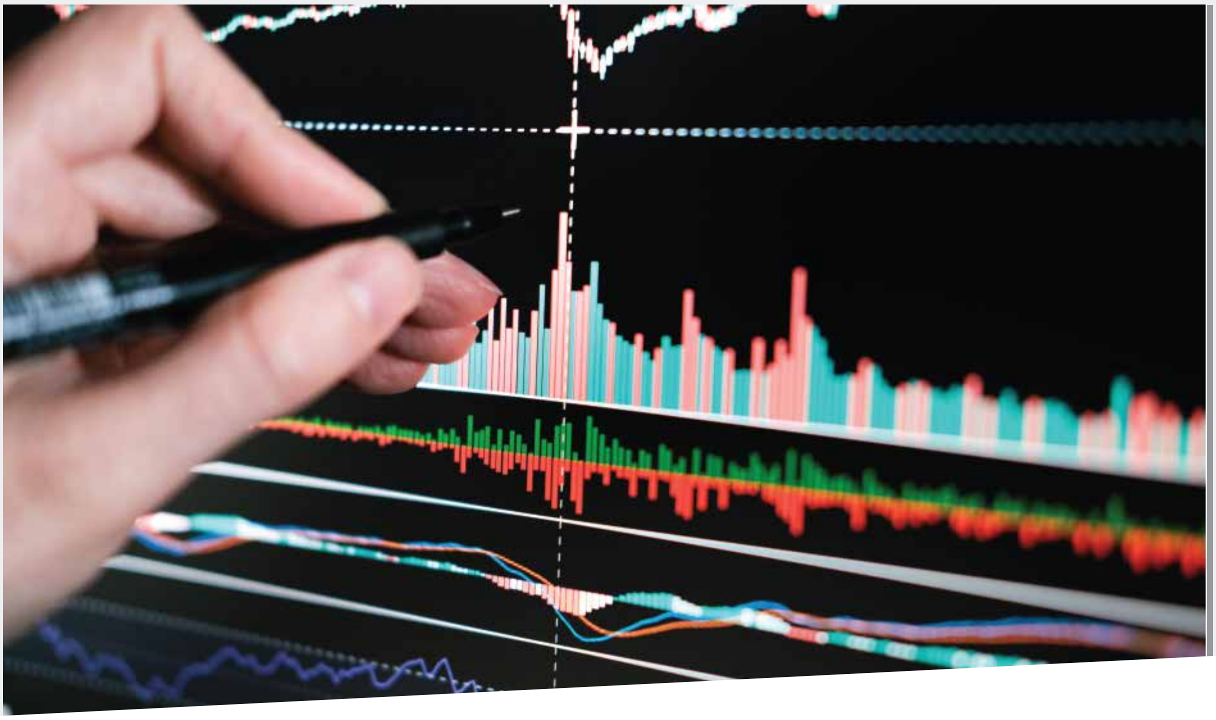
The Pilot Traders Beginner's Guide to Futures Trading



Learn the basics of the futures markets, trading, how to read financial charts, how to start your career as a trader, selling and buying, and how much to start with....

What Are Futures?

Futures are **financial contracts that obligate the buyer to purchase or the seller to sell an asset (like oil, gold, or stock indexes) at a predetermined price on a specific date in the future**. They were originally created to help farmers and businesses manage risk and stabilize prices. For example, a farmer could lock in the price of their crops months before the harvest, protecting against price drops.

Because the futures contract is an obligation to purchase or sell at a later date, the full contract value is not due upfront. However, the exchanges require margin—a small percentage of the contract value—to guarantee performance and reduce the risk of default by either party.

Today, futures are widely used not just for risk management but also for trading and speculation, which is where day traders and scalpers come in.

Basics of the Futures Market

1. Why Are Futures Traded on Margin?

Trading futures contracts on margin means that traders only need to deposit a small percentage of the contract's total value to open a position. This leverage allows traders to control large positions with relatively small capital. For example, if the margin requirement for a contract is 10%, a trader can control $100,000 worth of an asset with just $10,000. This amplifies both potential gains and potential losses.

