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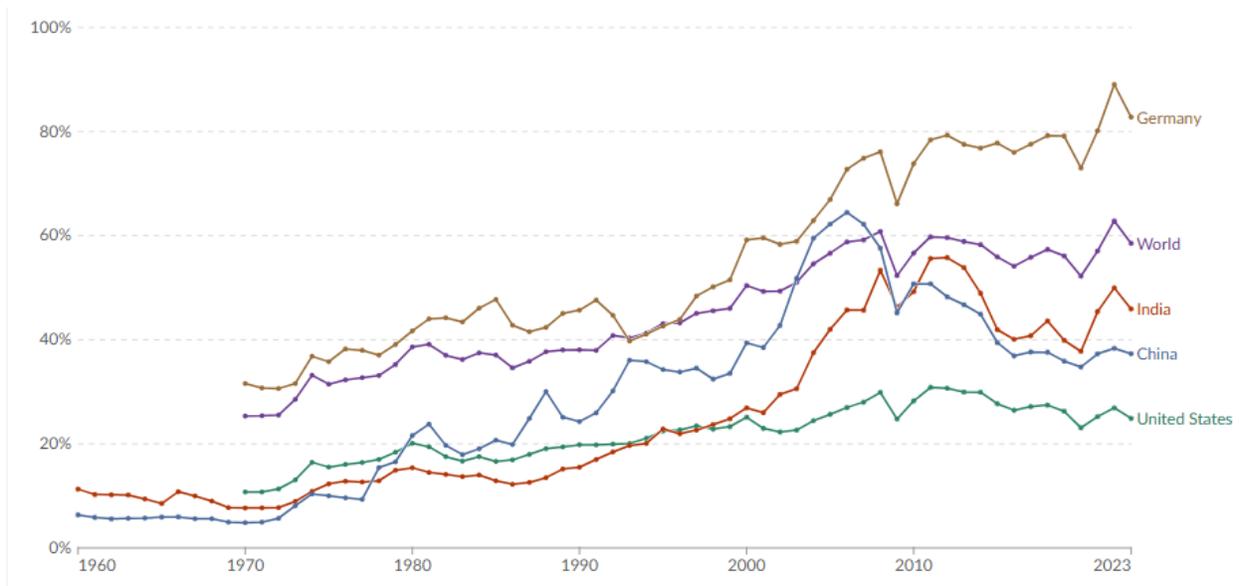
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**The Stock Market Takes Investors for a Ride**

**After suffering a 19% decline, including a steep drop following Trump’s tariff announcement on April 2nd, the S&P 500 has since rebounded 25%.** In our last quarterly report released on April 3<sup>rd</sup>, we noted that “it’s late to be selling stocks” and that “many technical indicators suggest that a bounce may be near.” Little did we know that the bottom of that correction came only days later on April 8<sup>th</sup>. We can only surmise why equity prices have come back so strongly. But it seems this remarkable rebound reflects the fact that Trump has thus far shown a willingness to bend and negotiate with important trading partners (despite caustic language); there has been no apparent effect on U.S. inflation from tariffs; the labor markets remain solid; investment spending remains strong; most Trump policies will benefit businesses operating in the U.S. Also, keep in mind that the U.S. primarily produces for itself and trade is a relatively small part of the economy. Lastly, it is becoming increasingly clear how amazingly useful artificial intelligence (AI) is. The impact on real productivity could be the kind of boost that comes along maybe every one-hundred years and similar in importance to the mechanization of farming.

**Trade as a share of GDP, 1960 to 2023**

Sum of exports and imports of goods and services, divided by gross domestic product, expressed as a percentage.



Data source: World Bank and OECD national accounts (2025)

