Reading Gaps in Charts to Find Good Trades

One of the most rewarding and challenging things I have done in my 40-year trading career is teach elementary school students the basics of technical analysis and how to apply those basics in order to make money trading stocks. Each student comes to the trading class with a fairly clean slate: They don't know much, if anything, about the markets and they don't carry any of the emotional burdens of having to make “real” money to pay the rent or buy food. They soak up what I am willing to teach, which is a delight, but once they soak it up, they roll it around in their heads and then ask some of the most thought provoking questions!

When starting with an unmarked chart of a stock, I often point out market structure: Swing highs and lows, ranges, double or triple tops or bottoms, and gaps. On one particular afternoon, I started with a chart and began marking out simple market structure, and after a few minutes, the questions began. Why did I place any significance when price gapped higher or lower? Did it matter if the gaps remained unfilled or were all gaps the same? If gaps are important, how can you use them to make money?

This is the chart I started with:

Then I began to draw in what I considered to be the significant market structure, the “Don't Miss These” things that each of them should see when they first examine an unmarked bar chart.

On the unmarked chart, the first market structure that caught my eye was the unfilled gap that price left right as the downturn began in earnest, and of course, I may have noticed it first because we generally look left to right.

With the unfilled gap out, I added another easily spotted structure—“Three Drives to the Top”—and these were particularly easy to spot because each top was lower than the prior top. Once I marked the three drives to the top formation, its twin formation became evident:

This particular set of three drives to the top and three drives to the bottom are generally very reliable because the tops are forming lower and lower highs and the bottoms were forming a flat base. One of two outcomes flow from this set and the resulting move is generally explosive:

- Either a fourth drive to the top breaks above the prior three highs (and remember, each of the three are swing highs so a break above this formation should indicate a change in behavior), or…
- The third drive lower fails to hold at the test of the flat base (or a minor rally following the third drive runs through the flat base). While forming this flat base, price has been restoring energy, and when the bottom is violated, it generally moves a good amount to the downside.

Let's look at the interplay of the market structure I have marked so far:

When I view these formations, I like to take them apart in my mind and think in terms of the physics behind the market structure, which is how one of my earliest mentors, Dr. Alan Andrews, taught me to think about the markets.

The unfilled gap right at the beginning of this chart (and if you are like me, you view this entire chart as a whole) is like the winding of a spring in a clock. The unfilled gap shows you this market is rested and ready to move, and it also gives you the direction as clearly as the hands of a clock moving in one direction.

To flesh out the analogy, the three attempts price makes to rally are like the swinging of the pendulum in an old fashioned clock—and each time the pendulum swings back within a confined space or range, it's as if the clock spring is being rewound tighter and tighter. When price breaks below the flat base on the third drive lower, the pent up energy is expended quickly and in one direction: Down!

Is there anything else we can learn from physics about this chart before we move on?

Let's examine this chart and keep in mind the analogy of price being a large clock with a wound spring driving price's movements. First, I measure where the wound spring of the clock was originally released and measure how far it powered price lower before it slowed and then restored its energy, in this case by trading within a tightening range that was marked with a flat bottom. Then I project that same distance from the area where the newly rewound spring was released (where price broke below the flat bottom of its trading range). As a student of physics, it is not surprising to me when the lengths of the two distances are very nearly the same, and in this case, price runs out of downside directional energy at almost exactly the same distance.

Now I am focused on the lowest low on the chart and the bars that follow it. Specifically, I am looking at the very last bar, which is a wide range bar. Does this bar have any significance? Or is this bar just a wide range bar in a cascading downtrend? Let's look at it closer.

I zoomed in so you could see the bars after the lowest low much more clearly. My eyes are drawn to the very last bar on the chart. Price had begun to climb out of the hole after meeting its projected low and had a nice little rally going. It may even have broken above a minor swing high or two. And then something—news, a very large sell order, an overall breakdown of the prices in the stock market—made price open up much lower than the close of the prior day. But even though it gapped open much lower, it found nothing but buyers at the lower levels.

How do I know there were buyers at the lower levels? Price closed near its high. In fact, it closed higher than it did the prior day. There is a trading term that was started in the currency markets in the mid-1980s: When this type of action was seen, large, knowledgeable traders would say that there were “whales feeding there!” In this case, when price gapped open much lower, the average retail trader either sold out or was stopped out of their long position, or worse, they may have even gone short when price gapped open, expecting the prior low to be broken. But a few large traders, the whales, bought all the shares being dumped and then began to buy more, pushing prices higher. Soon those traders who had gone short on the lower opening were buying, covering their losing short positions. And at some point, the retail traders who had been long but had dumped their long positions began to realize price wasn't going lower—not today, at least—and they also began buying, establishing new long positions at higher prices. And so the gap was filled and price closed higher on the day—quite a remarkable recovery!

But does one bar like this mean the selloff is finished? Of course not. Price action must be observed carefully from these levels. Price will tell us when the downtrend is over: If we continue to see buying activity, there will come a point where a change in behavior is obvious.

