Welcome to Market Geeks special report. Today I’m going to teach you a little bit about gaps, how to identify different gaps and most importantly how to put different type of gaps into proper context so that you can quickly identify current market conditions.

I will also show you one of my favorite gap strategies for market reversals. The Tail strategy is one of the 13 strategies that are included in our E-mini day trading course. However, it was originally created for stocks and occurs quite frequently, especially in NASDAQ stocks. The Tail strategy is a great strategy for beginners and does not require too much management.

Gaps are areas on a chart where the price of a stock or futures contract moves up or down, with no trading in between. To put in other words, a gap is a visible discontinuity between two price bars on a chart. In an upward trend, a gap is produced when the highest price of one bar is lower than the lowest price of the following bar. In a downward trend, a gap occurs when the lowest price of any one bar is higher than the highest price of the next bar.

Gaps occur as a result of short term fundamental or technical factors. For example, if economic announcement is higher than expected or a stock that makes up a large percentage of the index has surprise earnings news; any unexpected data can cause a short temporary gap in price of the index futures contract. Virtually, any event technical or fundamental that causes a temporary pause in either buying or selling will leave an empty gap or area on a chart.

When a gap is filled, it simply means that subsequently to the creation of a gap, prices traded at the level where the gap in price previously had occurred, this is also sometimes referred to as closing the gap.

There are four different types of gaps, since each type of gap has its own distinctive implication and relevance, it is very important to be able distinguish between the different type of gaps as quickly and as accurately as possible.
**Common Gap**

A common gap also known as area gap tends to occur when the index is trading between support and resistance levels and the price is moving sideways in a congestion range. A common gap is a break in price that does not result from any major factor and has no implication except a continuing trading range or price congestion. In general, there is no major event that precedes the common gap; it’s typically caused by a temporary imbalance between buyers and sellers.

Common gaps are typically filled quickly, due to the fact the index continues to trade in the same price range that existed when the break in price first occurred. For example, if price gaps from 1340 to 1342, it generally does not take more than a few trading bars for price to move back below 1342 price level and begin to fill the price gap.

Common gap should be distinguished from other type of gaps, due to the different implications that each type of gap has on market price and direction. For example, if a common gap is mistaken for a breakaway gap, the implication would be that index price will either rise or fall rapidly; conversely, if the common gap is mistaken for an exhaustion gap, the implication would be that a price reversal is soon to follow. Therefore, it’s very important to classify each type of gap correctly.
**Breakaway Gaps**

Of higher technical significance than the common gap, is the breakaway gap. This gap typically occurs towards the completion of a chart pattern, at or near the point that price begins breaking out or when the market is trading outside of a congestion area or trading range. Unlike common gaps that don’t carry much trading significance, the breakaway gap tends to signal a beginning of a breakout in the direction of the gap.
Runaway Gap
Continuation Gaps occur during strong trends, and are also referred to as “Runaway” and “Measuring” gaps. These gaps occur during, and in the direction of, an ongoing trend and are generally viewed as confirmation of a trend’s strength, and are not associated with the congestion area like the common gap or the breakaway gap. During strong trends, prices look like they are “running away” because pullbacks, if any at all, are brief and shallow.

Runaway gaps to the upside usually represent traders who did not enter during the initial move of the uptrend and eventually enter the trade because a retracement in price is not likely to occur. This usually represents increased liquidation of the index contract either due to technical factors or possible economic news that has a negative impact on the price of the index contracts.

Continuation gaps often occur at the halfway point of a trend, in the middle of rapid price advance or decline, and can be used to measure roughly how much further ahead the move will continue. To measure the predicted target high or low, add together the distance from the point where prices broke away from the pattern or congestion area, to the middle point of the gap.

For continuation gaps moving up, add the number to the midpoint of the gap and that should give you a reasonable projection of the target price.

For bearish or downwards continuation gaps where prices are decreasing, you would once again, add the distance from the breakaway point to the middle of the gap point and subtract that distance away from the gap midpoint, this should give you the probable extent of the decline and probable exit target.

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20-Mar-07 Or: 29.07 H: 29.25 L: 29.02 C: 29.02 Chng: +0.160 (0.55%) Vol: 3,377
Exhaustion Gap
True to its name, the exhaustion gap occurs near the end of a strong price move, and signals that a price reversal is near. They are many times the first signal of the end of strong directional price move. Occasionally, an exhaustion gap will mark the ultimate high or low of a trend or end a parabolic move going either up or down sharply.