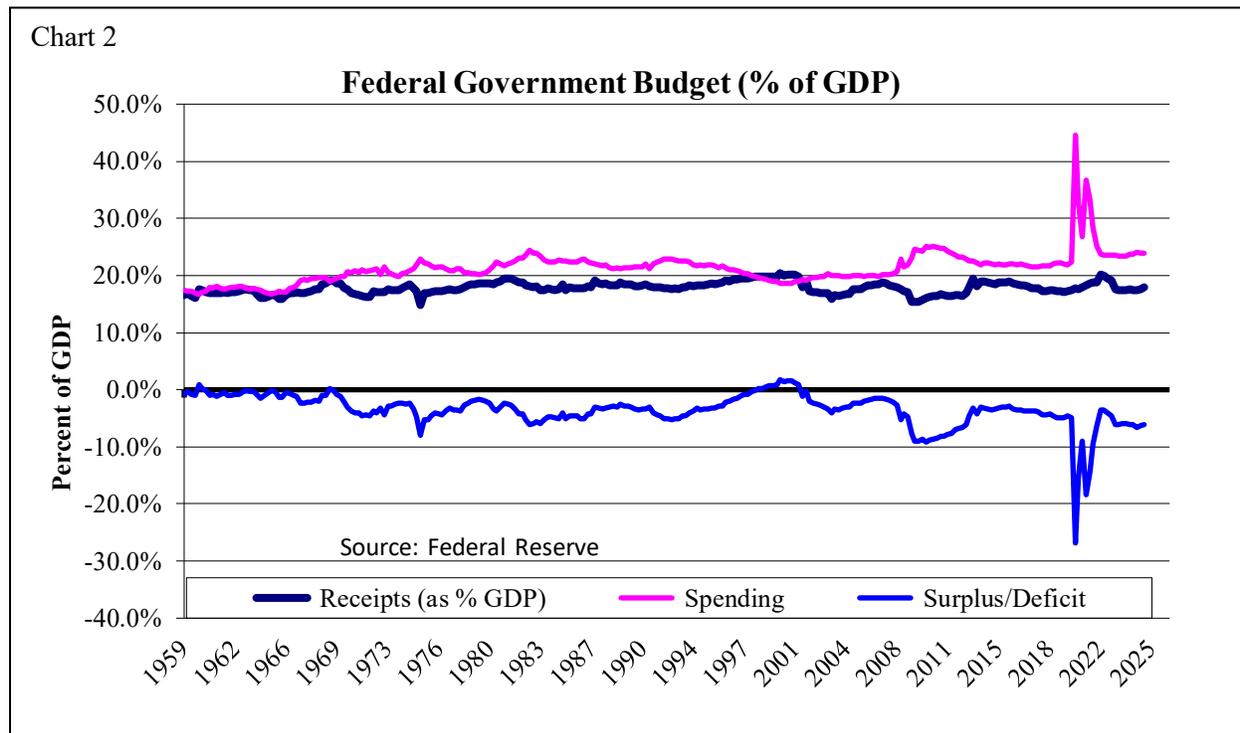
**The tariffs had a major impact on GDP data in the first quarter of 2025.** Personal consumption expenditures were up an anemic 0.5% annualized rate during the quarter, but gross private domestic investment increased at an amazing 23.8% rate. The game changer was imports, which were up at a 37.9% rate. Businesses rushed to maximize imports prior to the onset of new tariffs. Because of the rise in imports, which are accounted for as a subtraction, real GDP contracted 0.5% in the first quarter. Largely due to tariff effects, the consensus real GDP forecast for all of 2025 is now down to 1.5%. At the end of 2024, the consensus estimate for 2025 was 2.1%. Can we rely on these forecasts? It seems stock investors are more optimistic than the economists. Depending on the ultimate severity of the U.S. tariffs, and countervailing foreign retaliatory tariffs, results will vary. Nobody really knows. But one clue is Trump's repeated extensions of deadlines. He is a practical businessperson. It seems he doesn't want to burn the house down. The end result of his tariff policies may be less severe than initially appeared.

**The new U.S. budget bill has been subject to much misunderstanding as well as media inaccuracies.** The general criticism is that the bill will increase the deficit by more than \$3 trillion over a ten-year period because of big tax breaks to businesses and the rich. The new law also cuts Medicaid spending, which is the government health insurance for the poor (by U.S. standards at least). But here is some clarification: In 2017, a large tax bill became law that cut both corporate taxes, to make them more competitive with rates in other major economies, and individual income tax rates. The top corporate tax rate was cut from 35% to a flat 21% in 2017. The top income tax rate for individuals was cut from 39.6% to 37%. Some of those tax changes were scheduled to expire and revert to the pre-2017 levels at the end of this year. If those 2017 tax changes were allowed to expire, there would be a more than \$4 trillion tax increase as of 2026. The so-called \$3 trillion increase in the deficit is not an increase from current levels. It is a \$3.3 trillion increase from the level that would theoretically occur if the 2017 tax cuts were allowed to expire first. Compared to the current budget, the new law is estimated to reduce the deficit by some \$500 billion over ten years.

