WHEN NOTHING SAYS SOMETHING: UNDERSTANDING PRICE GAPS

By Wayne A. Thorp

The size of a gap in trading can provide an indication as to future price activity. The wider the gap, the less apt prices are to follow through in the direction of the gap. Especially wide gaps are an indication that the market may have overreacted to whatever event caused the price to gap.

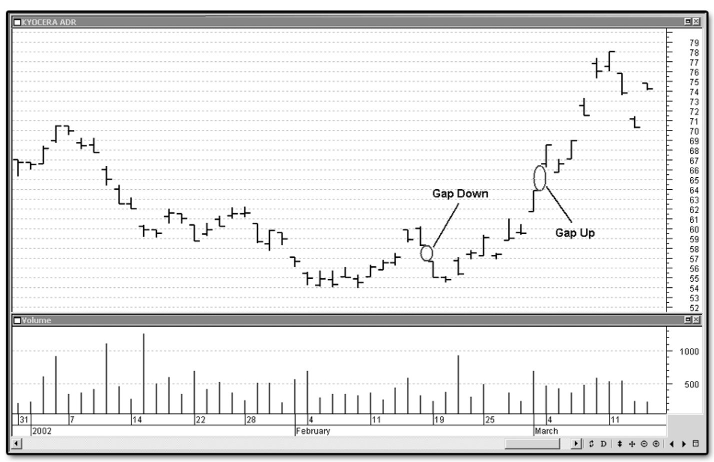
Technical analysis usually focuses on past price and volume movement to forecast future price movements. However, there are times when what does not happen can be just as telling—these are the times when gaps form. A gap occurs when no trading takes place in a price range—it is essentially a "non-event."

Gaps are caused by action that has taken place between the time of the close of the normal trading day and the next day's open. For instance, a significant news item, such as an earnings announcement, may not take place until after the closing bell. That can cause prices to open much higher or lower on the next trading day, depending on the scope of the news and whether it was expected or unexpected.

TYPES OF GAPS

An opening up gap takes place when the market for a stock opens higher than the previous day's high, while an opening down gap occurs when the market opens lower than the previous day's low. Figure 1 provides examples of both an opening up gap and an opening down gap for Kyocera.

FIGURE 1. KYOCERA: UPGAP AND DOWNGAP



Source: MetaStock by Equis

In general, the size of the gap can provide an indication of future price activity. The wider the gap, the less apt prices are to follow through in the direction of the gap. Especially wide gaps are an indication that the market may have overreacted to whatever event caused the price to gap, or that illiquidity (especially in the after-hours market) has come into play. In such cases, prices often reverse and "fill in" the gap.

This is not to say that all gaps are filled in. While there are times when prices will reverse against the direction of the gap, this can sometimes take weeks or even months. Our focus here will be on the four major types of gaps: common, breakaway, runaway, and exhaustion.

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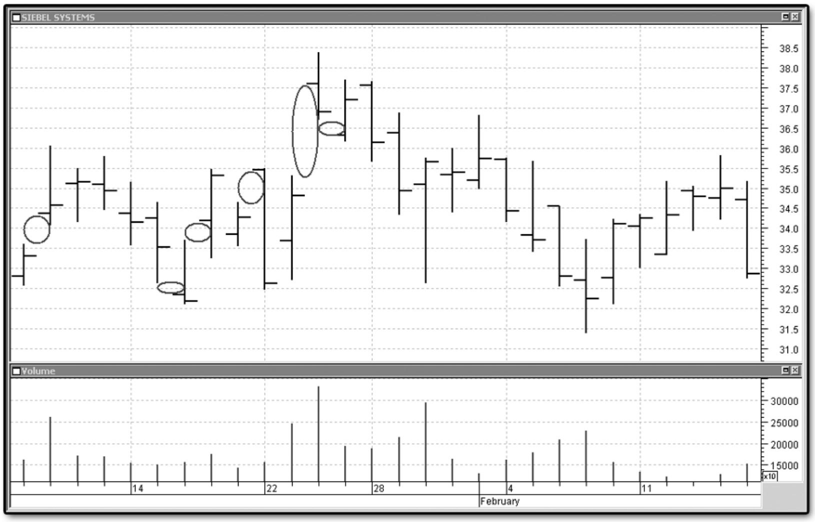
FIGURE 2. SIEBEL SYSTEMS: COMMON GAP



Source: MetaStock by Equis

COMMON GAP

Of the four types of gaps, the common gap, not surprisingly, occurs most frequently. It can occur to the upside or downside and can, depending on the security being charted, occur daily.

