Quarterly Market Review

First Quarter 2015

Homestead Funds

Summary

- Even with the drop in oil prices, the Core CPI (Consumer Price Index excluding the volatile food and energy product categories) rose only 1.7 percent over the last year, which is little changed from previous periods. This indicates to us that a major deflationary trend is not likely for the foreseeable future — potentially good news for growing the U.S. economy.
- While we expect that the Federal Reserve will finally notch up interest rates a bit by September, we think rates have nowhere to go but lower in Europe, barring an unforeseen economic boom in the Eurozone.
- We think that the equity market's relatively even temper in spite of elevated volatility in the bond market might signal that it has gradually grown accustomed to the inevitability of some increase in interest rates.
- The bull market turned six. From March 9, 2009, through the end of the first quarter, as measured by the S&P 500 Index, the current domestic bull market has lasted longer than the average U.S. bull market since the 1930s.

Macroeconomics

The markets continued their preoccupation with the ongoing price drop in the oil markets. With oil selling around $50 a barrel by quarter end, some energy analysts are predicting further price erosion to $30 a barrel, while others think oil could spike upward to $70 a barrel by year-end.

Generally, lower oil prices may be viewed as an underlying source of spending strength for consumers in the U.S. with one important distinction: the accompanying drop-off in drilling activity signals potential energy sector lay-offs in the near-term and a slow-down in that sector's capital expenditures. The good news is that energy capital expenditures — or CAPEX — represent a relatively small part of the overall economy.

While prices for materials and commodities firmed somewhat during the first quarter, according to the Thomson Reuters/Core Commodity CRB Index Bureau (CRB), commodities remained weak with prices down nearly 33% from their June 2014 highs. This pause in the downward trend mirrors the reversal in the strength of the U.S. dollar late in the quarter.

While we expect that the Federal Reserve will finally notch up interest rates a bit by September, we think rates have nowhere to go but lower in Europe, barring an unforeseen economic boom in the Eurozone. Even though several of the European Central Bank's participating countries embarked on their own version of the Fed's now dormant policy of Quantitative Easing (QE), Germany, Sweden, Netherlands and Switzerland have seen yields on five-year bonds drop into negative territory. The lack of a yield advantage on the fixed-income side overseas, however, turned out to be pretty good news for a number of the Eurozone's equity markets.

Macroeconomics continued

As we mentioned last quarter, while low inflation may benefit price-conscious consumers over the near term, over the long-term it can turn to deflation by postponing the demand for bigger-ticket items — and even lead to a recession if economic growth stalls for more than a quarter. However, as we looked at the Core Consumer Price Index (CPI) in the first quarter, we consider deflationary fears to be over-stated. Over the last three years, the Core CPI, which excludes generally more volatile energy and food prices, averaged about 1.8% on a trailing 12 month basis. Even with the drop off in oil prices, the Core CPI has declined to only 1.7%, which indicates to us that a major deflationary trend is not likely for the foreseeable future – potentially good news for growing the U.S. economy.

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.

Bonds

Bond investors in the first quarter continued to do better the further they went out on the yield curve — extending the trend which began in the first quarter of 2014.

The benchmark Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index returned 1.00 percent for the quarter, up 2.08 percent for the year, while the Bank of America/Merrill Lynch 1-5 Year U.S. Treasury Index gained 0.92 percent for the quarter and returned 1.91 percent for the year.

We continued to monitor and reduce liquidity for the Homestead Short-Term Bond Fund and the Homestead Short-Term Government Securities Fund in the first quarter given the likely modest path of Fed tightening. Overall, however, the funds' durations remain below those of their relative benchmarks.

While bond market volatility became slightly more elevated during the first quarter, we think it should be viewed against a broader backdrop. Utilizing the Bloomberg 10-Year U.S. Treasury Volatility Index as a gauge for fixed-income price swings, the index reached a level of volatility in the first quarter that was comparable to the "Taper Tantrum" of summer 2013, when the Fed first hinted that a rate rise was possible within six months, which sent the equity market into a sharp, short-lived decline. During the fourth quarter of 2014, in contrast, fixed-income price swings were less volatile. We think that the equity market's relatively even course in spite of elevated volatility in the bond market might signal that it has gradually grown accustomed to the inevitability of some increase in interest rates.

