IPS STRATEGIC CAPITAL

FINANCIAL Matters

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Trump's Tariffs: Lessons from 2018 and What to Expect in 2024

Winston Churchill once said, "The key to the future is to study the past; those who do not are doomed to repeat it." As former President Donald Trump signals his intention to reintroduce 25% tariffs on steel and aluminum, it's worth revisiting the impact of his 2018 tariffs. The stock market then saw an initial rally before experiencing a significant downturn due to inflation, rising interest rates, and trade uncertainties. Will history repeat itself?

What Happened in 2018?

In March 2018, Trump announced 25% tariffs on steel and 10% on aluminum, citing national security concerns. The tariffs were later expanded in June 2018 to include EU, Canada, and Mexico imports. The intent was to boost domestic manufacturing and reduce the trade deficit, but the results were mixed.

Immediate Economic and Market Impact

- **Higher Inflation:** The tariffs raised raw material costs for U.S. manufacturers, forcing them to pass costs onto consumers. Companies like Ford and General Motors had to lower their earnings forecasts due to higher steel prices.

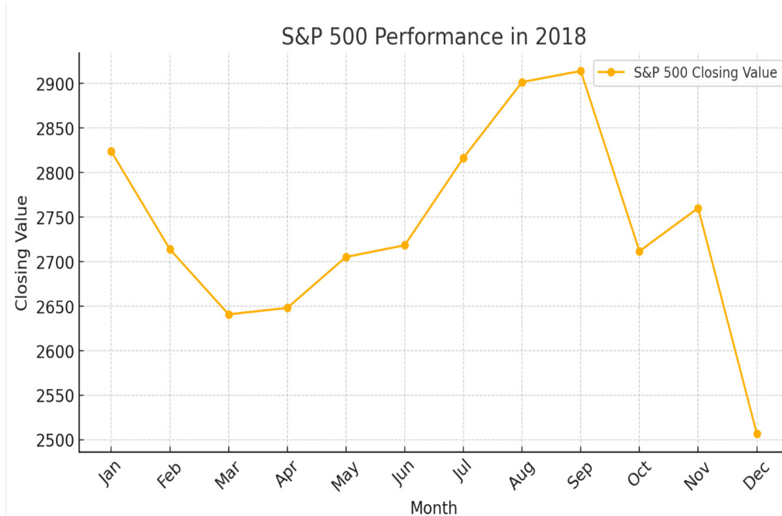

Figure 1: S+P Performance in 2018

- **Federal Reserve Response:** Inflationary pressures prompted the Federal Reserve to hike interest rates multiple times in 2018, tightening monetary policy and increasing borrowing costs.
- **Trade War with China:** China retaliated with tariffs on U.S. agricultural products and industrial goods, worsening global trade uncertainty.
- **Market Volatility:** The S&P 500 initially rallied in March 2018, but by September, concerns over interest rates and trade wars led to a sharp selloff. The market dropped over 20% by December, marking the worst year for stocks since 2008, (See Figure 1).

Global Response to the 2018 Tariffs

- **EU Retaliation:** The European Union imposed $2.8 billion in counter-tariffs, targeting politically sensitive U.S. industries like bourbon whiskey, Harley-Davidson motorcycles, and jeans.
- **Canada & Mexico Exemptions:** Trump eventually granted exemptions to these trading partners due to domestic manufacturer lobbying.
- **Minimal Boost to U.S. Steel Production:** While steelmakers saw short-term gains, they did not significantly increase production, and domestic steel prices remained high.

Trump's 2024 Tariff Plans: A Repeat of 2018?

Fast forward to 2024, and Trump is once again proposing 25% tariffs on steel and aluminum. The economic landscape has changed, but many of the same risks remain.

Similarities to 2018

1. **Tariff Structure:** The same 25% steel tariff

is being proposed, aimed at reducing imports and supporting domestic manufacturers.

2. **Inflation Concerns:** Just as in 2018, tariffs could raise costs for U.S. manufacturers, adding to inflationary pressures and forcing the Fed to keep interest rates higher for longer.

3. **Trade War Uncertainty:** The EU and China are likely to retaliate, just as they did in 2018, leading to potential disruptions in global supply chains.

Key Differences in 2024

1. **Higher Baseline Inflation:** Unlike 2018, the U.S. economy in 2024 is already dealing with elevated inflation, meaning tariffs could have an even greater inflationary impact.

2. **Federal Reserve Policy:** The Fed in 2018 was in a rate-hiking cycle, whereas in 2024, it is considering rate cuts. However, new tariffs could force the Fed to maintain higher rates for longer, hurting economic growth.

