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Quarterly Market Review

Fourth Quarter 2014

Homestead Funds

Summary

- The Federal Reserve (Fed) held fast to its commitment to end the fiscal stimulus policy known as Quantitative Easing (QE) during the fourth quarter, while setting the stage for a rate increase sometime in 2015 — a move likely to spur increased market volatility.
- The rapid decline in oil prices dominated economic news in the fourth quarter as burgeoning supplies exceeded global demand.
- The U.S. economy continued to demonstrate broad strength through the quarter, supported by a resurgence in consumer spending. As if setting the stage for continued market leadership in 2015, the U.S. easily outperformed most of its overseas counterparts.

Homestead Funds client services team would be happy to talk with you about your goals and current investment program. Give us a call at 800.258.3030.

Macroeconomics

While most of 2014 proved relatively calm, the sharp drop in oil prices in the fourth quarter, and a one-day "flash crash" in the Treasury market in October, offered investors a somewhat wilder ride at year-end than they had experienced earlier.

Oil's price decline, which generated concerns over a potential deflationary spiral and possible global recession, also complicated Fed efforts to raise short-term rates. With oil prices so weak, it was not surprising that yields at the long end of the Treasury market would drop also.

In addition to oil, prices for commodities and materials also slipped substantially as the dollar strengthened, which further contributed to the deflationary mood.

Meanwhile, tepid fundamentals from international equities solidified overseas positions as also-rans when compared with the strength of the U.S. market. As their country economies appeared to be slowing, central banks in Europe, China and Japan continued to implement approaches for stimulating growth.

Meanwhile, the Fed formally wrapped up its QE policies in 2014 in preparation for raising short-term rates at some point in 2015 — the first time it has taken this step in many years.

The continued surge in oil production from North America and elsewhere exceeded lackluster demand. The fourth quarter's price decline reflected the fact that worldwide supply favored buyers not sellers.

While deflation has its appeal in the short term (who doesn't like to have more money to spend?), the general decline in price levels can have a negative impact on the economy over the long term when larger, big-ticket purchases are postponed in the belief that they can be bought tomorrow at cheaper prices.

Bonds

Generally, bond investors in 2014 did better the farther they went out on the yield curve — which was the exact opposite of 2013.

The benchmark Bank of America Merrill Lynch 1–5 Year Corporate/Government Bond Index returned 0.40% for the quarter, up 1.51% for the year, while the Bank of America

Bonds continued

Merrill Lynch 1–5 Year U.S. Treasury Index gained 0.49% for the quarter and returned 1.24% for the year.

Oil prices declined and the U.S. dollar gained further ground in the fourth quarter. Accordingly, while the potential for Fed action weakened the short-term end of the market, the longer-term end was helped by deflationary activity. Three-year Treasury note yields ended the year higher, while five-year note yields dipped and long Treasury yields declined sharply.

For the Homestead Short-Term Bond Fund and the Homestead Short-Term Government Securities Fund, we took steps to further reduce liquidity in the fourth quarter, a move dictated less by feelings of bullishness than by our sense that there was no longer any point waiting for the Fed to raise interest rates. Rates had already moved up a bit, plus volatility and other factors produced some attractive investment opportunities. The funds' durations remained below those of their benchmark indices.

The credit markets experienced an unusual degree of volatility during the quarter. In addition to the macro factors noted earlier, investors were spooked by what turned out to be unfounded fears that a major bond investor, PIMCO, was selling off a large supply of its issues following the resignation of one of its founders.

The fixed-income markets could be in for even more turbulence in 2015. The "push and pull" dynamic between the Fed and market forces, which dominated the credit market in 2014, can be expected to spill over into 2015. The extent of volatility in store will depend on whether the Fed follows a slow, measured approach to rate policy or it feels compelled to take more dramatic actions. The market is currently betting on the former.

Equities

Like a football game in its first quarter, the end-game impact of sharply lower oil prices on the global equity markets can only be approximated at this early stage.

While there should be an immediate benefit to consumers in large oil-importing countries and regions, including China, Japan, Europe and India, there could be some negative impact on countries whose economies are largely dependent on oil exports, including Russia, Venezuela, the U.S. and many Middle Eastern nations. China faces a cyclical and possibly even structural slowdown, which has helped push prices for oil, copper and many other commodities sharply lower. This in turn puts pressure on commodity-exporting countries in emerging markets and elsewhere.

Still, the lower prices at the nation's gas pumps mean the American consumer has more money in hand. From the standpoint of stimulating consumption and increasing corporate profitability, the decline in oil prices is a positive. Eight of the 10 sectors in the S&P 500 Index posted positive returns during the period[1] — from technology, health care, telecom, consumer durables and financials to consumer staples, industrials and utilities. For other sectors, particularly energy and pockets of the manufacturing, capital equipment and other businesses with exposure to energy, a decline in oil prices typically triggers a slowdown in activity that puts downward pressure on revenue growth and profitability.

The S&P 500 Index, a barometer for large-capitalization performance, returned 4.93% for the quarter and 13.69% for the year, while the small-cap benchmark, the Russell 2000 Index, returned 9.73% for the quarter and 4.89% for the year.

The challenges consumers and corporations will face in 2015 are significant. Transitioning from a Fed-driven interest rate environment to a market-driven interest rate environment will contain potential perils. To help counter these unknowns, we pay particularly close attention to the management teams of the companies we research for our portfolios. We favor those teams with exceptional track records for thinking ahead and knowing their businesses intimately. We look to take advantage of their highly specialized knowledge and experience as they deploy their resources in pursuit of improving their standing within their industries.

We think of these leaders as protagonists whose exceptional backgrounds prepare them for the timely decision-making required to profit from situations while others might choose to deliberate from the sidelines.

The equity markets could exhibit heightened volatility in coming quarters as investors try to sort through a complicated mix of macroeconomic factors. Rather than follow the momentum of the market or the euphoria of the moment, we continue to focus on fundamentals and apply a rigorous analysis of each holding's potential for risk and return.

[1]Source: FactSet, *Sector Returns Represented by S&P 500 Sectors,* 4Q '14

Homestead Funds

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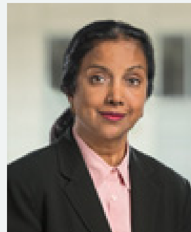

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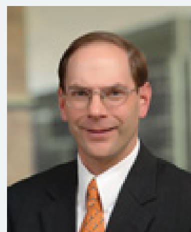

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Past performance does not guarantee future results.

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The BofA Merrill Lynch 1 – 5 Year U.S. Treasury Index measures the performance of short-term U.S. Treasury securities. The BofA Merrill Lynch 1 – 5 Year Corp./Gov. Index measures the performance of U.S. government and investment-grade corporate debt. The Standard & Poor's 500 Stock Index is a broad-based measure of U.S. stock market performance and includes 500 widely held common stocks. The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. It is not possible to invest directly in an index.

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