A common gap is characterized by an opening price that is outside the range of the previous trading day. Common gaps also tend to be found during periods of trading indecision or congestion. During such periods, you will find the price of the stock or commodity moving within a defined trading range with little volatility as there is a balance between buyers and sellers, with neither group having the power to sustain a prolonged upward or downward price movement. Another sign that the security has entered a period of congestion or sideways trading is a relative lack of trading volume.

In Figure 2, Siebel Systems was trading in a defined range between $32 and $37.50 in January and February 2002. During this period, as shown by the circles drawn on the chart, the price experienced several common gaps, both to the upside and downside.

Common gaps do not tend to be overly predictive of future price movements, since they rarely mark a fundamental shift in the market or in the underlying interest in the stock. They tend to be relatively narrow, and are typically filled (over time, prices trade through the gap).

One cause of a common gap can be a "surprise" event regarding a news item or an earnings announcement.

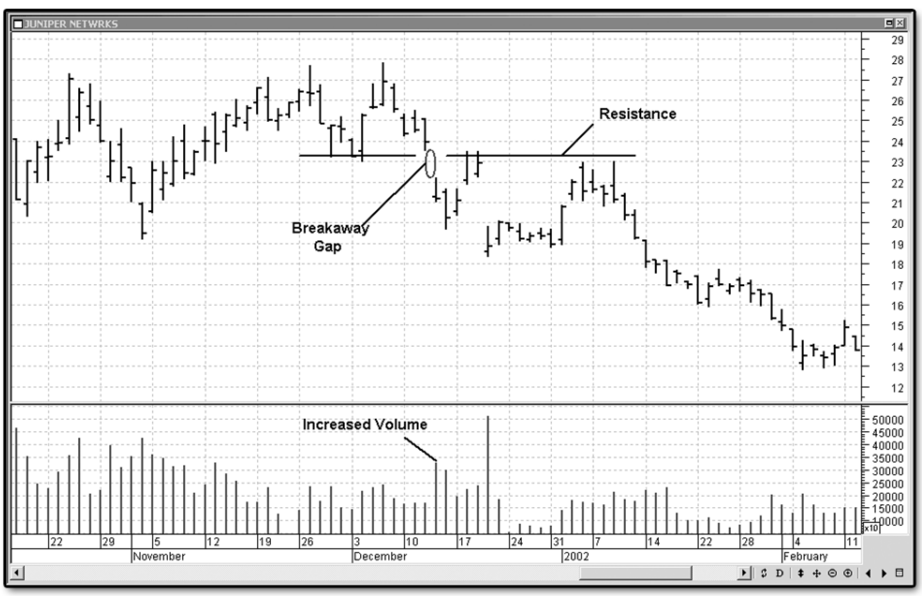
BREAKAWAY GAP

While common gaps tend to occur during the congestion phase where prices move in a narrow, defined range and are of little use from a trading aspect, breakaway gaps occur after this phase and typically mark the beginning of a defined trend.

In a breakaway gap, prices are moving away from their defined trading range. With a breakaway gap, one side of the market—either buyers or sellers—overcomes the other and a defined price trend begins.

Once a breakaway gap occurs, there is usually an increase in volatility as prices move more rapidly. Furthermore, the gap tends to serve as a level of support or

FIGURE 3. JUNIPER NETWORKS: DOWNSIDE BREAKAWAY GAP



Source: MetaStock by Equis

TABLE 1. TYPES OF GAPS: A SUMMARY

Gap Name	Definition	Where Occurs
Common Gap	Opening price is outside the trading range (prices between the low and the high) for the previous trading day.	Typically found when prices are in a sideways trend or in a period of congestion where prices are moving within a defined range.
Breakaway Gap	Low price for the day is above the high price for the previous day (uptrend); or high price for the day is below previous day's low price (downtrend). Price move is accompanied by a significant increase in trading volume.	Immediately following sideways trend or period of congestion. The breakaway gap announces that the price is moving out of the prior trading range.
Runaway Gap	Low price for the day is above the high price for the previous day (uptrend); or high price for the day is below previous day's low price (downtrend). Increase in volume a confirming signal, but not required.	Typically found during established price trends (up or down).
Exhaustion Gap	Large price difference between the previous close and the current open in the opposite direction of the prevailing trend.	At the end of a strong trend. An exhaustion gap typically signals the end of the trend.

resistance once prices move away from it.