2. How Do Exchanges Guarantee Performance?

Exchanges, like the CME Group, guarantee the performance of futures contracts through a system called a clearinghouse. Here's how it works:

- **Mark-to-Market**: Each trader's account is settled daily based on the closing price of their positions. This ensures that profits and losses are realized in real-time, reducing the risk of default.
- **Margin Requirements**: Traders must maintain an initial margin (to open a position) and a maintenance margin (to keep it open). If the account falls below the maintenance margin, a margin call is issued, requiring the trader to deposit more funds.
- **Default Protection**: The clearinghouse acts as the counterparty to every trade, ensuring that even if one party defaults, the other party is protected.

3. How Do Brokers (FCMs) Execute Customer Orders?

Futures Commission Merchants (FCMs) are brokers that execute customer orders on the exchange. Here's how it works:

- **Order Execution**: When you place an order, your FCM routes it to the exchange's trading platform, where it is matched with a counterparty.
- **Per-Contract Charges**: FCMs charge fees per contract traded. These fees cover their services, including order routing, execution, and clearing. Fees can vary depending on the broker and the volume traded.

- **Account Management**: FCMs also ensure that customers meet margin requirements and handle any margin calls.

We at Pilot Traders recommend that traders start with at least $50,000 in their broker account. This gives traders the ability to dollar-cost average their trades and manage the volatility in the futures market effectively. Of course, stop losses should always be used to mitigate ultimate risk in a trade. At a minimum, traders need $20,000 in their broker account to trade successfully. However, we strongly advise against putting $50,000 (or even $20,000) into a broker account if you cannot afford to lose that money. Trading futures carries inherent risks, and financial stability should always come first.

4. Different Indexes and Contract Values

Different futures contracts have varying values depending on the underlying index. Here are examples of the indexes we trade:

- **Nasdaq Futures (NQ)**: Each NQ contract represents $20 multiplied by the index price. For example, if the Nasdaq index is trading at 15,000, the contract value is $300,000. With a margin requirement of around $16,000, you can control $300,000 worth of the Nasdaq index.
- **S&P 500 Futures (ES)**: Each ES contract represents $50 multiplied by the index price. If the S&P 500 index is trading at 4,000, the contract value is $200,000. With a margin requirement of about $12,000, you can control $200,000 worth of the S&P 500 index.
- **Micro Nasdaq Futures (MNQ)**: Each MNQ contract represents $2 multiplied by the index price, making it 1/10th the size of the standard NQ contract. For example, if the Nasdaq index is trading at 15,000, the contract value is $30,000. This smaller size allows traders to participate with less capital, with a margin requirement of around $1,600.
- **Micro S&P 500 Futures (MES)**: Each MES contract represents $5 multiplied by the index price, making it 1/10th the size of the standard ES contract. If the S&P 500 index is trading at 4,000, the contract value is $20,000. This lower size and margin requirement (around $1,200) make it a popular choice for newer traders or those with smaller accounts.

These micro contracts allow traders to participate in futures markets with less risk while still benefiting from leverage and market movements.signaling a potential reversal to the upside.

Different Order Types

Understanding order types is essential for executing trades effectively in the futures market. Here are the main types of orders we use and how they function:

- **Market Order**: This Buy or Sell order executes immediately at the best available price. It ensures that the trade is executed quickly but may result in slippage, where the executed price is slightly different from the expected price.
- **Limit Order**: This order specifies the exact price at which you want to buy or sell. It ensures better price control, but the trade will only execute if the market reaches your specified price. At Pilot Traders, we use limit orders to dollar-cost average. This means breaking a trade into smaller parts and entering at various price levels, reducing the impact of market volatility and improving the overall entry price.
- **Stop Order (Stop-Loss)**: This order becomes a market order when a specific price level is reached. It's primarily used to mitigate risks by closing a position when the market moves against you. We also use stops to lock in profits when the market moves in our favor by setting a stop price at a certain profit level.
- **Trailing Stop**: This dynamic stop order adjusts as the market moves in your favor. For example, if you set a trailing stop $10 below the current market price and the price increases by $20, the stop will adjust upward, locking in additional profit as the market moves your way.

