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Crossing The Divide

Four Gaps And Their Technical Significance

Gaps can help or wreak havoc on your trading. Here we show you how you can recognize four different types of gaps, the sentiments associated with them, and how to employ them.

by Phillip Duke, PhD

The four different types of gaps are *initiation, continuation, trading,* and *exhaustion* gaps; the gap type depends on the sentiment that created it. Technical analysis of a trading position includes identification of gaps and determining and evaluating the sentiments that created them. An upside trading gap occurs when there is no trading between the prior day's high and the succeeding day's low; a downside trading gap occurs when there is no trading between the prior day's low and the succeeding day's high. Bar and candle charts show gaps as blank price spaces. A gap is evaluated in terms of its direction, location, size, and trading volume on the day it is created. The size and volume are relative and depend on comparing the gap size and volume with past gap sizes and volume.

Gaps of different shapes and sizes

In this article I will explain how to recognize gap types, the sentiments associated with them, and how to employ the gaps with their corresponding sentiments in trading.

1) Initiation gaps (Figure 1). The initiation gap, also called the breakaway gap, often but not always signals the beginning of a sizable price move. It is usually created by unexpected news of varying importance, which creates bullish or bearish sentiment of at least initial importance. Evaluation of the news regarding its continuing importance is an important part of attempting to determine how far the price move will carry.

The initiation gap is large and accompanied by heavy volume.

Sometimes after several days of trading, the price direction reverses and there is a price pullback to the gap's edge. If the price action fails to fill the gap, but then reverses and continues in the gap's direction, this signals confirmation of an initiation gap and you can expect a sizable move. If the pullback fills the gap, it is no longer an initiation gap. If the gap is filled, prices are more likely than not to carry on in the same direction that filled the gap.

Here's how you can trade the initiation gap. If the news that created the gap is of continuing importance, then take an immediate position in the direction of the gap. If not, wait for the pullback, and if the pullback price action fails to fill the gap, but turns and continues in the direction of the gap, take an immediate position in the gap's direction. If the gap is filled, take a position in the direction the gap was filled.

2) Continuation gaps (Figure 2). When prices are moving rapidly in the same direction and a gap appears, it is known as a continuation or runaway gap. These types of gaps occur more often with thinly traded vehicles and happen because the price is moving rapidly. Its size and volume are not important for identification; it is identified solely by its position. Continuation gaps usually occur close to the midpoint of the total price move in which it occurs.

To evaluate the total price movement, you need to measure the distance from the price where the move began to the middle of the gap. You can expect the move to carry this same distance and then end. If there are two continuation gaps, measure from halfway between them. When the continuation gap ends, there is usually enough of a price pullback, which, though not large, is sizable enough to justify taking profits and exiting at the move's end. The continuation gap says nothing about price direction once the price move in which it occurs ends.

To employ the continuation gap, close out and take profit on any position in the direction of the gap when the price is within a few percent of the estimated complete move. You could take a position in the gap's direction as soon as it appears and close the position out with the complete move.

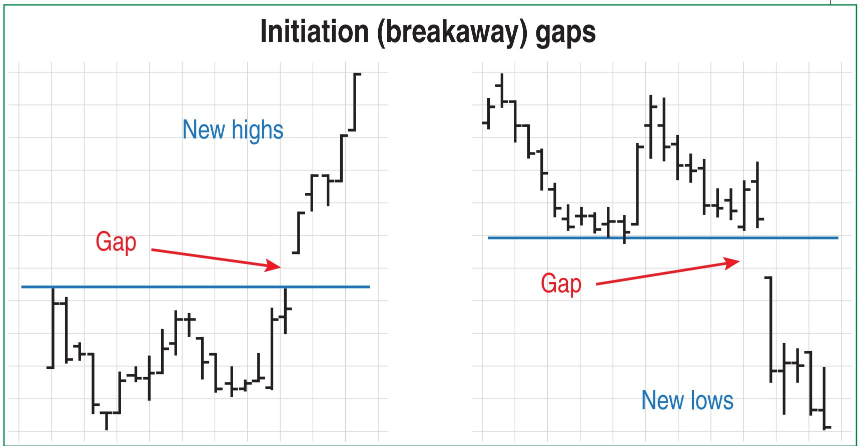

FIGURE 1: INITIATION (BREAKAWAY) GAPS. Also called breakaway gaps, initiation gaps often signal the beginning of a sizable price move.

