Gaps and Gap Analysis

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Price charts often have blank spaces known as gaps. They represent times when no shares were traded within a particular price range. Normally this occurs between the close of the market on one day and the next day's open.

For an up gap to form, the low price after the market closes must be higher than the high price of the previous day. Up gaps are generally considered bullish.

A down gap is just the opposite of an up gap; the high price after the market closes must be lower than the low price of the previous day. Down gaps are usually considered bearish.

Gaps result from extraordinary buying or selling interest developing while the market is closed. For example, if an earnings report with unexpectedly high earnings comes out after the market has closed for the day, a lot of buying interest will be generated overnight, resulting in an imbalance between supply and demand. When the market opens the next morning, the price of the stock rises in response to the increased demand from buyers. If the price of the stock remains above the previous day's low throughout the day, then an up gap is formed.

Gaps can offer evidence that something important has happened to the fundamentals or the psychology of the crowd that accompanies this market movement.

Timeframe of Gaps

Up and down gaps can form on daily, weekly or monthly charts, and are considered significant when accompanied with higher than average volume.

Gaps appear more frequently on daily charts, where every day is an opportunity to create an opening gap. Gaps on weekly or monthly charts are fairly rare: the gap would have to occur between Friday's close and Monday's open for weekly charts, and between the last day of the month's close and the first day of the next month's open for monthly charts.

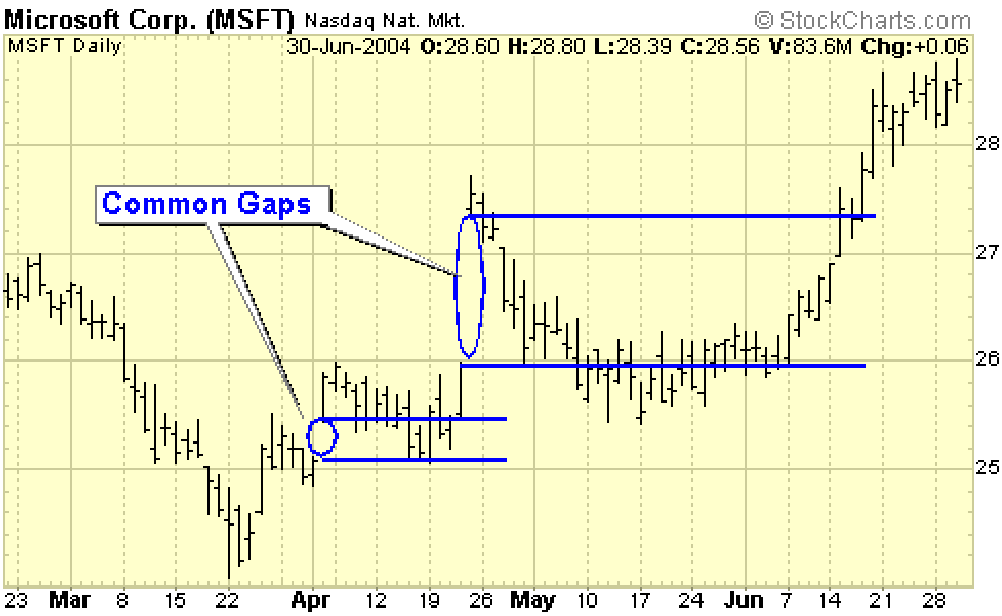
A price chart with gaps almost every day is typical for very thinly-traded securities and should be avoided. Prices often gap up or down at market open, but the gap does not last until the market closes. Such temporary intraday gaps should not be considered as having any more significance than normal market volatility.

Types of Gaps

Gaps can be subdivided into four basic categories: Common, Breakaway, Runaway, and Exhaustion.

Common Gaps

Sometimes referred to as a trading gap or an area gap, the common gap is usually uneventful. In fact, they can be caused by a stock going ex-dividend when the trading volume is low. These gaps are common (get it?) and usually get filled fairly quickly. "*Getting filled*" means that the price action at a later time (a few days to a few weeks) usually retraces at the least to the last day before the gap. This is also known as closing the gap. Here is a chart of two common gaps that have been filled. Notice that after the gap the prices have come down to at least the beginning of the gap? That is called closing or filling the gap.