3. **Economic Recovery & EV Industry Impact:** The auto industry, already struggling with the transition to electric vehicles (EVs) and supply chain challenges, could be hit harder than in 2018. Companies like Ford and GM that suffered from higher steel prices in 2018 could again face margin pressures.

4. **China & Global Trade Shifts:** China has strengthened its global trade relationships since 2018, meaning it may have more leverage in a trade war scenario today than before.

Potential Market Reaction in 2024

Looking at 2018, markets initially shrugged off tariffs before the S&P 500 collapsed by over 20% in Q4 due to Fed rate hikes and trade tensions. If history repeats itself, the stock market in 2024 could experience:

- **Short-term optimism** as manufacturers see higher domestic demand.
- **Medium-term inflation** pressures lead to concerns about Fed rate policy.
- **Long-term market correction** if tariffs escalate into a broader trade war, impacting corporate earnings and global supply chains.

Final Thoughts: Will History Repeat Itself?

The lessons from 2018 suggest that while tariffs may offer temporary protection for U.S. industries, they come with significant economic risks—inflation, higher interest rates, corporate earnings declines, and market volatility. If Trump's new tariffs follow the same trajectory, investors and businesses should brace for potential disruptions.

While the full impact of the 2024 tariff proposals remains uncertain, one thing is clear: the past provides a crucial guide to what may unfold next.

Building a Bulletproof Portfolio: Why Hedging Enhances Diversification

Investors have long relied on diversification as a risk management strategy, a concept solidified by Harry Markowitz and William Sharpe's Modern Portfolio Theory (MPT) in 1956. While diversification helps spread risk by allocating capital across various asset classes, it has limitations—especially during extreme market conditions when correlations increase. Hedging, a strategy historically used in commodity markets and later adapted to equities, offers a solution by providing stability even in volatile environments. By incorporating hedging into a diversified portfolio, investors can achieve more consistent and stable returns.

Modern Portfolio Theory and Diversification

Markowitz and Sharpe's work on MPT demonstrated that investors could reduce overall portfolio risk by combining non-correlated assets. The key takeaway is:

- Risk Reduction: Diversification works as long as the correlation coefficient between assets is less than 1, meaning they do not move perfectly in sync.
- Limitations During Market Crises: In extreme volatility, such as the 2008 financial crisis, correlations between traditionally diverse asset classes often converge toward 1. This leads to steep losses despite a well-diversified portfolio.

Visualizing the Problem

Figure 2, is a chart showing how correlation increases during a financial crisis:

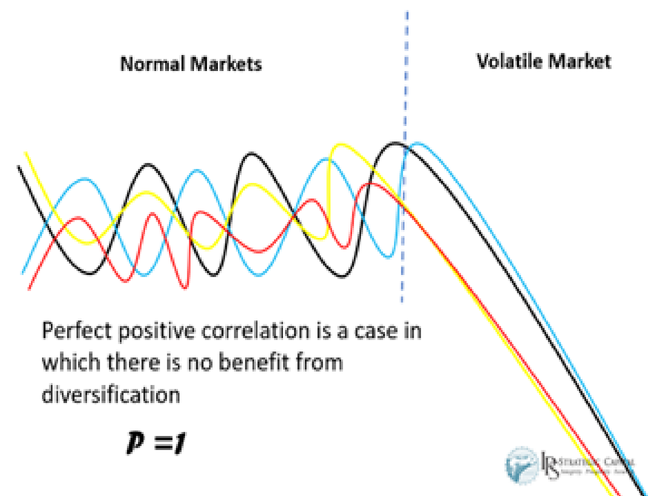

Figure 2: Crisis Correlations

The Evolution of Hedging

Hedging originated in the mid-1800s with the U.S. commodities market, allowing farmers, cattle ranchers, oil drillers, etc to lock in future prices and protect against unfavorable price movements. By the 1970s, financial markets adopted hedging strategies, with the Chicago Board Options Exchange (CBOE) launching financial derivatives such as options and futures.

Unlike diversification, hedging remains effective during market downturns because it involves taking counterbalancing positions not unlike an insurance policy. Common hedging instruments include:

- **Options:** Protective puts and covered calls mitigate downside risk.
- **Futures Contracts:** These helps offset losses in stock or commodity holdings.
- **Inverse ETFs:** Funds designed to move in the opposite direction of the market.