**In other words, the budget law is not some new tax cuts for the rich. What it does is make those 2017 tax cuts permanent, restores certain tax breaks for business investment, and also provides tax relief to retirees and low income families.** For example, the child tax credit for working families was increased from \$2,000 to \$2,200 and made permanent. There is a new \$6,000 tax deduction for seniors 65 years and older. When combined with other deductions, it is estimated that nearly 90% of seniors will owe no income taxes on their Social Security benefits. Social Security is the U.S. government "pension" system. The working class now will benefit from provisions in the bill that exempts income taxes on tips as well as overtime pay. For example, if a laborer gets 1.5 times his hourly rate beyond a 40 hour work week, the 0.5 portion would not be subject to income taxes.

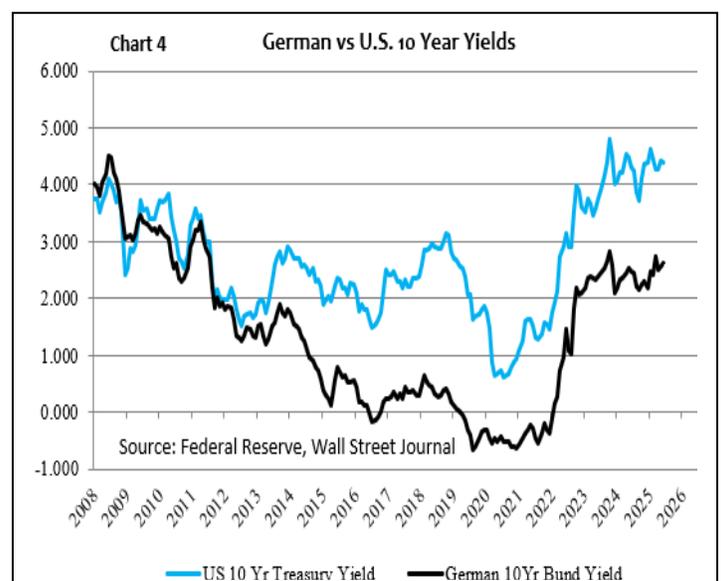
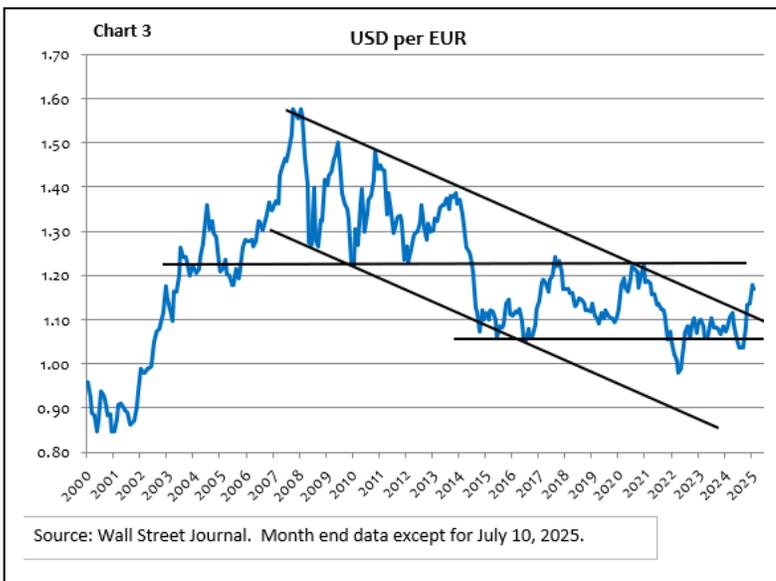
**The Big Beautiful Bill also restored certain tax breaks for business that are important for U.S. growth.** In the original 2017 law, businesses could immediately expense, i.e., deduct for tax purposes, research and development (R&D) spending. Businesses could also take bonus depreciation on capital expenditures, but these benefits were phased out starting in 2023. The new July 4, 2025 law restored these investment friendly tax benefits. The restoration of these policies will encourage capital investment, expansion, and innovation. For industries adopting AI and automation, the ability to write off these investments quickly improves return on capital and accelerates deployment. This creates a favorable environment not just for corporate earnings growth, but for broader economic productivity gains as businesses scale more efficiently.