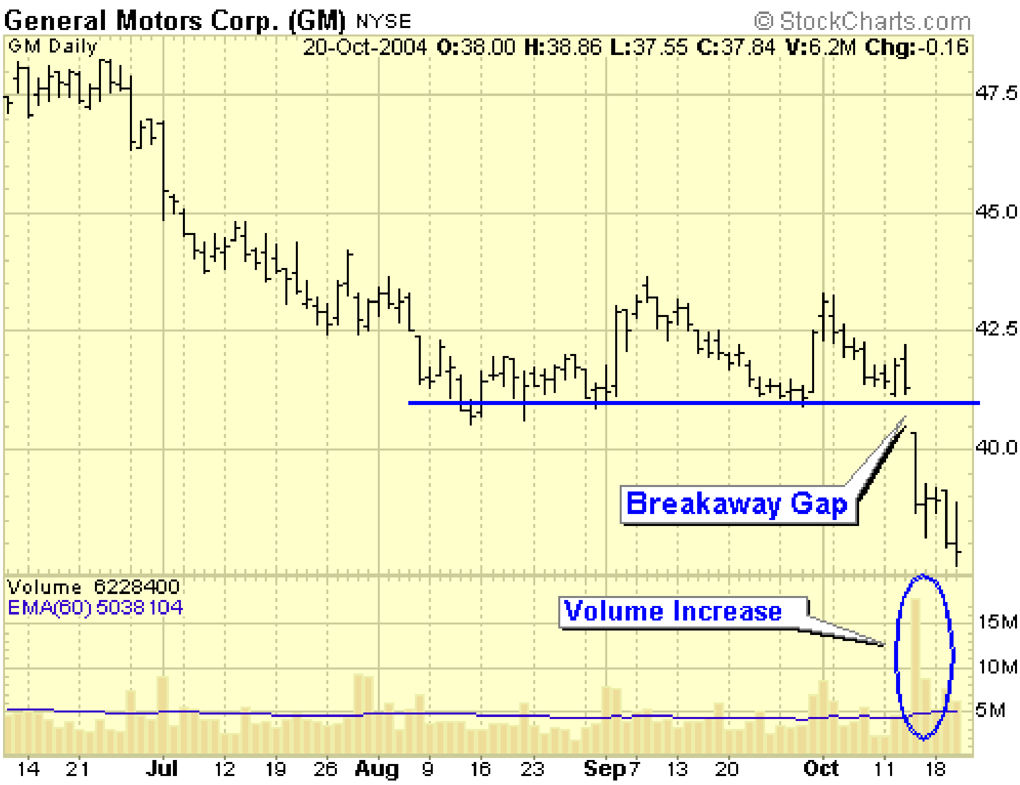


A common gap usually appears in a trading range or congestion area, and reinforces the apparent lack of interest in the stock at that time. Many times this is further exacerbated by low trading volume. Being aware of these types of gaps is good, but it's doubtful that they will produce trading opportunities.

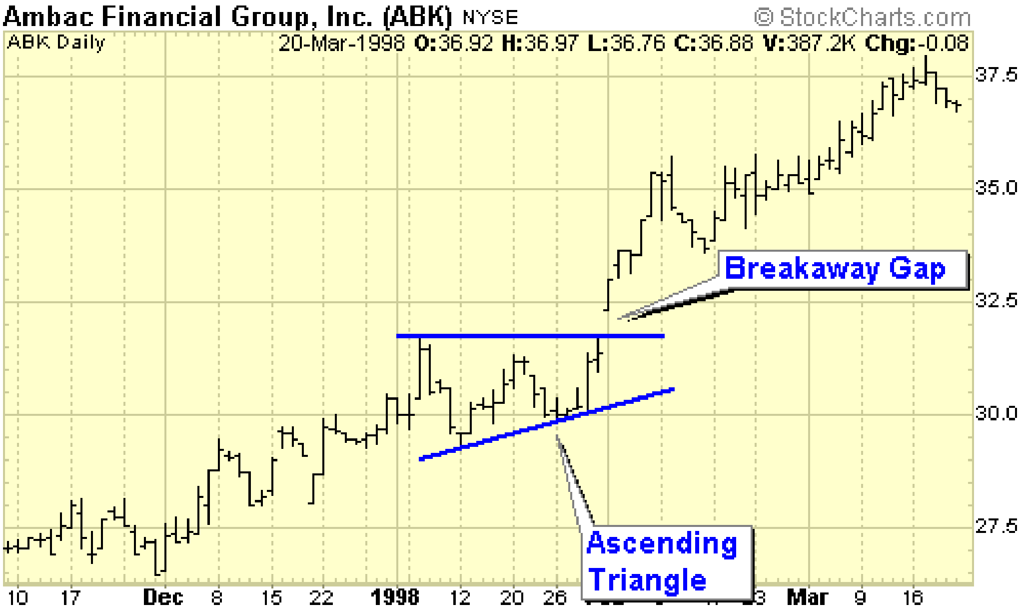
Breakaway Gaps

Breakaway gaps are the exciting ones. They occur when the price action is breaking out of a trading range or congestion area. To understand gaps, one has to understand the nature of congestion areas in the market. A *congestion area* is just a price range in which the market has traded for some period of time, usually a few weeks or so. The area near the top of the congestion area is usually resistance when approached from below. Likewise, the area near the bottom of the congestion area is support when approached from above. To break out of these areas requires market enthusiasm, and either many more buyers than sellers for upside breakouts or many more sellers than buyers for downside breakouts.