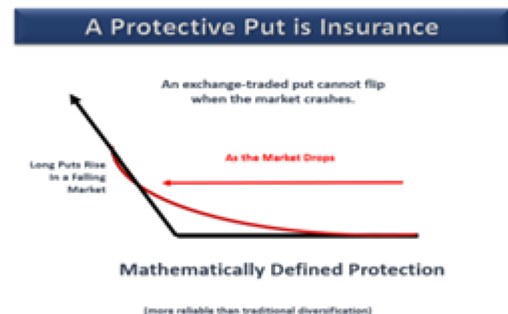

Figure 3: Protective Puts As Insurance

The Power of Hedging in Portfolio Stability

Studies have shown that portfolios incorporating hedging strategies achieve better downside protection without sacrificing long-term returns. Consider the following:

2008 Financial Crisis: The S&P 500 dropped nearly 58.5%, while hedged portfolios using protective puts limited losses to 10-15%.

- **2020 COVID-19 Market Shock:** Traditional diversified portfolios suffered major drawdowns, whereas those using hedging strategies outperformed by reducing volatility.
- **Risk-Adjusted Returns:** Hedging improves the Sharpe Ratio, a measure of return per unit of risk, making portfolios more efficient.

Visualizing Portfolio Performance

Figure 4, is a comparison of portfolio drawdowns with and without hedging.

Building a Bulletproof Portfolio

By combining hedging with diversification, investors can create a portfolio resilient to market turbulence. Key principles include:

1. **Diversify Across Asset Classes:** Spread investments across equities, bonds, commodities, and real estate.
2. **Utilize Hedging Instruments:** Implement options, futures, and inverse ETFs to offset downside risk.
3. **Regularly Reassess Correlations:** Market dynamics shift over time, requiring periodic portfolio adjustments.
4. **Focus on Risk-Adjusted Returns:** Optimize the balance between risk and reward to achieve stability.

Conclusion

While diversification is a foundational investment principle, it is not infallible—particularly in times of market stress. Hedging complements diversification by providing an added layer of protection, reducing losses during downturns, and enhancing risk-adjusted returns. By integrating hedging techniques, investors can build a truly bulletproof portfolio, ensuring long-term financial stability and success.

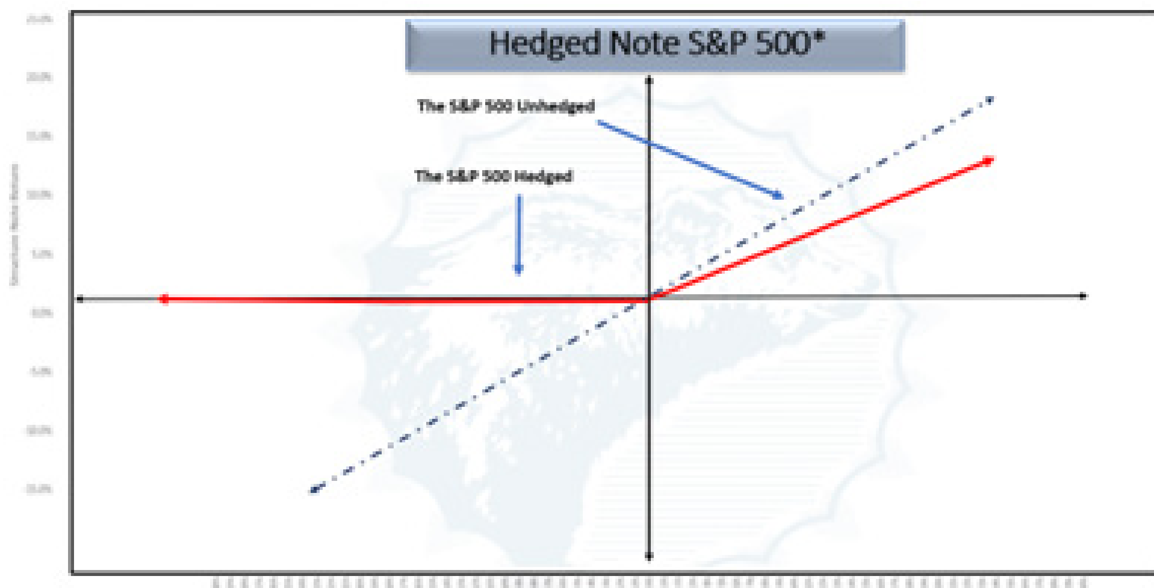

Figure 4: Comparison of portfolio drawdowns with and without hedging.

When planning for the future, many investors focus on returns—how much their money will grow over time. But what if I told you that it's not just the return on your money that matters? Instead, the volatility of returns plays a critical role in growing and preserving wealth over the long run.

