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There is a substantial risk of loss associated with trading Derivatives . Losses can and will occur. My methods will not ensure profits

Friday, August 3, 2012

Gaps

Gaps are regular occurrences in futures market. Gaps occur due to the overnight change in sentiment of the participants. Being technical traders we are not bothered about the "why" but concerned about "What".

Every gap is unique and require different treatment depending upon the situation. Still general guidelines can be formulated to deal with gaps.

There are two types of gaps depending upon the location of the gap open. Inside Gaps and Outside gaps. Inside Gaps are gaps happening inside prior days range and do not need any special treatment. Let the market trade and interact with a Decision Point .We can trade the price action around DP as usual.

When the price gaps outside the previous day range, it is called an Outside Gap. When the price start trading outside the previous day range , it is a major transition and a change of sentiment. Price is likely to continue moving in the direction of impulse.

Outside gaps can be further classified into two categories. Trend Gaps and Counter Trend Gaps.

1. Trend Gaps are gaps in the direction of the previous day(or days) trend. For example Gap up above the high of a previous up day (or days) and Gap down below the low of the previous down day (or days). Trend gaps are likely to attract profit booking at the first sign of opposite order flow.

2. Counter Trend gaps are gaps against the previous day (or days) trend. For example a Gap up above the high of a previous down day(or days) and a Gap Down below the low of a previous up day (or days). Counter trend gaps will attract orders in that direction from new traders as well as the covering from trapped traders. CT gaps are likely to trigger an impulse move in the direction of the gap.

As you know , my trading revolves around Decision Points. I always try to hide my stop behind a DP. If the gap is an inside one , I let the market trade and wait till it hit a DP to make a decision.

In case of an Outside gap, if it is trading within my risk tolerance level, I take a position without waiting for the price to hit a DP. I hide my stop below the PDH or above the PDL depending upon the direction of the gap. If the price is not within my risk tolerance level , I let the market trade and reveal its intention.

Posted by [SMART Trader](#) at 12:29 PM



10 comments:



[Raghu R Bhat](#) August 3, 2012 at 8:22 PM

Clearst expo of gaps I have seen - wish I had seen it yesterday :) - going through your blog this weekend to get the complete picture.

regards
rb

Reply



[Sunil Saranjame](#) August 3, 2012 at 9:23 PM

Numero uno.

Gracias.

Reply





[SMART Trader](#) August 3, 2012 at 10:05 PM


SS



bienvenida


ST
Reply


 [bizagra](#) August 3, 2012 at 11:56 PM
sir..thanks..very informative post...)
Reply

 [Sunil Saranjame](#) August 4, 2012 at 8:10 AM
ST,
We need to do some testing on opening gaps esp full gaps and maybe we can make some rules like -
'If the market opens full gap down then sell at the open (within the first 3 minutes)'
I have 5 minute historical data and will run some tests on it and let's see what we get.
Thanks
Reply


 [ratnakar](#) August 4, 2012 at 4:04 PM
very good.. thank u...
Reply

 [SMART Trader](#)  August 4, 2012 at 6:40 PM
@Bizagra
@ratnakar
Thanks
@SS
Thanks, Please do it. If possible get separate statistics for trend gaps and CT gaps
I do not have any charting software. So cant do any back testing. I am using web based charts
ST
Reply

 [xrtrader1](#) October 7, 2014 at 10:23 PM
Wow..
Reply

 [DM](#) December 16, 2014 at 11:09 PM
ST,
How do you define up/down days?
Does the close have to above/below the prev close? OR is a single green/red candle against the trend sufficient to qualify it up/down day?
Thanks,
Reply

▼ Replies

 [SMART Trader](#) December 16, 2014 at 11:24 PM
If a day opens at the low and closes near the high of the day range it it can be considered as an up day
You can safely assume the creation of some positional longs during the day. If a CT outside gap open happens, these new longs will panic. They will try to exit the trade if price moves down fueling the down trend
ST

Reply

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