**On the spending side, the most controversial and largest issue are cuts in Medicaid spending.** But to be accurate, the cut is a reduction in the rate of increase. Medicaid spending is now projected to grow at a 2% rate over the next ten years, down from the previous expectation of a 4.5% growth rate. Over the ten years through 2023, federal Medicaid spending increased at an unsustainable rate of about 9% per year. The most significant aspect of the new legislation is that able-bodied adults, age 19-64, must complete 80 hours of work per month, or participate in volunteer work, or attend school or job training. They could lose their benefits if they don't comply. Much of the criticism over Medicaid has been a rapid rise in single men in the program, which has corresponded with a decline in the labor force by men. The male labor force participation has fallen to 67.8% in June 2025, down from 72% in 2010 and 75% 25 years ago.



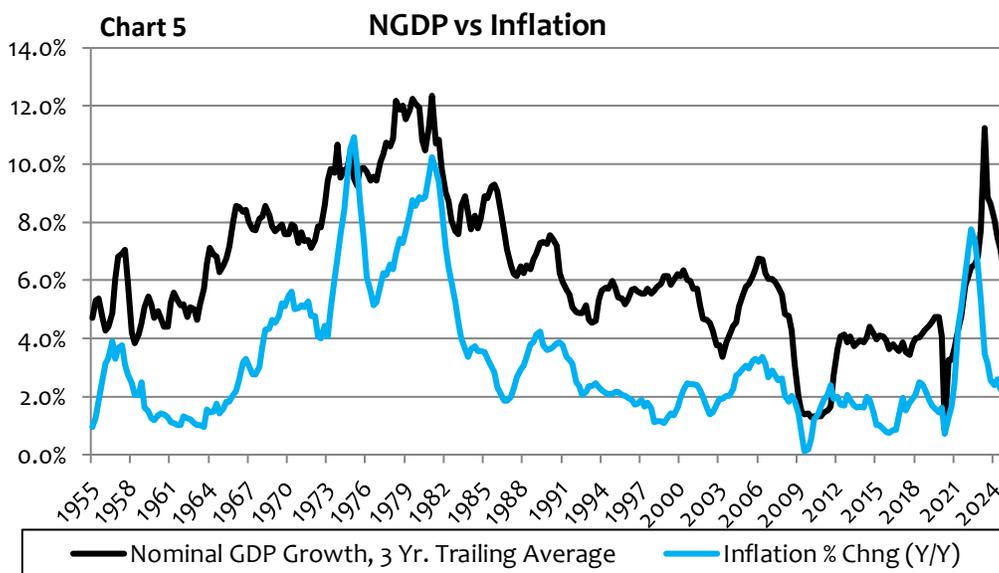
**It is rather interesting to note how steady federal tax receipts have behaved over the years despite ongoing changes to tax law (see Chart 2 above).** Federal tax receipts have averaged 17.8% of GDP from 1959 through the first quarter of this year. In 1959, federal income tax rates were as high as 91%, and yet tax revenues were only 16.6% of GDP, below the long-term average. In the first quarter of this year, tax revenues were 17.9% of GDP, a tick above the long-term average despite a top tax rate of only 37%. In contrast, federal spending has averaged 21.3% of GDP since 1959 and was 23.9% of GDP in the last quarter. Furthermore, it's clear to see that the federal budget deficits exploded during the pandemic due to spending. The problem has not been a lack of taxation.

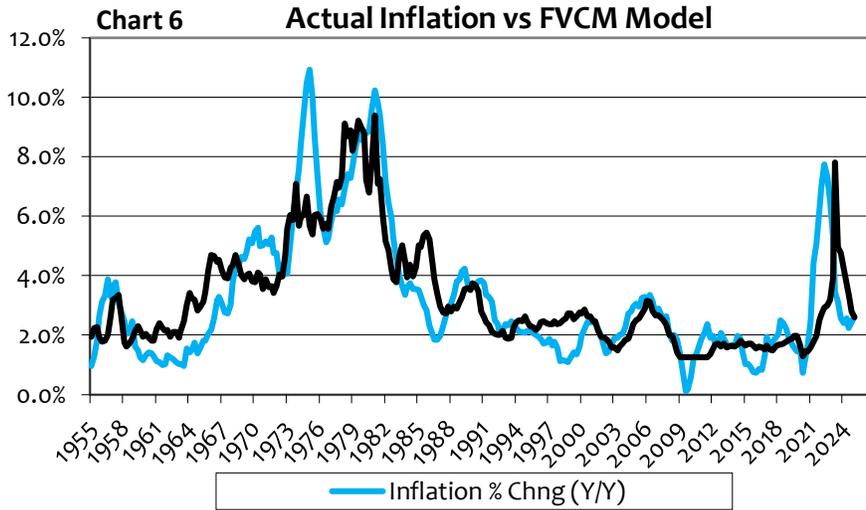
**Following its strong appreciation this year, the Euro has pulled back to around \$1.16 from its recent high of \$1.18. Upside for the Euro appears limited at this point.** The interpretation of changes in f/x rates is speculative, but it is widely agreed that they are largely determined by capital flows. Trump's rhetoric and tariff policies have clearly alienated people and discouraged capital flows to the U.S. However, ten-year bond yields in the U.S. remain relatively high and attractive. The investment environment in the U.S. continues to stand out, supported by a strong legal system and constitutional framework—despite political turbulence or media speculation. Technically, the Euro faces substantial resistance around the 1.22 USD level, which could cap further appreciation. While the downside for the dollar seems limited, a de-escalation in trade tensions may create conditions for a potential rebound in the USD.