The implication of a breakaway gap to the upside is that prices tend not to fall back below the price level of the gap. For a breakaway gap to the downside, prices have a hard time rising back above the price level of the gap.

An examination of volume also helps in the analysis. A confirming signal of a breakaway gap is a marked increase in trading volume. This increase in volume is brought about by traders either moving to cover short positions or attempting to enter long positions.

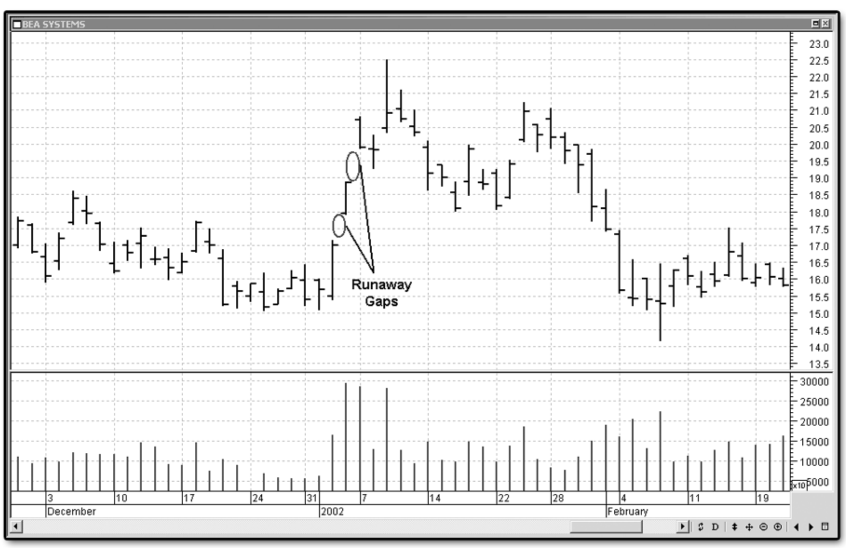
Figure 3 shows a downside breakaway gap for Juniper Networks that took place on December 13, 2001. The gap is accompanied by an increase in volume, a good indication that a downward trend has begun. Furthermore, we see that the gap becomes a level of resistance as prices test the level only a few days later. Prices fail to climb above the level of the gap on this occasion as well as when prices returned to this level two weeks later.

RUNAWAY GAP

Runaway gaps appear when a stock or commodity is in a strong, defined trend—either up or down. These are either upward or downward spikes in price, and are caused by additional traders wanting to participate in the current trend. Those that missed the initial move of the trend are now clamoring to get in, which only magnifies the trend, leading to runaway gaps.

Often, you will see several runaway gaps in the direction of the trend. While an increase in volume does not always occur with runaway gaps, any increase in trading volume is a further validation of the move. In the case of BEA Systems (Figure 4), there were two runaway gaps in a row in the first week of 2002. The spike in trading volume that takes place on these days confirms the high level of buying that is taking place to create these runaway gaps.

