Chain of Events

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Last Week's S&P 500 Index: +0.7%

Key takeaways

- *Now that a "Phase 1" trade deal appears to be agreed to by both the U.S. and China, a positive chain of events has the potential to become reality.*
- *As trade tensions ease, corporate confidence may lead to more capital expenditures (capex) spending, higher gross domestic product (GDP), and increased corporate earnings.*

So it appears that the U.S. and China have agreed to a "Phase 1" trade deal, although there is no signed paperwork at this point. That will likely occur in February if media reports are accurate. But keep in mind that the stock market has been anticipating postitive trade news for most of this year. We believe that is one of the major reasons why the S&P 500 has continued to march to new record highs with only a few minor stumbles along the way. An accommodative Federal Reserve along with easy monetary policies coming from virtually all of the other major global central banks have also helped push stocks higher. And all of this has occurred with very little chasing, at least up to this point, by the many underexposed equity investors who are sitting on what we would consider to be too much cash. A laundry list of well known uncertainties has kept money on the sidelines.

What we do know is that economic growth, and therefore corporate earnings growth, has experienced headwinds as companies have held back on capex over the bulk of this cycle and more recently as trade tensions intensified. It only makes sense that companies would take a cautious view on future economic activity when the two largest economies in the world are locked in a trade battle whose outcome is tough to predict. Look no further than the tumbling earnings of technology-exporting corporate giants located in countries like South Korea and Taiwan for indications that capex are struggling to gain traction.

Where will this positive news on the trade front lead? What might it mean for earnings and the stock market? Let's try to examine how the chips might fall now that it appears a Phase 1 deal is agreed to and close to being on paper and signed. To begin, as mentioned, many corporations have been hesitant to initiate any new capex campaigns given the trade uncertainties. An initial deal where trade tensions are lowered could lead to a change in the psyche of corporations in terms of economic uncertainty. While we wouldn't expect it to happen overnight, we believe easing trade tensions should lead to a higher degree of corporate confidence that the global recovery will continue into the future. Some of the many capex spending plans that have been shelved may be resurrected now that there is a clearer view of the playing field.

Should the above possibilities develop, economic growth would become less dependent on consumer spending as capex rose and added to GDP. It has been typical later in a cycle for the baton to be passed from the consumer to corporations as capex plans kick in to upgrade, expand, and meet rising demand. This can happen even in the modest-growth environment that we are expecting. It has been the U.S. consumer who has kept the current expansion moving ahead.

Then, finally, higher GDP resulting from a consumer who continues to spend plus the added capex investments resulting from more confident companies would have the potential to positively affect earnings and earnings growth in the quarters (and years) ahead. Stock prices have typically benefited from rising earnings over time.

This is the chain of events that, ideally, could play out and help keep this economic expansion and bull market intact.

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