Module 1- Chapter 10 – Gap Analysis in Charts

Gaps, in the world of technical analysis, represent areas on a chart where no trading activity took place, resulting in a "gap" in the price chart. Recognizing and understanding the significance of these gaps can be pivotal for traders to capitalize on potential opportunities and manage risk.

A gap occurs when there's a significant difference between the closing price of one period and the opening price of the next, without any trading occurring between these two prices. These gaps are often the result of some fundamental event or news item that significantly changes the perceived value of an asset overnight.

What it is and what it shows

Gaps can appear on any time frame, from minute charts up to monthly charts, and can be observed in stocks, futures, and other financial markets. They often indicate strong sentiment about a security and can give insights into the future direction of its price.

The types of gaps include:

Common Gaps: These are usually not associated with any news event and are often filled relatively quickly. They don't offer much insight into price direction.

Breakaway Gaps: These gaps occur after a consolidation or trading range and signify the start of a new trend. A stock that's been trading in a tight range may suddenly gap up or down, signaling the beginning of a new uptrend or downtrend.

Runaway (or measuring) Gaps: These gaps are seen in the middle of a trend and suggest the trend is likely to continue. For example, in a bullish trend, a runaway gap would be a gap up, indicating strong interest even at higher prices.

Exhaustion Gaps: These are found near the end of a trend, signaling that the trend might be running out of steam and a reversal could be near.

Island Reversal Gaps: This is a scenario where the market gaps in the direction of the prevailing trend, trades for a few days, and then gaps back in the opposite direction, leaving a "gap island" on the chart. This can be a powerful reversal signal.

How to trade it

Gap analysis can be incorporated into trading in several ways:

1) **Gap Fill Strategy**: Many traders believe that price often comes back to fill the gap. Thus, after observing a gap, they may enter a position betting on the price moving back to fill the gap.

Example: A stock closes at Rs.500/- on Monday. Due to positive earnings released after the market close, it opens at Rs550/- on Tuesday. A trader might short the stock, expecting the price to move back down to Rs.500 to "fill the gap."

Continuation Strategy: For runaway gaps, traders might bet on the trend's continuation. This is often backed up by strong volume during the gap, which supports the strength of the move.

Example: If a stock in an existing uptrend gaps up from Rs.600/- to Rs.650/- with strong volume, a trader might see this as a continuation of the bullish trend and enter a long position.

Reversal Strategy: For exhaustion gaps and island reversals, traders might bet against the prevailing trend, anticipating a reversal.

Example: In a prolonged downtrend, if a stock gaps down from Rs.300/- to Rs.280/- but then rallies and gaps up the next day to Rs.320/-, leaving an island reversal, a trader might go long anticipating a bullish reversal.

In conclusion, gaps can provide valuable insights into market sentiment and potential price direction. As with all technical tools, gaps should be used in conjunction with other indicators and methods to confirm signals and manage risk effectively.