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Technical Analysis and the Oil Price "X" Factor

Technical Analysis involves the scrutiny of the price data for a commodity and doesn't take into account the physical components which affect that price. Having said that, it relies on one of the main fundamental drivers of commodity prices, which is the supply/demand relationship, to gauge the mood of the market, as to whether it is bullish or bearish. This relationship develops patterns and trends in price which have been proven over time to be guides to the likely future direction.

The further manipulation of the data provides indicators which help determine the conditions affecting the price and aids the fine tuning of the analysis. For our purposes here we will concentrate on the basic analysis and most particularly on pattern development.

Being able to identify patterns as they form on the charts is one of the essential skills that chart followers develop as part of their Technical Analysis regime. It is one of the principles of charting that patterns form as a result of the struggle in the supply-demand relationship, relying on the precept that when a trade is made in the market place that it represents all the known knowledge at that time and is what the stock is valued at by the market, under those conditions.

It follows that as the buyers and sellers (demand and supply) absorb the market knowledge, their actions and reactions tend to occur to similar information in the same fashion flowing through into the way the trades are made. Hence, certain patterns tend to form in the same way over time, perhaps not identically but close enough to be easily recognizable. One of these is the Diamond pattern.

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The word “Diamond” conjures up the exotic and special and the pattern certainly holds a special place in charting as the formation can either reverse a major trend or continue it. It is a result of market uncertainty and the price fluctuations are initially held within diverging guidelines which swing to converging in the second half of the phase.

Often described as a mixed breed, the diamond can combine the qualities of some of the other patterns within the TA tool box and the diamond is often thought to amalgamate the qualities of a head and shoulders pattern with those of the triangle in the one formation. Alternatively it can bring together two triangles back to back, appearing with the first triangle inverted and the second progressing normally. The outcome of the pattern is difficult to determine during its development, until one of its guidelines is broken, and then the minimum resultant move away from the pattern will be equivalent to the height of the pattern in the direction of the pattern break (using logarithmic scale).

Along with its volatile style the commodity will experience irregular market participation (volume), but can lead to explosive outcomes.
On the chart for West Texas International Crude, a diamond has been forming since 2005. The price for oil built a strong base over a 30 year period between 1974 and 2004.
During that time the price swung from $10 to $40, until mid 2004 when the price finally broke away, launching itself on a skyrocket rise with a minimum projection to $100 but with the advance likely to take the price towards $160 and possibly beyond.

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As momentum accelerated the price raced higher but at $145 in July 2008, exhaustion set in and the price was checked over a three week period. The divergence in momentum produced a top which on the fall beneath $125 in August of that year, triggered a dramatic sell-off which saw the price collapse back to base support at $30 within a few months. The combination of support in the area initiated a reversal which followed through with a recovery during 2009 slowing down to consolidate through most of 2010.

When observed on the larger time scale, the entire action form mid 2005 has formed a dynamic diamond pattern. The 2008 peak at $145 and trough at $31 have provided the pivots for the phase with the subsequent oscillations between$60 and $100 forming the final stages of the phase. Unfortunately, as stated earlier, the pattern represents market uncertainty and the outcome of the phase is difficult to determine during its development, but once one of the guidelines is significantly broken there will be an equally dynamic outcome for world oil prices and continues to be my commodity “X” factor for 2011.

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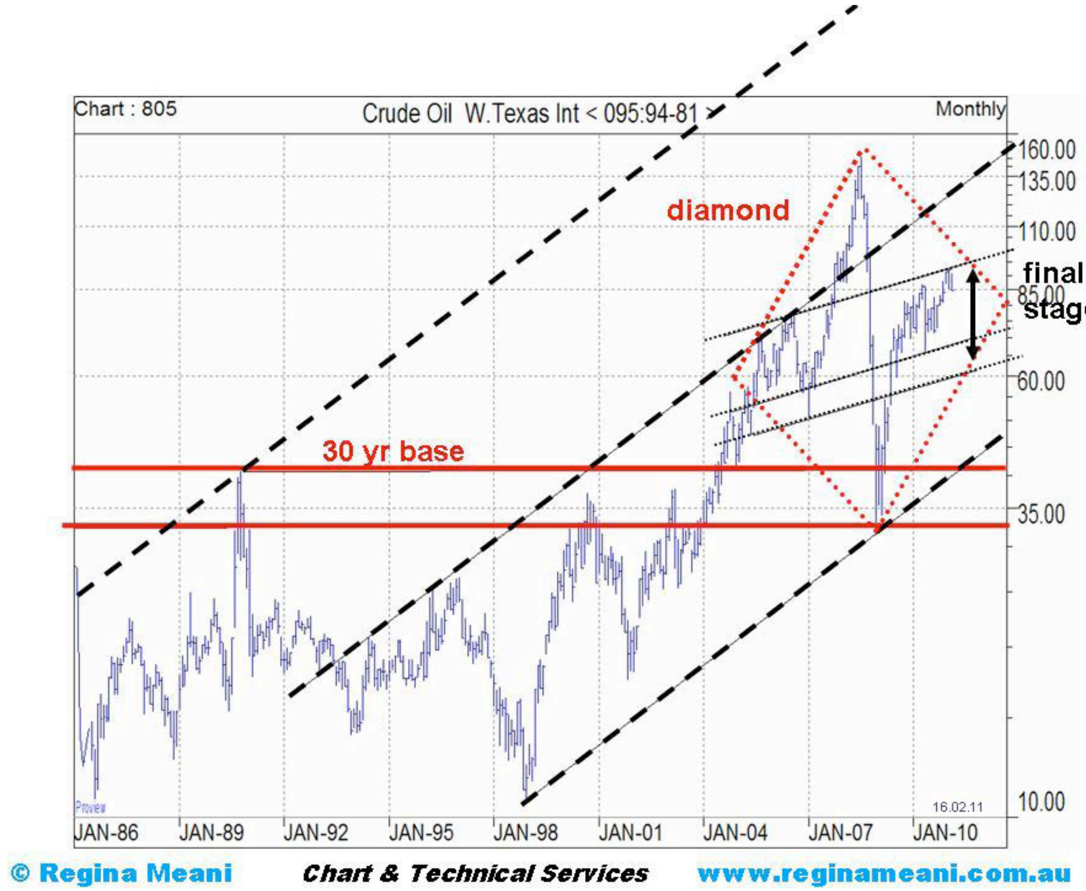

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About the Author:

Regina Meani has over 32 years in the stock market as chart & technical analyst, and associate director for Deutsche Bank, and for Huntley's before freelancing. She has lectured for FINSIA, Sydney University and the ASX and written 'Charting- An Australian Investor's Guide'. Regina is a certified financial technician (an international accreditation) a former Director of Australian Technical Analyst Association and is President of Australian Professional Technical Analyst (APTA)

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