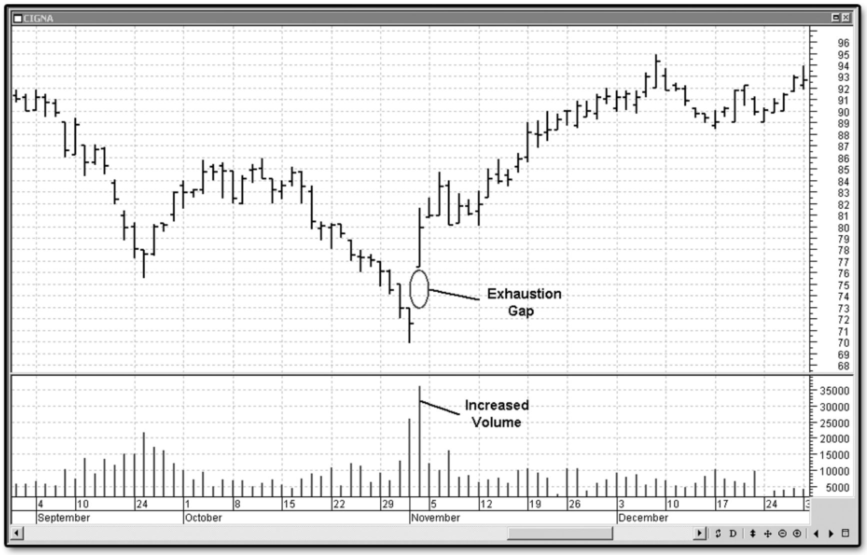
FIGURE 4. BEA SYSTEMS: RUNAWAY GAP



Source: MetaStock by Equis

EXHAUSTION GAP

FIGURE 5. CIGNA: EXHAUSTION GAP



Source: MetaStock by Equis

An exhaustion gap signals that a trend has run out of steam and a major reversal has begun. No new highs or lows will occur following an exhaustion gap.

Exhaustion gaps are marked by high trading volume and a large price difference between the previous close and the current day's open in the opposite direction of the trend that had been in place. The increase in trading volume stems from traders who are trying to close their positions. Volatility also tends to increase following this gap.

Figure 5 shows an exhaustion gap for Cigna. After falling roughly 15% over the prior two weeks, the price gapped upward significantly on November 2, 2001, on extremely high volume—an indication that prices are reversing and the downtrend is over. In over a month, the price had risen almost 25% from the low.

TRADING THE GAP

How can you use gaps as part of a trading strategy?

Breakaway gaps are useful in determining future levels of support or resistance.

When a breakaway gap occurs to the upside, the gap typically becomes a support level that prices tend not to fall back through, whereas a breakaway gap to the downside oftentimes becomes a level of resistance that prices have a difficult time rising above. When a breakaway up gap occurs, you can enter a long position and place a stop directly below this level.

The procedure would be the opposite for a breakaway down gap—go short at the gap and place a stop directly above that level. In the case of Juniper Networks shown in Figure 3, you could have sold the stock short (on an up-tick in price) at the downside breakaway gap and placed a stop at the level of the gap.

If you are using runaway gaps in a trading strategy, you will want to see if certain conditions are being met before entering a trade. For up gaps, enter a long trade on the open when the prior day's close was higher than the open and is in the top half of the price range for that day.

In the case of a gap down, a strategy would be to enter a short trade at the open if the close for the prior day was lower than the open and in the bottom-half of the price range for that day.

For breakaway and runaway gaps, the strategy is to trade *with* the gap. For exhaustion gaps, the strategy is to trade *against* the gap. Therefore, the strategy of some traders is to sell short the stock at the open for an up gap and enter a long position for a down gap—in both cases, traders would exit on the close.

No matter which gap you are trading, it pays to study the markets you are planning on trading and understand the behavior of the various gaps in the particular market. For some securities, gaps occur so frequently that they provide no useful basis on which to make trades.

CONCLUSION

Gaps can provide useful insight into the underlying trend in prices. In order to fully understand gaps and correctly read the signals of a gap, it is important to understand the behavior of the market and/or the security being traded.

By familiarizing yourself with the price behavior of a given security—especially in regards to the way prices behave when a gap develops—you have a tool at your disposal that could prove useful for your trading strategy. ✦

Resources

Joe Luisi and Jayanthi Gopalakrishnan, "What You Need to Know About Gaps," *Stocks & Commodities*, September 2000, 32-39.

Joe Van Nice, "Gap Watching," *Stocks & Commodities*, 5:8 (284-285).

John Crane, "Another Chance With Breakaway Gaps," *Stocks & Commodities*, 9:3 (129-130).

Thom Hartle and Melanie F. Bowman, "Gaps," *Stocks & Commodities*, 8:12 (453-455).