This is where Monte Carlo simulation comes in. It helps investors understand how market fluctuations—especially volatility—impact financial longevity. Let's break it down in simple terms.

What is Monte Carlo Simulation?

Monte Carlo simulation is a powerful financial modeling tool used to predict how different market conditions affect a portfolio over time.

Instead of assuming a fixed return every year (which isn't realistic), Monte Carlo looks at:

1. **Historical volatility** – How much returns have fluctuated in the past.
2. **Mean return** – The average return over time.

Using these two inputs, Monte Carlo runs thousands of simulations (representing potential future years) based on statistical probabilities. This helps investors see a range of possible outcomes instead of just relying on a single average return.

Why Volatility Matters More Than Return

Most people think that wealth grows simply by earning high returns. But in reality, consistent, stable returns often build more wealth than high but unpredictable returns.

To understand why, let's compare two portfolios:

1. **Portfolio A**: High volatility, meaning returns fluctuate a lot from year to year.
2. **Portfolio B**: Same average return as Portfolio A but with lower volatility.

Monte Carlo Simulation Results

Below are two charts showing how Portfolio A and Portfolio B perform over time:

Chart A: High Volatility Portfolio

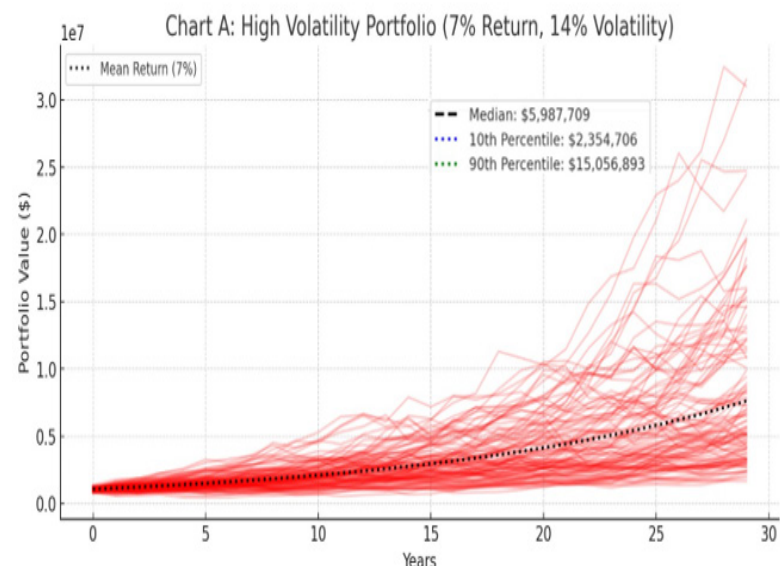

Figure 5: High Volatility Portfolio

- The portfolio has the same average return as Portfolio B, but with higher ups and downs.
- This leads to a greater risk of major losses that can hurt long-term growth.
- Investors may experience periods where their portfolio shrinks dramatically, requiring them to withdraw funds at a bad time.

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Chart B: Low Volatility Portfolio

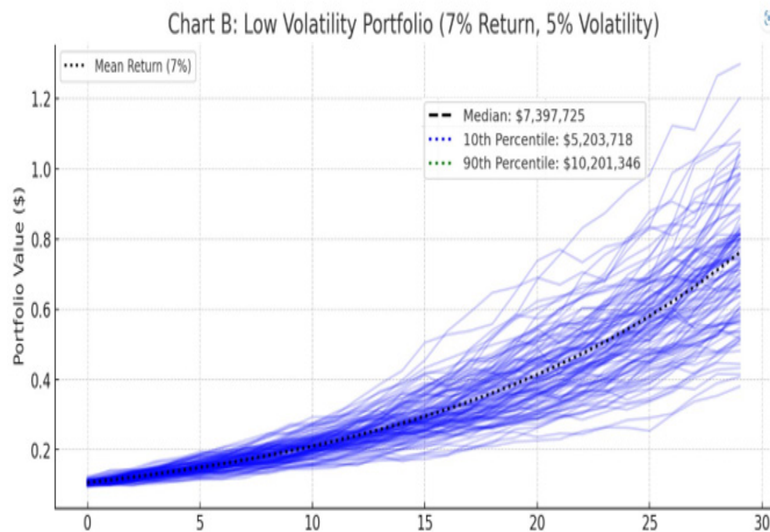

Figure 6: Low Volatility Portfolio

- Returns are steadier and more predictable.
- This reduces the chance of running out of money too soon during retirement.
- Over time, stable growth leads to better financial longevity.

Why Do the Final Accumulated Numbers Differ Despite the Same Mean Return?