By using these order types strategically, we manage risk effectively while maximizing potential gains.

Understanding Candlesticks

Candlesticks are one of the most popular tools for analyzing price movements in the futures market. Each candlestick represents a specific time period (e.g., 1 minute, 5 minutes, 1 day) and provides four key pieces of information:

- **Open**: The price at which the asset started trading during the time period.
- **High**: The highest price reached during the time period.
- **Low**: The lowest price reached during the time period.
- **Close**: The price at which the asset finished trading during the time period.

Anatomy of a Candlestick

- **Body**: The rectangular part of the candlestick shows the range between the open and close prices.
  - A green body indicates that the close price is higher than the open price (bullish).
  - A red body indicates that the close price is lower than the open price (bearish).
- **Wicks (or Shadows)**: The thin lines above and below the body represent the high and low prices during the time period.
  - The top of the upper wick shows the high price.
  - The bottom of the lower wick shows the low price.

Common Candlestick Patterns

- **Doji**: A candlestick with a very small body and long wicks, indicating market indecision.
- **Hammer**: A candlestick with a small body at the top and a long lower wick, often signaling a potential reversal to the upside.
- **Engulfing Candle**: When one candlestick completely "engulfs" the previous one, indicating strong momentum in the direction of the engulfing candle.

By understanding candlesticks, traders can identify potential trends, reversals, and key price levels in the market.

Indicators: Exponential Moving Averages (EMA)

Exponential Moving Averages (EMAs) are technical indicators that smooth out price data to identify trends over specific time periods. Unlike simple moving averages, EMAs give more weight to recent prices, making them more responsive to current market conditions.

EMAs We Use

- **9-Period EMA**: Tracks short-term trends.
- **21-Period EMA**: Indicates intermediate trends.
- **50-Period EMA**: Highlights long-term trends.

How We Use EMAs

1. **Buy Signals**:
   A. We look for a strong upward trend when the 9-period EMA crosses above the 21-period EMA and both cross above the 50-period EMA.
   B. A buy signal is particularly strong when a bullish candle closes above the 50-period EMA.
2. **Sell Signals**:
   A. We monitor for a downward trend when the 9-period EMA crosses below the 21-period EMA and both cross below the 50-period EMA.
   B. A sell signal is confirmed when a bearish candle closes below the 50-period EMA.

By observing these crossovers and combining them with candlestick patterns, we can identify high-probability trade setups while maintaining clear risk management.

Support and Resistance

Support and resistance are fundamental concepts in technical analysis that help traders make informed trade decisions.

- **Support**: A price level where an asset tends to stop falling and may reverse upward. This occurs because demand increases as the price drops to that level, creating a "floor."
- **Resistance**: A price level where an asset tends to stop rising and may reverse downward. This happens because selling pressure increases as the price approaches that level, creating a "ceiling."

Pivot Points

Pivot points are specific price levels calculated using the previous day's high, low, and close prices. They act as potential support and resistance levels and help traders predict market movements. Pivot points are often used to identify:

- **Main Pivot Level**: A central price level that indicates the overall market trend. Above the pivot, the market is considered bullish, and below it, bearish.
- **Support Levels (S1, S2, etc.)**: Price levels below the main pivot that act as potential support zones.
- **Resistance Levels (R1, R2, etc.)**: Price levels above the main pivot that act as potential resistance zones.

How We Use Support, Resistance, and Pivot Points

- **Identifying Entry Points**: We look for support levels to buy, anticipating a bounce, and resistance levels to sell, expecting a reversal.
- **Setting Stop Losses**: Placing stop-loss orders below support levels (for long trades) or above resistance levels (for short trades) to minimize potential losses.
- **Determining Profit Targets**: Using resistance levels to set profit targets when entering long trades and support levels for short trades.
- **Breakouts and Pullbacks**: When the price breaks through support or resistance, it may indicate strong momentum. We often wait for a pullback to the broken level (now acting as the opposite: resistance becomes support, and vice versa) to confirm the breakout before entering a trade.
- **Using Pivot Points for Intraday Trades**: Pivot points provide additional guidance for short-term trading, helping us decide on entry, exit, and risk management levels.