There are some factors that may help differentiate the exhaustion gap from the runaway gap, for example, the pace of the trend usually slows down before the exhaustion gap, the gap usually occurs near the price target projected by the chart pattern or if several runaway gaps preceded the current gap the more likely the current gap is a exhaustion gap. Exhaustion gaps are usually filled rapidly after occurring because price tends to turn direction quickly after the gap is formed and fill the gap while trading in the opposite direction.

Conclusion
By having a solid understanding of technical chart patterns and the different type of gaps that occur at different time and their significance, you will develop an excellent ability to determine what stage the market is in, at any given time.
The Tail Strategy

The tail trading strategy is one of my all time favorite short term trading strategies for trading stocks. It’s a reversal strategy that occurs very rarely on stock index futures contracts; although it doesn’t occur often it’s a very accurate when it does manifest itself. I mostly trade stocks with this pattern.

I usually don’t like to use words like accuracy when it comes to trading, but I have to say this strategy remains one of the most consistent trading patterns I have ever seen. When I learned this strategy in the mid nineties and I would often use it to short stocks. Selling stocks had a short sale rule and by the time my short would get executed, I was always late for the meat of the trade. Most exchanges have done away with short selling rule so that disadvantage is no longer there. Nonetheless, this trade requires fast execution and works exactly the same way with stocks as it does with stock index contracts.

To find the TAIL pattern you must look at daily charts and not the intraday charts that are typically used in day trading.

The TAIL pattern looks like a combination of a key reversal and an exhaustion gap and is easy to spot when looking at bar charts. What we want to see is a market that’s breaking out of a trading range, starting with a gap and then towards the end of the day erase most of the gains and close near the bottom 25 percent or lower of the daily range. The bigger the gap and the longer the reversal bar the better the reversal. The bar looks like it has a long tail, hence the name tail for this trade. Once you get familiar with this pattern you won’t need anything but a quick visual analysis to locate it quickly.

Short Rules

The complete short rules for the Tail trade are as follows: check daily price bars for 10 day high accompanied with gap that reverses and closes at the 25 bottom percent of its trading range. Once you locate a Tail pattern wait till the next day session to start. This begins at 9:30 eastern time and 8:30 central time, do not do anything the first half hour of the trading day no matter what.

After the first half hour place a sell stop 2 ticks below the low that was made on the day of the Tail pattern. If the market is already below that point (this happens all the time) then sell at the market. The stop loss on this trade is 1 tick above the Tail bar high and the profit target is an exit at the end of the trading session.
**Long Rules**

The long rules for the trade are as follows: check daily for market making 10 day lows on daily stock or index futures charts. Look for a low coupled with a gap and a close that’s within the top 25 percent range. The next morning wait the first half hour of the trading day and place a buy stop 1 tick above the high of the Tail bar.

If the market is already trading above that price, which is fairly typical, enter at the market. Place a stop loss 1 tick below the low made on Tail day the market should never go to that point. If the trade is working out correctly, close position at end of the trading day.

The reason the trade works is because it takes advantage of exhaustion gap coupled with a 10 day high and low. Many traders use 10 day high and 10 day lows as short term breakout signals. These signals have an accuracy rate of about 30 percent. Therefore there’s a 70 percent chance that the breakaway gap will end up being an exhaustion gap. When monitoring charts for breakouts, always consider the past chart history to see what behavior the market exhibited in recent history.

**Final Thoughts**

The Tail strategy is a great short term reversal strategy that withstood the test of time. Keep in mind that there are several other general market direction indicators that must be considered when trading this strategy. These indicators are discussed at length in Market Geeks E-mini Day Trading Course.

Always remember that gaps don’t occur in a vacuum, always look at the big picture and try to identify the type of gap that is forming. The last thing you want to do is take a long position when an exhaustion gap to the upside is forming or take a short position when a breakaway gap is forming to the upside. By identifying the gap correctly, you reduce your chance of initiating a position at the wrong time or in the wrong direction.
RECOMMENDED RESOURCES

For more information on different gap formations and trading strategies, order the E-mini day trading course today at MarketGeeks.com

A classic book that discusses different chart patterns including gaps is Technical Analysis of Stock Trends by Robert Edwards and John Magee.

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