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Technical Analysis: Crude Oil

Price breaks $48 support? Get ready to buy closer to $35-$40.

| TECHNICAL ANALYSIS | Crude Oil| Technical Note

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WTIC breaks through $48 support as we expected. What to buy if price goes into the $35-$40 range?

Since our recent report *Technical Analysis: Crude Oil, Is Oil bottoming? Insiders seem to think so*, dated 12 Jan 2015, as well as our 1Q 2015 market outlook seminar held on 10th Jan 2015, we mentioned that that the "bottom was close, but could fall further." This was based on the lack of strong supports, lack of momentum upturn as well as the hedging behavior of oil commercials. Additionally, we mentioned that the "obvious" technical long term trendline support at $48 was "**not** a true support", compared to the far stronger zone between $35-$40. Since then, the WTI price has broken down through the $48 support to close yesterday at $46.11 with lows at $44.20. The closer we get to this zone, the better the buying opportunity.

CONCLUSION: Buy USO to play crude prices

To get ready for a potential bottom in WTI prices, we did a comparison of correlations studies on various investment ETFs (futures vs equity based) to WTI price. We find that oil contract futures based ETFs have much better beta (sensitivity in same direction) as well as higher R^2 (correlation is higher) but have negative alpha (penalties to carry). For the shorter term, less than 2 years, we find these ETFs the best proxies to play WTI prices. Of which, we recommend the USO as it is the most popular, the most liquid, and has a smaller bid-ask spread than the other futures based ETFs.

However, for longer term investors who has a multi-year horizon, the equities index ETFs may be more favorable because although their R^2 are generally less than 40%, which implies that 60% of the reason of its price movement is likely *not* WTI price related, they have positive carries (positive alphas imply you are compensated for holding them vs if you were investing in WTI spot instead). Of the few ETFs listed, the XLE has the best alpha of 16% with comparable beta and R^2 compared with the rest.

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			ALPHA	BETA	R^2	
USO	Futures	1x leverage	-23%	82%	86%	United States Oil Fund LP's objective is to track changes in percentage terms of the price of the WTI Crude Oil futures contract on the NYMEX.
USL	Futures	1x leverage	-10%	63%	69%	United States 12 Month Oil Fund LP's objective is to track in percentage terms of the price of an average of the next 12 month's WTI Crude Oil futures contracts on the NYMEX.
OIL	Futures	1x leverage	-26%	85%	85%	iPath S&P GSCI Crude Oil Total Return Index ETN provides investors with a cash payment at the scheduled maturity or early redemption, based on the performance of its underlying index, the S&P GSCI Crude Oil Total Return Index.
UCO	Futures	2x leverage	-50%	153%	80%	ProShares Ultra Bloomberg Crude Oil ETF will seek daily investment results that correspond to twice (200%) the daily performance of its corresponding benchmark, the Bloomberg Crude Oil
IEO	Equities	Basket	15%	56%	35%	iShares U.S. Oil & Gas Exploration & Production ETF tracks the Dow Jones US Select Oil Exploration & Production Index. The ETF holds U.S. energy stocks of all cap sizes. The ETF uses a market capitalization weighting methodology.
XOP	Equities	Basket	15%	59%	35%	SPDR S&P Oil & Gas Exploration & Production ETF's objective is to replicate as closely as possible the S&P Oil & Gas Exploration & Production Select Industry Index, an equal-weighted index.
IXC	Equities	Basket	9%	43%	34%	iShares Global Energy ETF's objective is to seek investment results that correspond to the performance of the S&P Global Energy Index.
IGE	Equities	Basket	12%	49%	37%	iShares North American Natural Resources ETF's objective seeks investment results that correspond to the performance of the S&P North American Natural Resources Sector Index.
XLE	Equities	Basket	16%	47%	36%	Energy Select Sector SPDR Fund tracks the performance of the Energy Select Sector Index. The ETF holds large-cap U.S. energy stocks. It invests in companies that develop & produce crude oil & natural gas, provide drilling and other energy related services. The holdings are weighted by
XOM	Exxon Mobil	Single Stock	12%	28%	20%	Exxon Mobil Corporation operates petroleum and petrochemicals businesses on a worldwide basis. The Company's operations include exploration and production of oil and gas, electric power generation, and coal and minerals operations.