Support, resistance, and pivot points are crucial tools that help traders identify where to enter, exit, and manage trades effectively.

Consolidated and Range-Bound Markets

A consolidated or range-bound market occurs when an asset’s price moves within a defined range without breaking higher or lower for an extended period. This type of market typically indicates indecision among traders, as neither buyers nor sellers have enough momentum to establish a clear trend.

Key Characteristics

- The price repeatedly bounces between support and resistance levels.
- Low volatility compared to trending markets.
- Often marked by smaller candlesticks or patterns that indicate uncertainty.

Risks of Consolidated Markets

- **Breakouts**: A consolidated market can eventually break out of its range, either to the upside or downside. If a trader is positioned on the wrong side of the breakout, it can result in significant losses.
- **False Breakouts**: The price may briefly move beyond the range but then return, trapping traders who expected a sustained breakout.

How We Trade Consolidated Markets

- **Wait for Confirmation**: Before entering a trade, we look for clear confirmation of a breakout beyond the established range.
- **Trade the Range**: While the market is consolidating, we may trade between the support and resistance levels, buying near support and selling near resistance.
- **Use Tight Stop Losses**: Given the risk of sudden breakouts, we use tight stop losses to limit potential losses.
- **Monitor Volume**: Increased trading volume can signal that a breakout is imminent, helping us prepare for potential opportunities or risks.

Consolidated markets can be tricky to navigate, but understanding their behavior can help minimize risks and identify profitable opportunities when trends eventually emerge.

What Is Day Trading?

Day trading involves buying and selling futures contracts within the same trading day, closing all positions before the market closes. The goal is to profit from short-term price movements.

Key Characteristics:

- **No Overnight Risk**: Positions are closed daily, avoiding risks from after-hours news or events.
- **Focus on High Liquidity**: Traders stick to highly traded futures (e.g., S&P 500, Nasdaq).
- **Requires Quick Decisions**: You need to act fast, as price movements can be rapid.

What Is Scalping?

Scalping is a type of day trading focused on making very short-term trades to capture small price changes multiple times a day. Scalpers may hold a trade for just seconds or minutes.

Why Scalping?

- Low Risk Per Trade: Since positions are small and short-lived, losses are usually limited.
- High Frequency: Multiple small wins add up over time.
- Requires Discipline: Scalping relies on strict adherence to a strategy and quick execution.

Software We Use

At Pilot Traders, we use **Orion Pilot Traders Edition,** a powerful trading platform. You can subscribe to our software on our website at pilottraders.com. This software has been developed over the last 20 years, incorporating our proven strategies and automating them for efficient execution. It is fully programmable, making it an essential tool for traders at any level. You can also see this software in action on our daily trading livestreams, Monday through Friday, from 6:45 A.M. to 10:00 A.M. PST

Risks of Trading Futures

While futures trading can be lucrative, it also carries significant risks:

- **Leverage Risk**: The same leverage that magnifies gains can also amplify losses. It's possible to lose more than your initial margin deposit.
- **Market Volatility**: Futures markets can experience sudden and extreme price swings, leading to rapid losses.
- **Margin Calls**: If your account balance falls below the maintenance margin, you'll need to deposit additional funds to keep your positions open.
- **Psychological Stress**: The fast-paced nature of futures trading can be mentally and emotionally demanding.

Mitigating Risks

- Use stop-loss orders to limit potential losses.
- Trade with a clear plan and predefined risk management rules.
- Avoid over-leveraging your account.

Final Thoughts

Futures trading and day trading/scalping can be highly rewarding but also risky. Start with these basics and practice using a demo account before risking real money. Always have a plan, use stop losses, and manage your risk carefully.