This particular bar is interesting because of the failure of the large gap lower to hold, but at the moment, it is just something interesting to file away in the back of your mind as you watch price unfold from this point. Let's watch price unfold a bit and see what we notice.

First, let's find that wide range bar that gapped lower but closed higher—and you can see I marked it on this chart. You can see that bar did not signal price was about to skyrocket higher; instead, it was indeed something to file away in the back of your mind. There were “whales,” or large traders, willing to buy this stock as it traded towards it prior low.

Depending on the length of your holding period and how much risk you are willing to place upon your account, you can do different things with this information:

- If you are a long-term investor looking to add long-term positions to your portfolio, there may be a price down near the prior low where you are willing to buy some of this stock (it is a major company and has a very large daily volume, by the way) with a stop loss 30 to 50 cents below the prior low.
- If you are a trader who uses daily bars when trading stocks and has a holding period of days or a few weeks, you may be willing to watch price action before deciding where this stock is heading. You may be willing to trade time and price to get more information before you make a trading decision. Since I am a trader, not an investor, I am always willing to make this tradeoff.

So I watched patiently. As it traded lower from the wide range bar that gapped lower and closed higher and headed towards the prior lows, I had no sign from price that a change in behavior had occurred. I was willing to watch as price declined to see if the whales were still buying at lower levels, and to get me interested in getting long this stock, I would need to see some signs of strength.

Price traded lower but was unable to approach its prior low. Then price began to stair step higher. As I watched patiently, I began marking swing highs and swing lows. Price eventually climbed above two swing highs that I

had marked from the prior move lower (marked in dashed red lines), a measurement I generally use to tell me to pay attention, a change in behavior may in the making.

But let's go back to the clock spring analogy again: Price has climbed higher and it has taken out two prior swing highs. But it stopped right where the clock spring should have run out of directional energy if price was still vibrating with the same frequency. Price has now retraced 50% of its selloff, the amount of potential energy price found each time in the clock spring on the way down. To get me interested in buying this stock, I need a sign of strength, and I need to know there are buyers at higher levels.

Or perhaps I will be a seller as price retests the 50% retracement area.

Or perhaps I will continue to wait.

My actions at this point will depend on what price shows me next.

Price rallied even further, breaking above the halfway point marked by the blue multi-pivot line. It also left several unfilled gaps on the way up. Now price may have topped out. It has broken below several swing lows made during this current rally, a sign that generally makes me pay attention in case a change in behavior has taken place.

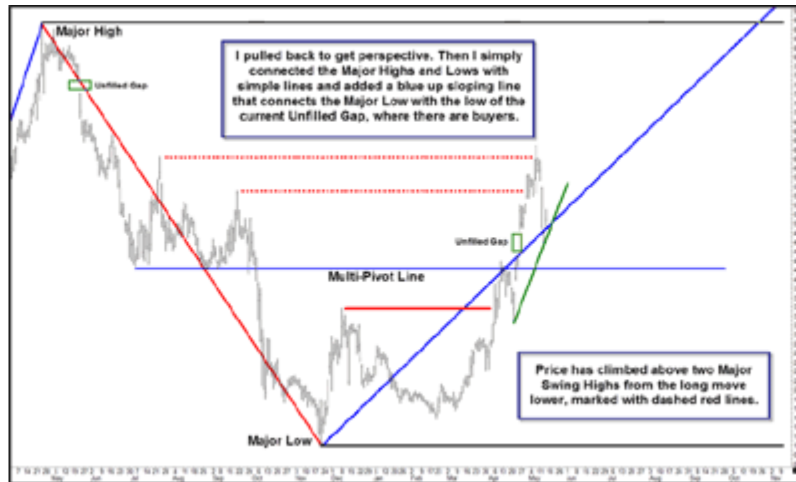
But look carefully at the last bar on this chart. Price has sold off below two prior swing lows, and these are signs of weakness. It tried to enter and fill an unfilled gap, but it failed to fill that gap. It gapped lower inside the unfilled gap, but closed near its highs. This is a sign of strength. Is this a sign that whales are interested in buying at these higher levels?
In my mind, the next bar should give me key information:

- If price turns lower and fills the currently unfilled gap, price is likely headed lower.
- If price heads higher, leaving this gap unfilled, it is a sign of strength, a sign that the whales missed this move higher (I certainly chose to sit on the sidelines while this stock rallied quite a bit) and have an interest to buy at this unfilled gap.
- If price trades quietly for a bar or two, which is always possible, I'll simply wait for price to show its hand. I believe price is now at a level where the next move will give me a clear direction.

Price gives me an indication that the whales have left limit buy entry orders at the unfilled gap area. I cannot overstate how much of an edge you have as a trader when you have the ability to read where the large buy or sell orders are sitting in the market by the price action on a simple bar chart. I learned this ability because I was one of the five or six cash forex traders who spawned the original term “whales” in the mid-1980's. It was easy for me to see my own “tracks” on a bar chart because I knew what orders I was working in the market and how these orders showed up in the price action. And I quickly learned what the “tracks” of the other whales looked like that traded in my active time zone. Eventually, the similarities of the whale tracks became apparent and it became second nature to me to be able to see these signs on a bar chart.