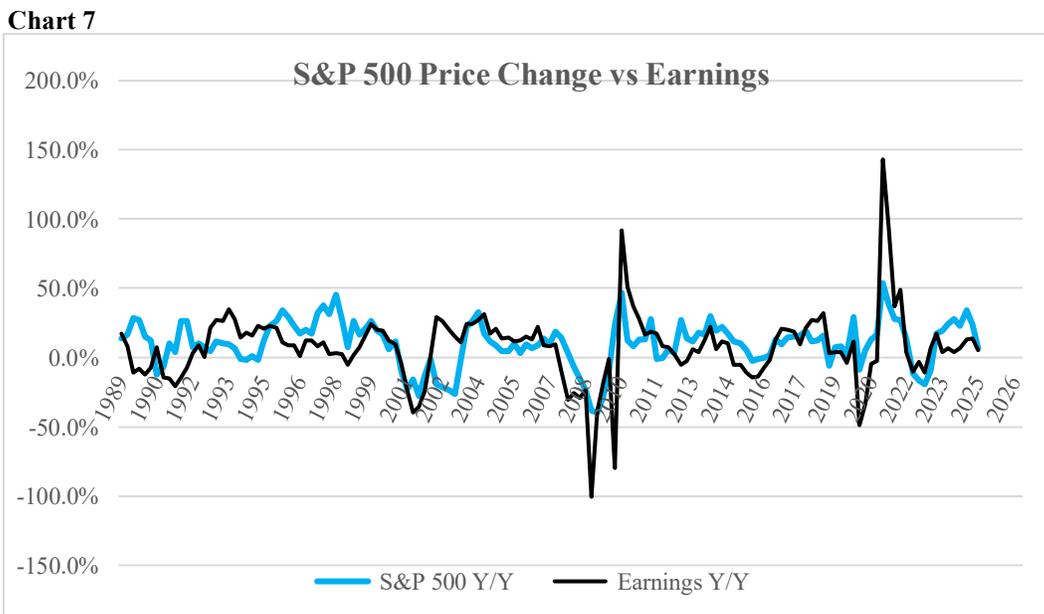
**Corporate earnings reporting season has just begun, and the expectation is that earnings growth for the 2025 second quarter will be modest—about a gain of 5%, year-over-year, with revenues also up about 5%.** The mediocre results reflect the Federal Reserves’ relatively high interest rate policy, which is having a depressing effect on spending and nominal GDP. On the other hand, the weaker dollar should start to have a positive impact. Somewhere around 40% of the earnings of the S&P 500 are derived from sales and production overseas. Those profits translate into more dollars when the USD weakens. Ordinarily profit margins would widen under these circumstances, but the administration’s tariff policies will pressure profit margins. Companies will absorb some of the tariff costs of foreign production rather than try to recoup the higher costs by passing them on with higher prices to consumers.

**The slowdown in spending and nominal GDP growth is depressing corporate earnings, but the good news is that inflation is expected to continue to head lower.** In Chart 5 below, you’ll notice how the year-over-year rate of inflation tends to track nominal spending over the previous three years. Our model in Chart 6, essentially tries to put that relationship together. During the pandemic, the model performed very poorly because, with many people staying at home and not producing and yet getting support checks from the government, there was a sudden and atypical spike in inflation. But with the trailing three-year growth rate in nominal GDP down to 5.9%, as of the first quarter of 2025, the model estimates inflation at 2.6%, which is exactly what it was. Furthermore, nominal GDP grew at a meager 3.2% annual rate during the first quarter of 2025 and the trailing average and inflation should continue to fall—probably much more than people expect.