Even though both portfolios have the same 7% average return, the final accumulated wealth is significantly different due to volatility and compounding effects. Here's why:

1. **Volatility Drag & the Impact of Negative Returns**

- In Chart A (High Volatility: 14%), the 10th percentile portfolio experiences severe downturns. Even though the average return is 7%, these large negative swings reduce long-term compounding potential.
- In contrast, Chart B (Low Volatility: 5%) experiences fewer sharp declines, allowing for steadier, more consistent growth.

2. **Compounding Works Against High Volatility**

- The power of compounding relies on consistent growth.
- In a high-volatility portfolio, a large loss requires an even larger gain to recover. Example: If you lose 50%, you need a 100% gain just to break even.
- The low-volatility portfolio doesn't suffer from these extreme swings, making steady growth more effective over time.

3. **Sequence of Returns Risk**

- If an investor needs to withdraw money during a downturn (as seen in the 10th percentile line in Chart A), they may lock in losses, making recovery much harder.
- In contrast, the low-volatility portfolio is more predictable, reducing the risk of selling assets at a loss.

Key Takeaways from the Charts

- **High volatility portfolios** have a much wider range of outcomes—they can grow a lot, but they also run a greater risk of significant losses.
- **Lower volatility portfolios** provide more consistent, reliable wealth accumulation, leading to a higher median wealth value despite the same 7% mean return.
- **Compounding** works better in a stable environment—lower volatility allows for more predictable and effective long-term growth.

This is why investors should focus not just on return, but also on controlling volatility—because in the long run, stable growth builds wealth more effectively than unpredictable high return.

How Historical Stress Testing Helps Investors

Monte Carlo simulations help investors understand possible future outcomes, but another crucial tool is historical stress testing.

Some portfolio visualizer software examines a client's current asset allocation mix and evaluates how it would have performed during major bear markets, including:

- **The Dotcom Crash (2000-2002)** – A nearly 50% market drop in the S&P 500 due to overinflated tech stocks.
- **The 2008 Financial Crisis** – A housing bubble collapse that led to a global recession and a 57% market decline.
- **The 2020 COVID-19 Crash** – A sharp but short-lived 34% drawdown due to pandemic uncertainty.

By running historical stress tests, investors can see:

- How much their portfolio would have lost during these crises.
- How long it would have taken to recover based on asset allocation.
- Whether their current portfolio can withstand similar market crashes in the future.

Why Most Advisors Don't Show Historical Drawdowns

Many financial advisors hesitate to show clients the worst-case scenarios for their portfolios. Why?

1. **Fear of Losing Clients** – If an advisor presents a historical drawdown where the portfolio would have lost 40-50%, the client might panic and take their money elsewhere.
2. **Short-Term Focus** – Many advisors emphasize short-term performance and "beating the market" instead of preparing clients for inevitable downturns.
3. **Lack of Risk Management Strategies** – Some portfolios are built solely on historical average returns without incorporating downside protection strategies, making them vulnerable in bear markets.
4. **Clients Don't Ask for It** – Many investors don't know to request historical stress tests, and advisors may avoid the conversation unless prompted.

However, successful long-term investors embrace these insights because they help quantify risk and ensure that their portfolios are truly built for financial longevity.

Key Takeaways

- Monte Carlo simulation helps investors

see the range of possible outcomes instead of assuming a fixed return.

- It models historical volatility and average returns to simulate thousands of possible future scenarios.
- A portfolio with lower volatility tends to last longer and perform better in the long run, even if it has the same average return as a high-volatility portfolio.
- Historical stress testing evaluates how a portfolio would have performed in major bear markets, helping investors make informed risk management decisions.
- Most advisors don't show historical drawdowns because they fear losing clients or don't focus on long-term risk management.

"My short-term risk management is to survive until Tuesday, And my long-term risk management is to survive until Thursday."

When it comes to building wealth and ensuring financial longevity, it's not just about how much you make it.

Would you rather have wild swings in your investments or a steady path to financial security? Monte Carlo simulations and historical stress testing can help you answer that question with confidence. IPS Strategic Capital can run these scenario's for our clients complimentary to examine assets held outside of our management.

Upcoming Luncheon

Join the IPS team at 240 Union Restaurant in Lakewood CO, and hear Dominick present on how changing tariff policy will affect the investment landscape, how to increase the certainty in your financial plan during uncertain times, and more.

Luncheon days and times:
Tuesday, March 18th at 11AM and 1:15PM
Wednesday, March 19th at 11AM

Please call or email Mallory to reserve your spot at mallory@investps.com or 303-697-3174.

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