Risk Disclosure

Trading futures involves substantial risk of loss and is not suitable for all investors. Past performance is not indicative of future results. We at Pilot Traders are not investment advisors, and all trading decisions are made at your own risk. You should carefully consider your financial situation and consult with a licensed financial advisor if necessary before engaging in futures trading. Only trade with capital you can afford to lose.

Remember, the key to success is consistency, discipline, and continuous learning!

Trading Glossary: Key Terms to Know

Ask Price
The lowest price a seller is willing to accept for a security. Also referred to as the "offer price."

Bear Market
A market condition characterized by declining prices and pessimism.

Bid Price
The highest price a buyer is willing to pay for a security.

Bid-Ask Spread
The difference between the highest price a buyer is willing to pay and the lowest price a seller is willing to accept.

Breakout
When the price of a security moves outside a defined support or resistance level with increased volume, often signaling the start of a new trend.

Bull Market
A market condition characterized by rising prices and optimism.

Candlestick Chart
A chart that displays price movements using candlesticks, which show the open, high, low, and close prices for a specific time period.

Capital Gains
The profit made from selling an asset at a higher price than its purchase price.

Day Trading
A trading style where positions are opened and closed within the same trading day.

Drawdown
The peak-to-trough decline in an investment’s value, usually expressed as a percentage.

Fibonacci Retracement
A tool used in technical analysis to identify potential support and resistance levels based on the Fibonacci sequence.

Fundamental Analysis
The analysis of market sentiment, often through news, social media, and other indicators, to gauge trader behavior.

Futures Contract
An agreement to buy or sell an asset at a predetermined price at a specified time in the future.

Hedge
A risk management strategy used to offset potential losses in one position by taking an opposing position in a related asset.

Trading Glossary: Key Terms to Know

Index
A statistical measure of the performance of a group of stocks, such as the S&P 500 or Dow Jones Industrial Average.

Leverage
Using borrowed funds to increase the potential return of an investment. Leverage can amplify both gains and losses.

Limit Order
An order to buy or sell a security at a specific price or better.

Liquidity
The ease with which an asset can be bought or sold in the market without affecting its price.

Long Position
Buying an underlying asset with the expectation that its price will rise.

MACD (Moving Average Convergence Divergence)
A trend-following momentum indicator that shows the relationship between two moving averages of a security's price.

Margin
The amount of money a trader needs to deposit to open and maintain a leveraged position.

Market Order
An order to buy or sell a security immediately at the best available price.

Moving Average (MA)
A commonly used technical indicator that smooths price data to identify trends. Examples include simple moving averages (SMA) and exponential moving averages (EMA).

Option
A contract that gives the holder the right, but not the obligation, to buy or sell an asset at a predetermined price before a specified date.

Portfolio Diversification
A strategy that involves spreading investments across various assets to reduce overall risk.

Resistance Level
A price level where a security tends to find selling pressure, preventing it from rising further.

Risk Management

The process of identifying, analyzing, and taking steps to minimize investment risks.

RSI (Relative Strength Index)
A momentum oscillator that measures the speed and change of price movements, typically ranging from 0 to 100.

Scalping
A high-frequency trading strategy that involves making small profits from numerous trades throughout the day.

Short Position
The practice of selling an underlying asset with the intention of buying them back later at a lower price to profit from the decline.

Spread
The difference between the bid price and the ask price. A narrower spread indicates higher liquidity.

Stop Loss Order
An order placed to sell a security when it reaches a certain price, designed to limit losses.

Support Level
A price level where a security tends to find buying interest, preventing it from falling further.

Swing Trading
A trading strategy that seeks to capture short- to medium-term gains over a few days to weeks.

Take Profit Order
An order to close a position once it reaches a predefined profit level.

Technical Analysis
The study of historical price movements and patterns to forecast future price movements.

Trend
The general direction in which a market or security is moving. Trends can be upward, downward, or sideways.

Volatility
A measure of how much the price of a security fluctuates over a given period. High volatility means larger price swings.

Volume
The total number of shares, contracts, or lots traded during a given time period. High volume often indicates strong interest in a security.

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