As we have seen during the first half of this year, the stock market has a tendency of sometimes rising and falling in somewhat extreme ways--down 19% and then up 25%. As shown in Chart 7 below, there is a loose relationship between the year-to-year rise in earnings and the rise in stock prices. But the relationship is not only loose, sometimes we see earnings leading the market, and sometimes the market leads earnings. But what is fairly clear, recessions result in sharp drops in both earnings and stock prices. That is usually the best time to commit new capital to the stock market, but also the time most people are two anxious about the economy and business. Because of this unpredictable volatility, it is generally best to stay invested throughout the cycles.

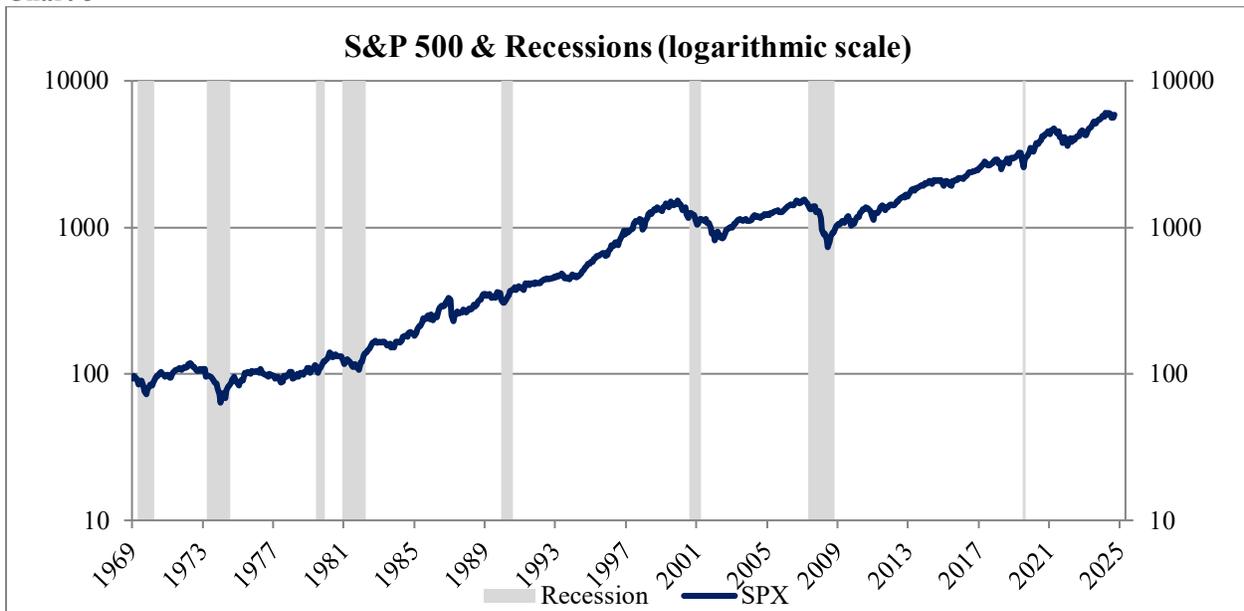


**The U.S. economy has proven to be amazingly resilient and increasingly so. Earnings should continue to trend higher.** The time between recessions and major bear markets appears to be lengthening (see Chart 8 below). Past recessions were created or exaggerated because of erratic monetary policy. There have been lessons learned, and improvements made. In decades past, the business cycle was exaggerated by high inventory levels and the need by businesses to reduce production and labor in order to cut inventories when spending falls. Inventory management is much more advanced than in the past. Also, the economy is much larger and more “services” oriented, which is inherently more stable. Furthermore, advanced information systems help businesses adjust quickly to changes in conditions in ways that help reduce recessionary contractions. And as we previously discussed, AI may prove to be as important to national productivity as the mechanization of farming. Just as tractors and combines transformed agriculture, freeing up labor and driving massive gains in output, AI is now poised to revolutionize sectors from manufacturing to healthcare to logistics. Adding to this optimism, the Big Beautiful Bill will help foster growth by improving business incentives, boosting corporate investment, and enhancing after-tax returns. This pro-growth policy backdrop points to a sustained period of innovation-driven productivity gains, further reinforcing the case for long-term equity exposure. These are compelling reasons to stay bullish and invested.