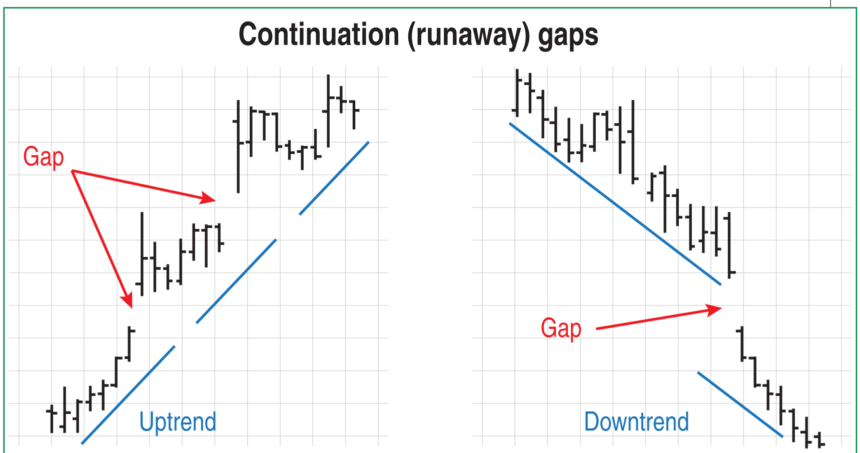

FIGURE 2: CONTINUATION (RUNAWAY) GAPS. A continuation or runaway gap appears when prices move rapidly in the same direction. They usually occur in thinly traded trading vehicles.

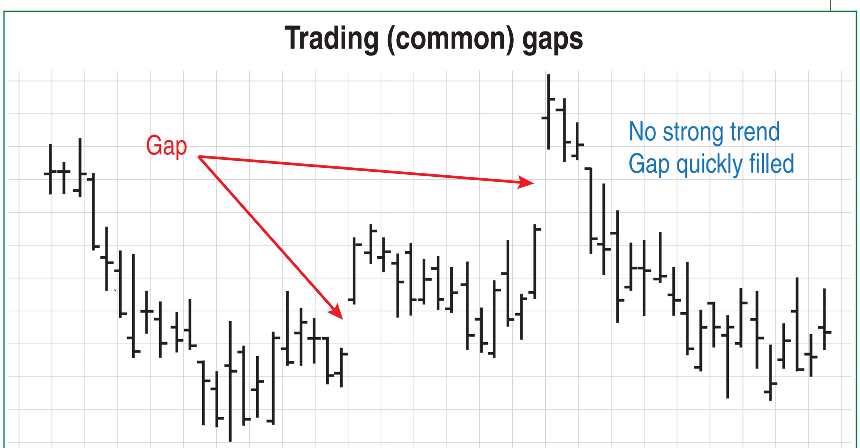

FIGURE 3: TRADING (COMMON) GAPS. Trading gaps, also known as common gaps, occur on medium or low volume. They don't have much significance regarding the overall direction of price and they're usually filled within a few weeks.

3) Trading gaps (Figure 3). The trading gap, also called the common gap, occurs when the price trades normally and a small gap occurs on medium or low volume. This type of gap usually occurs due to chance, and has no significance regarding the overall price direction. However, trading gaps are usually filled, probably within a few weeks.

When the price move that formed the gap ends, the price

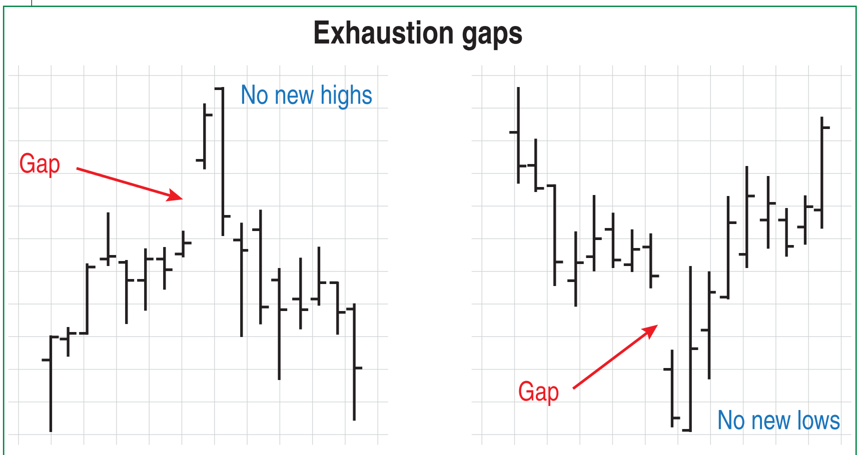

FIGURE 4: EXHAUSTION GAPS. This type of gap appears toward the end of a sizable move. It suggests that the interest in the trading vehicle is exhausted.

