Gas Bulls Have Reached Their Breaking Point

An inverse head-and-shoulders pattern developed last week in the NYMEX natural gas market. As Investopedia describes (here), this pattern is identified when the price falls to a trough (1st shoulder), then rises to the "neckline". The price then falls below the former trough (1st shoulder) to form the "head", and then rises again to the "neckline". Finally, the price falls once more, but not as far as the second trough ("head") to form the 2nd shoulder. Once the final trough (2nd shoulder) is made, the price heads upward, toward the resistance, i.e., the "neckline".

In effect, the first shoulder is the antepenultimate selloff and as illustrated, this shoulder was put in on strong volume. However, there was a dearth of volume on the formation of the "head" (the penultimate selloff). Volume characteristics are important. As taught in Futures Trading 101, a good rule-of-thumb is to apply algebraic notation when analyzing price and volume to determine directional bias.

In the case of the formation of the "head", the *algebra* suggests this was a bullish signal. For instance, falling (−) volume coupled with falling (−) price is bullish, i.e. (−) × (−) = (+).

Lower prices were realized as money was pulled out of the market. Accordingly, the *head* was created by bulls liquidating the longs that they established on the runup from the first shoulder to the neckline.

Inverse head-and-shoulders patterns are used to predict reversals in bear markets. Earlier this week, the market spiked through the *neckline* — which occurred on heavy volume. This move signaled a bullish breakout. Contact us for more detail on how to apply technical analysis to your hedging strategies.

Back to backwardation.

Since the start of winter, the cross-seasonal March/April spread on the NYMEX traded in contango (March discount to April) in 30 out of 40 sessions. This was a clear bearish telltale given that traders were unwilling to pay a premium to own gas for delivery in a winter month. However, with markets through the Midwest and East getting hammered by arctic air this week, the spread has moved back to backwardation (March premium to April).