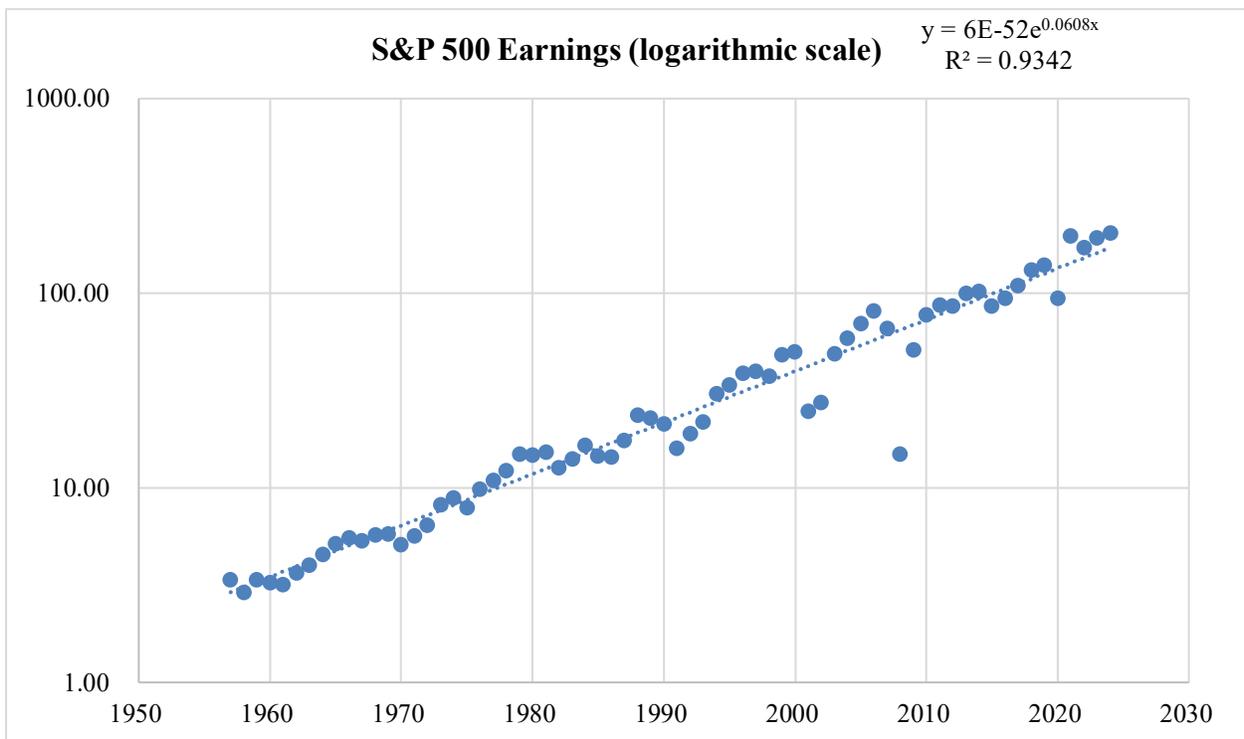
**The outlook for inflation is also bullish for stocks.** We are going through a slowing in growth at present as the Federal Reserve, contrary to what President Trump thinks, does the proper thing by keeping interest rates high to ensure that inflation continues to head lower. Nothing is more corrosive to business and investment than inflation. It is arguable that the Fed is better staying overly tight and for too long, rather than ease prematurely. Why? The pain of easing monetary policy prematurely and having inflation rebound, would force the Fed to raise rates again under conditions where employment is already weakening. If it becomes clear that inflation is materially below the Fed’s 2% target, we will have the pleasure of experiencing reductions in interest rates with low inflation. That is an environment that will benefit stock prices.

**Looking at the months ahead, there are naturally many unknowns about the economy and the direction of stock prices. Expect volatility but stay invested anyway.** The tariff negotiations add a level of uncertainty because these factors are not something businesses and markets have had to contend in recent history. These factors are “outliers.” However, in addition to the positive tax incentives recently made permanent, other efforts to streamline bureaucracy and reduce government regulations will make it easier to build electrical infrastructure, encourage commercial and home construction and other capital projects, and will foster economic growth. Expect the U.S. economy to continue to outpace Europe, Japan and most other parts of Asia, including China, which is in crisis.

Chart 8



Source: S&P Global, FVCM



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# U.S. MARKET REPORT

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