A gap is evaluated in terms of its direction, location, size, and trading volume on the day it is created.

will probably reverse and fill the gap. So you should immediately take a position in the gap's direction, or take an opposite position when the move ends. Close out the position and take profit as appropriate. The trading gap is the most difficult gap to trade with, because the price moves resulting after the gap are relatively small.

There is a saying that "all gaps are filled." This is pretty much true for trading gaps, but not necessarily true for other types of gaps.

4) Exhaustion gaps (Figure 4). I have left this most interesting and profitable gap for last. The exhaustion gap appears close to the end of a sizable move. It suggests that almost everyone who has an interest in the trading vehicle has already taken a position and that interest has now exhausted. Because of this, the price action may produce a large gap on light volume. The large size on light volume signals that the number of willing and able traders has thinned considerably.

The exhaustion gap could form as a breakout from a congestion pattern. It is always in the direction of the prior long-term price movement. It occurs only after a prior sizable long-term move and this, together with its large size and especially light volume, distinguish it from the initiation gap. The exhaustion gap may lead to the formation of a small island congestion pattern, which, after a few days or weeks of trading, suddenly forms an initiation gap in the opposite direction. The initiation gap confirms the exhaustion gap. This chart pattern is called an *island reversal*. In some cases, the price may simply turn and reverse immediately or a day or two after the exhaustion gap. Exhaustion gaps are more common at tops than at bottoms, but they can and do occur at both.

Keep in mind sayings such as "every price advance weakens the market" and "every price decline strengthens the market." The exhaustion gap occurs after a relatively large price movement that has taken place over several months. At that point, just when it seems as though the price will continue moving without ever stopping, that's when the exhaustion gap occurs.

Be on the alert for an exhaustion gap after a sizable price move with a duration of a few months. When you identify the gap, take a trading position at the extreme of its movement, in the direction the price is now expected to gap. If you would rather wait to be certain, then wait for the reverse initiation gap and take a trading position in its direction. The trading gap followed by an initiation gap signals a major price reversal, and the entire prior price movements may retrace.

Being correct in your evaluation that the move has ended is gratifying, especially when most other traders expect the price move to continue as before. It can also be profitable when you roll over at the top or bottom and reverse your position at that top or bottom. The exhaustion gap is my favorite gap.

5) Hybrid gaps. Occasionally, but luckily not often, a gap appears to be a hybrid of two gaps. The price action that follows the gap is similar to that expected to follow after two different kinds of gaps. I have coined the term *hybrid gaps* for them. They are due to mixed sentiment, which I believe stems from news whose purport is unclear, which results in traders interpreting them in two different ways.

In closing

You should only employ gaps as part of your overall technical analysis. The detailed final technical analysis of a position requires that you recognize and evaluate numerous technical factors, including price and volume action, and indicators based on both. The most difficult part is the evaluation, when you weigh and compare numerous different considerations. Volume is a tool used for verification, so when a volume indicator and a price indicator give different interpretations, the volume indicator is usually more reliable.

Because of the complexity of technical trading, I suggest you use no more than two trading vehicles at the same time. This allows you to become intimately acquainted with the price actions of the trading vehicles. For example, it'll help you to determine the relative size and trading volume of different gaps.

Keep in mind that news is constantly being generated and entering the markets, that new and unexpected news relating to your trading vehicle can enter the market at any time and completely invalidate the most careful and thorough technical analysis. Since technical analysis is based on probabilities, not certainties, according to probability theory you will necessarily be wrong sometimes. You should be right most of the time, but occasionally you will be wrong. It's inevitable, and knowing that it is inevitable will prepare you to cope with it when it happens.

Of course, the large and successful insurance and gambling industries are also based on probabilities and not certainties. Over time, they do well. If you trade so that the probabilities are in your favor, cut your losses and let your profits run, and take profits as indicated, then please invite me for a visit on your private yacht or jet plane, or both. I thank you in advance for the visit, and am looking forward to it.

Phillip Duke has a B.S. in chemistry from UCLA and a doctorate in experimental pathology from USC. His interest in commodity trading started at an early age. He has traded several commodities, the first being corn futures. He can be reached at drpduke@wmconnect.com.