Now that I know there are whales feeding at the unfilled gap area and price has shown its hand by gapping and closing higher, what I am going to do with this information?

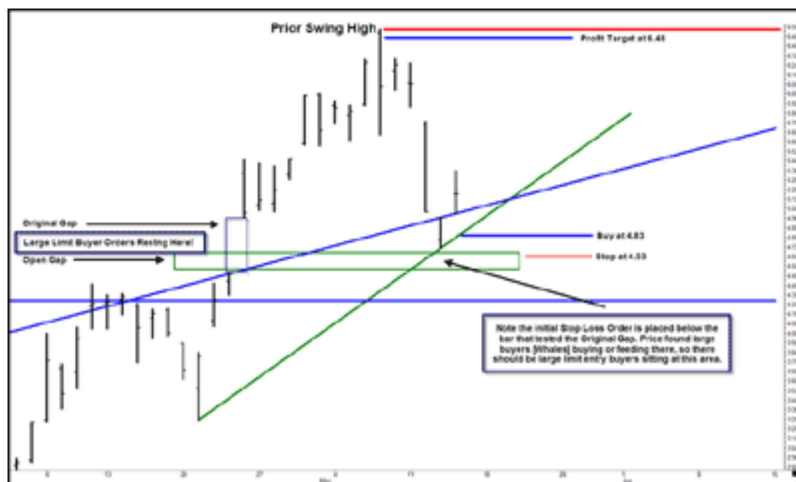
I add a simple trend line drawn from the low of the prior swing low below the multi-pivot line and connect it to the low of the bar that failed to fill the unfilled gap (where the whales have left large limit buy orders). Are there other things to consider?



I pull back for perspective and simply connect the major highs and lows with simple lines. I add a blue, up-sloping line connecting the major low and the low of the unfilled gap, where I know the whales have left limit buy entry orders.

Price has broken above two major swing highs from the long move lower, a sign that a change in behavior may have occurred, although I have mentioned this several times at various places that this is the first time price action has confirmed this potential change in behavior.

Now that both price and market structure have given me what I was looking for, let me show you my orders:



I want to buy a retest of the green, up-sloping simple trend line at 4.83. My initial stop loss order will be at 4.53, and if my limit buy order is filled, my profit target will be just below the last swing high, at 6.48.

Note that I placed my stop loss order below the low of the bar that failed to fill the unfilled gap, where I know whales have left large limit entry buy orders. If price begins to run through their orders, or if they pull their orders and the gap gets filled, I no longer have the market structure in place that spawned this trade idea.

Sometimes, you must be patient and diligent and stick with your plan until price decides to let your limit orders get filled. As each bar closed (especially because these are daily bars), I move my cursor to see where price will intersect with the green, up-sloping line. In this case, I got filled on the fifth bar. Because I am trading against an up-sloping line and the intersection price climbs higher with the close of each bar, there is a price where the risk/reward has eroded too much or the initial stop loss has gotten too large for me to continue to work the orders associated with this trading idea.

After moving my order higher four times, I am risking 63 cents to make a potential $1.32, which gives me a risk/reward of just over two to one. I rarely take trades with risk/rewards under two to one, so if I had not gotten filled on this bar, I probably would have pulled the order. I also like my retests to be between three and five bars after the initial test; once it takes more than five or six bars, I will generally pull my orders and watch price again, waiting for another clear sign that there are buyers or sellers in the market.

But I do get filled on the fifth bar at $5.16. I immediately check to make sure my initial stop loss is in the market and then I enter my limit sell order (my profit order) at $6.48. Then I check again to make sure I bought the amount of shares I wanted to buy, and at the price I wanted to buy them. Now is the time to find any problems, not after price has moved far away from this level. Once I am sure I have the position I want, and at the price I expected, I double check the orders I am working in the market. Now I have to watch price and execute the plan I made before entering the position.

Once I am long at $5.16, the next several bars are uneventful; then price begins to creep higher. When price gaps open higher and closes quite a bit higher, I cancel my initial stop and enter a break even stop loss order. Remember, the original risk/reward on this trade was barely acceptable to me, so this unfilled gap gives me an opportunity to “collapse” my risk. If price is not heading higher from here after leaving another higher unfilled gap, I don't want to lose money on this trade.

Once I moved my initial stop loss order to a break even stop loss order, price made an orderly climb higher and my limit sell order was filled at $6.48 four bars later, giving me a net profit (before brokerage) of $1.32. You can see the unfilled gaps played a major part in my thought process and decision making. Many traders don't understand the significance of gaps, and this article has just scratched the surface of their meaning and how to use them to your advantage. But understanding and using unfilled gaps, as I have in this example, is something you can practice and ultimately add to your trading tool kit.

I hope you found this example interesting and informative.

I wish you all good trading!