

How to Trade ES Emini Gaps

There is not a lot of middle ground when comes to the trading of gaps; traders either swear by them or ignore them. Gaps are formed by a variety of factors, and come in two distinct flavors. Some gaps are formed by institutional traders, others are formed by retail and novice traders, and it is important to be able to identify each type of gap in order to trade it properly. From the onset, let's characterize a gap as a significant break in the price action to the upside, or sometimes to the downside. Generally speaking, a gap will look like a missed bar followed by the resumption of the trading action at a significantly higher or lower level than the level of the gap origination. My personal favorite gaps are the ones formed at the opening of the trading of the day versus the closing price (I'm referring to the ES contract here) of the day before. Now I can hear the traders saying that the ES contract trades all night long, continuing directly into the next day. I give overnight traders little weight, as the direction of all night trading is not necessarily indicative of what the session traders are thinking at the opening bell. If there is a 10 point difference between the previously evenings close and the opening bell of the next trading session, there are some definite trading opportunities a trader should consider. My first consideration when evaluating a gap situation is to decide whether or not the gap is the result of professional traders or amateur traders. Here is my criteria for evaluating professional versus amateur gaps: 1. Professional traders are loath to jump on a bandwagon, which is to say they are not going to pile onto a stock rapidly rising or falling. Professional traders buy after prolonged wave of selling has occurred. Conversely, professional trade sell after a prolong wave of buying has occurred. (You might refer to my article about the NYSE tick to get a better handle on this phenomena)

2. Amateur traders buy into a prolonged wave of buying, and sell into a prolonged wave of selling. Quite simply, the want to jump on board a ride out any potential future gains. This is a dangerous strategy and one that I do not recommend. The inevitable outcome of piling onto a rising ES contract is generally to lose money when the gap contract losses steam and then rapidly fades in the opposite direction. Never underestimate the ferocity or intensity of these fades as they can be dramatic. As you may have already ascertained, gaps can be dicey business, and anyone who claims that any "gap will refill" may be only partially right. It takes careful analysis to trade a gap and non small amount experience to trade them properly. And true gap traders go so far as to classify gaps into three distinct flavors. 1. Breakaway gaps usually occur when a contract has been trading in a tight range, or consolidating pattern. At some point it often breaks out of this range and gaps out of it consolidating range. These potential gap situations are among my favorite gaps to trade by simply initiating buys and selling 1.5 points above and below the tight trading range and simply wait for a breakaway or breakdown in the consolidating pattern. This particular strategy, especially when accompanied by tight stops represent a low risk gap trading strategy. 2. Exhaustion gaps occurs when the market simply begins running out of steam and makes a last euphoric stab at new highs. These gap formations have not been profitable for me as it is very difficult to time the last gasp, which is also followed by a sharp move to the other direction. 3. Continuation gaps occur during a strong move, or trend, in and advancing price. Again, these can be tricky, but nowhere as treacherous as exhaustion gaps.

There are many windy books written on how to trade gaps, many which contain very specific parameters in which to initiate a gap-related trade. For my money, though, I look at gaps as follows: 1. If stocks start to accelerate upward after a significant period of buying, look to short. Usually amateurs are the driving force in the drive upward. 2. The exact opposite is true on the short side, if stocks begin a rapid move downward after a significant move down, look to go long. As you can see, I would rather match wits with the amateurs than the professionals. Futures trading is a zero sum game and experience is everything, I don't try to tangle with experienced traders, it usually isn't very profitable.

About the Author

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