Volume will (should) pick up significantly, not only from the increased enthusiasm, but because many are holding positions on the wrong side of the breakout and need to cover or sell them. It is better if the volume does not happen until the gap occurs. This means that the new change in market direction has a chance of continuing. The point of the breakout now becomes the new support (if an upside breakout) or resistance (if a downside breakout). Don't fall into the trap of thinking this type of gap, if associated with good volume, will be filled soon. It might take a long time. Go with the fact that a new trend in the direction of the stock has taken place, and trade accordingly. Notice in the chart below how prices spent over two months without going lower than about 41. When they did, it was with increased volume and a downward breakaway gap.

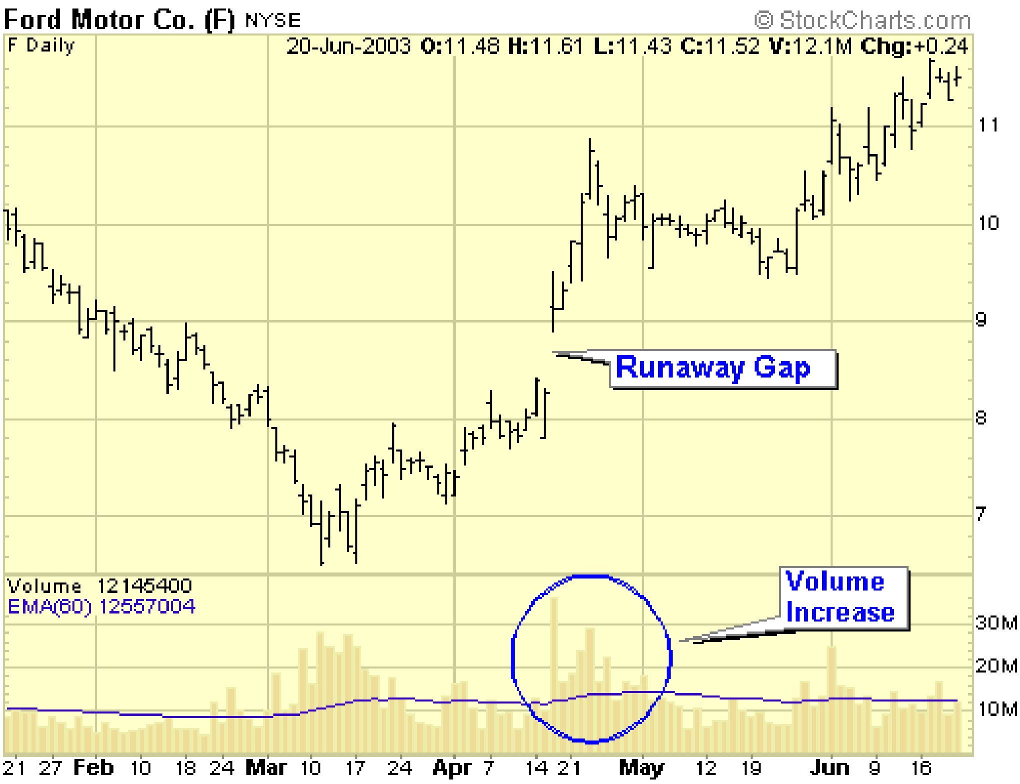


A good confirmation for trading gaps is whether or not they are associated with classic chart patterns. For example, if an ascending triangle suddenly has a breakout gap to the upside, this can be a much better trade than a breakaway gap without a good chart pattern associated with it. The chart below shows the normally bullish ascending triangle (flat top and rising, lower trend line) with a breakaway gap to the upside, as you would expect with an ascending triangle.



Runaway Gaps

Runaway gaps are also called measuring gaps, and are best described as gaps that are caused by increased interest in the stock. For runaway gaps to the upside, it usually represents traders who did not get in during the initial move of the up trend and while waiting for a retracement in price, decided it was not going to happen. Increased buying interest happens all of a sudden, and the price gaps above the previous day's close. This type of runaway gap represents an almost panic state in traders. Also, a good uptrend can have runaway gaps caused by significant news events that cause new interest in the stock. In the chart below, note the significant increase in volume during and after the runaway gap.



Runaway gaps can also happen in downtrends. This usually represents increased liquidation of that stock by traders and buyers who are standing on the sidelines. These can become very serious as those who are holding onto the stock will eventually panic and sell – but sell to whom? The price has to continue to drop and gap down to find buyers. Not a good situation.

