrel of oil, bullish technical signals are emerging near the right edge of this long-term chart. The color of the Impulse system* has changed from red to blue this month, permitting buying. The Force Index* (in the lowest pane) began to rise towards its lower channel line. You can see that earlier such returns into the channel gave good buy signals.

Monthly charts are not for precision timing – for that we have weekly and daily charts - but it does suggest that a rally towards the previous support line in the upper 70s is more likely than another decline.

I hope this helps you in planning oil-related trades.



*The Impulse system and the Force Index are explained in Dr Elder's book *The New Trading for a Living.* My review of the book is now on the Book Reviews page on the Free Resources menu on the free website www.bwts.com.au I do not sell the book, but it may be purchased directly from Dr Elder at www.elder.com. Ask him to sign the book for you.

