

Lesson 2

Cluster Theory II

Now that we have established that balance regions (volume clusters) act as support and resistance, we need to observe the relationships of how exactly this happens.

Dalton discusses the idea of rejection and acceptance. Basically, price must constantly probe key reference areas in order to discover where current value is.

If you think about this, it should make sense to you. One example would be price going down to make a new low. Price must go down to test the low to see if there is any more business to be done there. If price goes to a new low and cannot attract any more business, price will reverse and an up auction will begin. This is something we see time and time again in the markets.

So, we can break these probes of key reference areas into a few different categories. Please note that Cluster Theory is research I have done in my studies of Auction Market Theory. You will not find this information anywhere else.

Failure Rejection

As price attempts to probe a previous balance region, price is rejected. Thus, the level holds and price reverses direction. There are three specific variations of this.

The first is price gets rejected before it even has a chance to enter the cluster. It gets rejected on the outer edge, which corresponds to a low volume area. The second is price enters the cluster and gets rejected somewhere between the outer edge and the mean, corresponding to a high volume area. The third is price pushes through the entire cluster and is finally rejected all the way at the other edge, corresponding to a low volume area. This variation is very rare. Although we are not discussing trading tactics based on these principles yet, it is important to remember this.

Pass-Through Rejection

This type of price reaction at a volume cluster is the rarest. The rejection comes in the form of price just rushing through the level with no opposite response whatsoever. Basically, the support or resistance you were expecting to show up never does. Please note again that this is the rarest occurrence.

Level Acceptance

This is when price gets “stuck” in the cluster. Price will test the level, find an opposite response, but the response will not be enough to drive price completely away. Price is accepted in the level and will start to rotate, once again forming balance in the same area.

So What Does It All Mean?

It means that by understanding these relationships, we can be ready to observe the market real-time in order to anticipate a reaction. As a level probe is being conducted our observation combined with our knowledge of them will allow us to make an educated "read" on the probe.

Let me give you an example. In an upwards trending market, we observe a price probe of a previous balance area below. We see no price reaction as it enters the upper edge as well as no reaction as it reaches the mean. This scenario leaves us with the possibility of a pass-through rejection, the third case in a failure rejection, or level acceptance. We have enough information to make an educated "read". Since we know that pass-through rejection is rarest, we can just assume that isn't going to happen. Of course, it will happen from time to time but our read is based on the odds. So, if we rule that out, we're left with a failure rejection at the lower edge or level acceptance.

Now think about those two actions. A failure rejection would mean price reverses to the upside, exits the cluster and continues the up trend. Level acceptance means price reverses to the upside but can't break free of the cluster. Price gets near the upper edge, but doesn't quite have the push needed. Price then falls back and starts to rotate in the previous balance area. Both of these scenarios results in a bounce off the lower edge and an up move to the upper edge. We have made a read that, given our understanding of price reactions, will lead to a high probability price move from the lower edge to the upper edge in the very least, which can be used to execute a trade.

Conclusion

Understanding these relationships is the last step in the beginner's learning process. Once this is understood you will be able to start putting Lesson 1 & 2 together to make trading decisions. I understand that you are probably more confused than ever after reading this text. Don't worry. We are going to go through examples in the video. Make sure you read this text a few more times until you feel you at least have the general idea, then move on to the video.