January 2025

MARKET UPDATE

In mid-December, the Federal Reserve cut rates by another 0.25 percentage points. However, the biggest news came at the press conference when they signaled a more hawkish stance heading into the new year, signaling just two rate cuts next year, down from four projected just a quarter ago. This moved nearly all capital markets with a dramatic upward shift in the yield curve, pushing bond prices down, and equity market volatility that was particularly harsh in US small cap stocks.

The Russell 2000 was the worst in the month, losing 8.26%, with the Russell Midcap index not far behind, losing 7.04%. The story of smaller companies being more dramatically impacted by shifting expectations in rates has been a frequent story in 2024. Recall that smaller companies generally have fewer options for credit and those are typically more expensive than marquee large cap companies. That has meant when rate expectations fall, small and mid-cap stocks may benefit, but the reverse is also true, which is what happened in December.

The rate moves punished bond investors again, with the Bloomberg US Aggregate falling 1.64% in December though staying positive for the year, up 1.25% for 2024. The yield curve is almost in a more normal upward sloping shape, though is still a bit jagged at the short end of the curve, but the recent moves, particularly in the 5-year maturity and beyond, has moved the yield curve into its steepest position in quite some time.

Across the economy, jobs continue to be fairly stable, rebounding as expected, in the November report following October’s meager reports amid the strikes and hurricanes. On the consumer front, initial reports of holiday season sales appear positive, and the latest retail sales report showed that sales rose 0.7% in November, boosted by car sales and online shopping. Inflation improvement has effectively stalled with headline inflation rising over the last two reports, which has contributed to the new Fed narrative. Expect the Fed to continue to dominate the market narrative as 2025 gets going.

ADVISORS’ PERSPECTIVE

January 2025 opens with a sense of caution after a sharp spike in the VIX, triggered by the December 2024 Federal Open Market Committee (FOMC) meeting. The markets reacted swiftly as expectations shifted, revealing the Fed's continued vigilance against inflation despite signals of economic growth. Investors had been bracing for a potential shift in the Fed's stance, but the announcement reinforced a hawkish tone. This led to a notable sell-off, pushing volatility higher, as the likelihood of extended high rates took center stage. Changing monetary policy expectations have been one fairly consistent source of volatility across the year and will likely remain a major market theme heading into 2025.

Looking back at 2024, the S&P 500 had an impressive run, posting 57 new all-time highs throughout the year. However, such banner years often create a sense of uncertainty in the year that follows. The optimism that drove equities to new heights was fueled by strong corporate earnings, resilient consumer spending, and a better-than-expected economic recovery. Yet, there were pockets of concern about the sustainability of growth given global geopolitical tensions and the still-evolving impact of higher interest rates. This backdrop raised doubts about whether the market could continue its momentum into 2025.

Despite these concerns, there’s a sense that inflation, while still a challenge, is well off its peak. Consumer prices have been moderating, but there are still key sectors experiencing price pressures. The labor market has shown resilience, which could keep wage inflation elevated, particularly in service sectors. This will be a critical variable to watch as it will influence both inflation trajectories and the Fed’s future decisions.

As we head further into 2025, the markets may continue to grapple with these competing forces. The S&P 500’s performance following banner years often shows a cooling period as investor enthusiasm slows and profit-taking increases. The VIX’s recent spike suggests that volatility could persist in the near term as markets adjust to the Fed’s stance on inflation and rates, corporate earnings slow down, and geopolitical tensions linger. It remains to be seen whether the broader market can sustain the growth seen in recent years, or whether 2025 will mark a period of consolidation as investors await clearer signals from the Fed and global economies. The start of the new year suggests a year of careful navigation, where patience and risk management will be key.

We remain cautiously optimistic and continue to use a quantitative investing approach. In times of uncertainty, it is more important than ever to follow the data and not make decisions based on emotions. Hilltops partnership with Helios relies on facts and data, which we use during our recalculations on a bi-weekly basis. Our models adjust appropriately to market conditions.

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