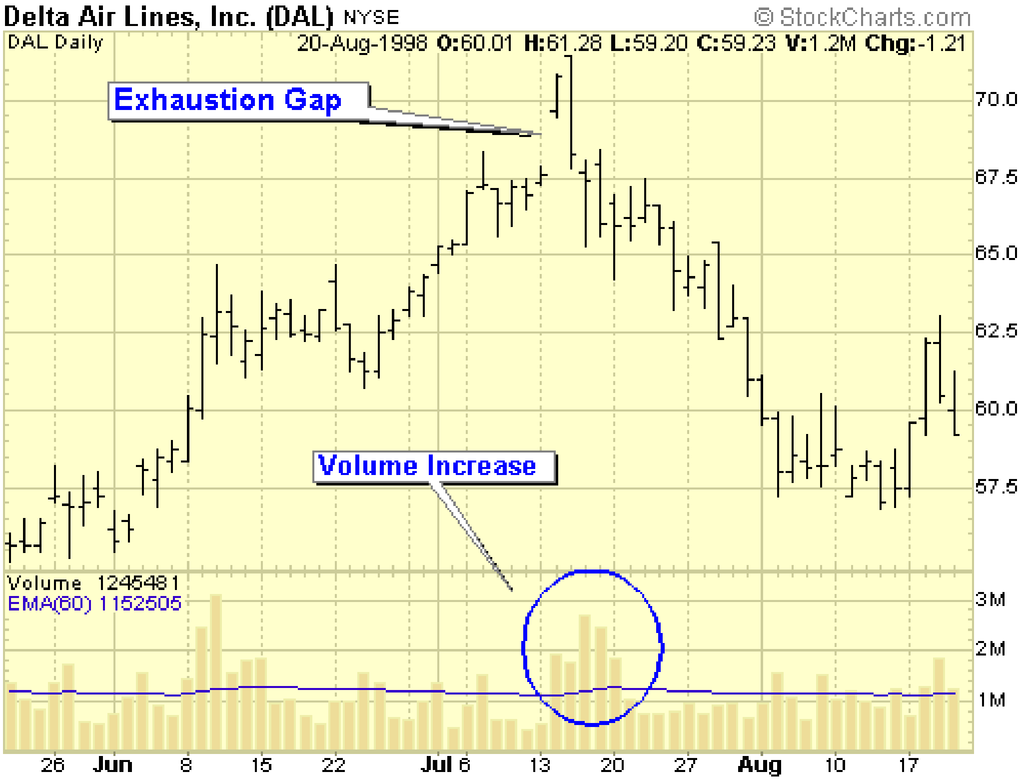
The term *measuring gap* is also used for runaway gaps. This is an interpretation that is hard to find examples for, but it is a way of helping one decide how much longer a trend will last. The theory is that the measuring gap will occur in the middle of, or halfway through, the move.

Sometimes, the futures market will have runaway gaps that are caused by trading limits imposed by the exchanges. Getting caught on the wrong side of the trend when you have these limit moves in futures can be horrifying. The good news is that you can also be on the right side of them. These are not common occurrences in the futures market, despite all the wrong information being touted by those who do not understand it and are only repeating something they read from an uninformed reporter.

Exhaustion Gaps

Exhaustion gaps are those that happen near the end of a good up- or downtrend. They are many times the first signal of the end of that move. They are identified by high volume and a large price difference between the previous day's close and the new opening price. They can easily be mistaken for runaway gaps if one does not notice the exceptionally high volume.

It is almost a state of panic if the gap appears during a long down move where pessimism has set in. Selling all positions to liquidate holdings in the market is not uncommon. Exhaustion gaps are quickly filled as prices reverse their trend. Likewise, if they happen during a bull move, some bullish euphoria overcomes trades, and buyers cannot get enough of that stock. The prices gap up with huge volume; then, there is great profit taking and the demand for the stock totally dries up. Prices drop, and a significant change in trend occurs. Exhaustion gaps are probably the easiest to trade and profit from. In the chart, notice that there was one more day of trading to the upside before the stock plunged. The high volume was the giveaway that this was going to be either an exhaustion gap or a runaway gap. Because of the size of the gap and the near tripling of volume, an exhaustion gap was in the making here.



Conclusion

There is an old saying that the market abhors a vacuum and all gaps will be filled. While this may have some merit for common and exhaustion gaps, holding positions waiting for breakout or runaway gaps to be filled can be devastating to your portfolio. Likewise, waiting to get onboard a trend by waiting for prices to fill a gap can cause you to miss the big move.

Nevertheless, gaps are a significant technical development in price action and chart analysis, and should not be ignored. Japanese candlestick analysis is filled with patterns that rely on gaps to fulfill their objectives.