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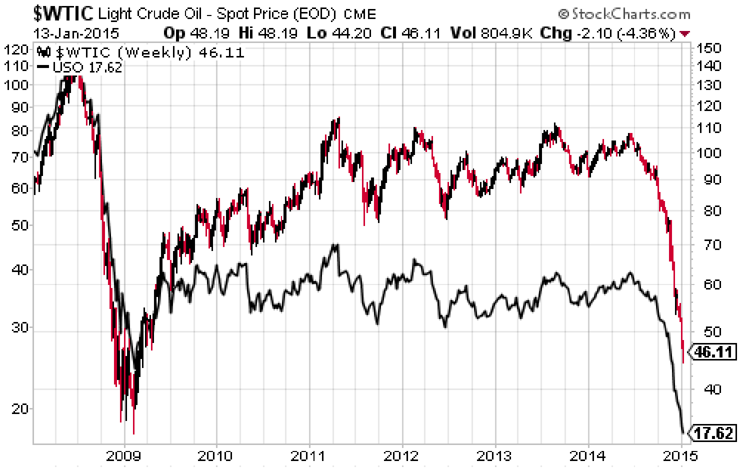


Chart of WTI prices vs USO

Recap of why the bottom is close, but may fall a little further

Reasons why the bottom is close

1. **Insider CEO open market purchases for XLE are close to decade high:** CEO buy vs sell ratio close for the Energy Select Sector SPDR (XLE) are close to decade highs at 3.3 vs 3.7 (Jul 08). High levels of such purchases tend to coincide to intermediate bottoms in the price of energy stocks, as insiders are likely to believe that crude prices are very cheap and expect an improvement going forward.

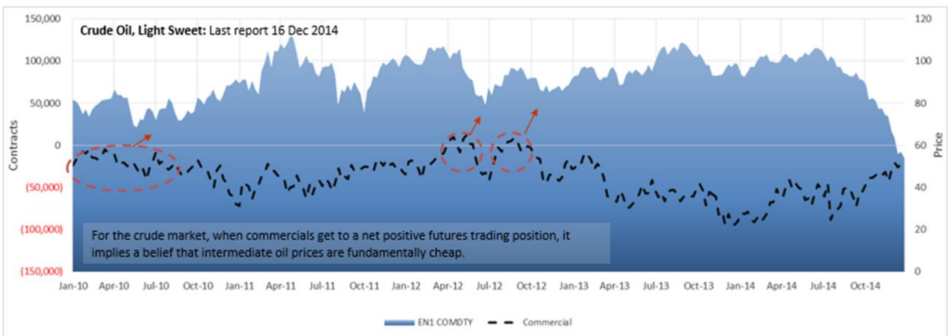
2. **XLE to WTIC ratio is also at decade high.** Referring to the 2nd chart section on the following page, relatively high peaks in the ratio also tend to correspond to intermediate or long term bottoms in crude oil prices. High relative price performance show that the XLE is not being sold off at the same rate as crude itself, increasing the probability that these depressed prices have a larger speculative component rather than fundamental than the *market* is discounting.

Source: Gurufocus

Reasons why oil may fall a little lower

3. **Uptrend line is not a "true" support.** Although the price is sitting on the technical decade long uptrend line around $48 and may afford some temporary resistance. Uptrend lines tend to be subjective and are more of psychological supports, not "true" supports. Strong supports usually include zones of buy/sell congestions, levels of major resistance/support breaks, key retracement zones, or emotional buying/selling points. We believe a far stronger support is in the $35-$40 zone.

4. **Oil Commercials futures hedging is not as net long as it could be.** Intermediate bottoms in crude price tend to occur shortly after commercials have a net zero or net position hedging position. With such a steep drop in crude, we would expect hedging levels to be more positive. We believe should oil price drop further, the likelihood for commercials to reach that hedging level is good.



Source: Bloomberg

Based on the Commitment of Trader's report, "commercials" are defined as entity that is commercially engaged in business activities hedged by the use of the futures or option markets. Commercial positions are usually more long term in nature and less speculative.

5. **Price chart itself shows no consolidation, reversal pattern, and monthly momentum has not ticked up yet.** The downtrend is still intact for now, and the MACD (black line) has shown no sign of ticking up yet.

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Conclusion

Early sophisticated investor strength is high at present prices, indicating that fundamentally insiders are considering oil to be cheap at these prices. However, with no improvement in momentum, a still clear downtrend, and commercials not as "bullish" as we like, it is possible for price to break the uptrend line support at 48, but we see strong support at the $35-$40 region and would not be surprised to see a strong buy reaction at those prices. However, we note that not many had expected oil price to go this low last year, and in a sense we are in "no mans" land. This scenario lends itself well to technical analysis, especially if it goes beyond trendlines and momentum. Be vigilant for sharp reversals patterns that may occur, especially if OPEC decides to cut production.

Intermediate upside technical target, once the bottom is in, is at $70-$80 zone which is strong resistance

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