For its part, the Fed seems to be in no hurry to raise rates. Their statements during the first quarter hinted that inflation may move lower in keeping with their slightly more downbeat prognosis for economic growth. The March employment report was very weak and may give the Fed another reason to pause before starting to tighten. The market believes that the ultimate level on fed funds will be well below the Fed's expectations, and the first rate increase may not happen until December 2015 or early 2016. We would not be surprised to see a move before then.

Bonds continued

Meanwhile, investors are still pouring significant dollars into low-yielding bond investments, as figures from the Investment Company Institute showed recently.[1] Over the course of the past year, the dominance of mutual fund asset flows shifted from equity to bond funds. This activity is in keeping with "The Great Rotation" from equities to bonds, which market analysts predicted would occur as baby boomer objectives evolved from equity growth to income-generation. While equities held the high ground during January-February of 2014 with net new flows of $42.8 billion versus bond flows of $11.2 billion, by January-February of 2015 the order shifted from $27.5 billion for bonds to $20.8 billion for equities.

Equities

The S&P 500 Stock Index managed to hang on to a modest gain of 0.95 percent for the first quarter of 2015. The broad-based index has now posted gains for nine consecutive quarters, its longest quarterly winning streak in 17 years. In fact, the domestic bull market from March 9, 2009 through the end of 2014, as measured by the benchmark, has lasted longer than the average U.S. bull market since the 1930s.

The small-cap benchmark, the Russell 2000 Index, returned 4.32 percent for the quarter and 8.21 percent for the 12-month period.

Market watchers stayed focused on the implications of lower oil prices on the global economy throughout the period. With so much job growth centered in the energy sector over the past few years, some analysts have been questioning whether lay-offs from the energy sector might extend beyond the oil fields into the general economy.

Our view is that outside of the immediate energy sector, the overall impact is generally very positive for the rest of the economy from the perspective of employment and spending. However, opinions may diverge on specifics: those who consider lower energy prices to be a long-term phenomenon will more likely spend than save, while those who see the price drop as short-lived will likely save rather than spend.

As fundamental analysts, Homestead portfolio managers make their decisions to buy, sell or hold securities not on the basis of economic sectors, however, but on the individual merits of each company. Our investment horizon at Homestead can range from five to 20 years, depending on the firm. Such a strategy favors low portfolio turnover which may prove particularly advantageous in today's market environment. Higher turnover during a bull market, in fact, can contribute to additional trading costs in the form of commissions, as well as increased tax exposure from realized capital gains.

Occasionally, our preference for low portfolio turnover leads us to hold good companies whose stock prices have gone through tough times. In situations where we still believe in a company's long-term growth prospects, we may very well give a selection more time to make adjustments, find its footing and move ahead.

[1]Source: Investment Company Institute
http://www.ici.org/research/stats/trends/trends_02_15

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Past performance does not guarantee future results.

Investments in fixed-income funds are subject to interest rate, credit and inflation risk. Equity funds, in general, are subject to style risk, the chance that returns on stocks within the style category in which the fund invests will trail returns of stocks representing other styles or the market overall. Share prices of small-capitalization stock funds may be more volatile than those of large-capitalization stock funds. Smaller companies may have limited product lines, markets or financial resources, or their management teams may have less depth and expertise, compared with large-capitalization companies.

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. The 10-Year U.S. Treasury Note Volatility Index is an estimate of the expected 30-day volatility of CBOT 10-year Treasury futures. Indices are unmanaged and investors cannot invest directly in an index.

The views expressed in this market commentary are those of the individual as of the date noted and may have changed since that date. The opinions stated may contain forward-looking statements and may discuss the impact of domestic and foreign markets, industry and economic trends, and governmental regulations of the funds and their holdings. Such statements are subject to uncertainty, and the impact on the funds might be materially different from what is described here.

Investing in mutual funds involves risk, including the possible loss of principal.

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