Quarterly Market Review

First Quarter 2016

Homestead Funds

Summary

- Global growth is tepid, but most measures in the U.S. economy remain stable or positive. Investor sentiment continues to be jittery.
- Bonds saw another active quarter, as the outlook for rate increases adjusted to a slower pace, lowering Treasury yields. Credit spreads expanded as stocks fell, but receded back to year-end levels by the end of the quarter.
- Stocks continued to be highly correlated with oil, pulling back in the first half of the quarter as oil fell and rising in the second half of the quarter when oil rose. Broad stock indices were flat or slightly up.

When we look to the fundamentals today, we do see some areas of weakness, but the bigger picture is reassuring.

Macroeconomics

Markets today are walking a fine line between climbing up and pulling back. For example, in the third quarter of 2015, stocks nosedived more than 10% as investors worried about China, struggling oil prices and coming interest rate hikes. Accordingly, the Federal Reserve delayed its first interest rate increase. Then in the fourth quarter, stocks and oil rebounded with enough gusto that the Fed finally made its first rate hike in nine years. Stocks finished the year barely up.

The first quarter of 2016 was a faster cycle of many of the same issues. China and oil down, interest-rate-increase anxiety up, stocks fell. In mid-February, Federal Reserve Chair Janet Yellen announced that the Fed would take a slower pace for rate increases; meanwhile, oil found a bottom and rebounded, stocks recovered. Again, stocks eked out a small gain, all told.

This lack of conviction or trend is a funny place to be. It's a sign to us that investor sentiment is fragile and looking for a shoe to drop. It could also be that, seven years into a prosperous market, investors have some expectation that the good times can't last forever. Indeed, the average bull market, or period of positive returns for stocks, is about four years, historically.

These swings in sentiment and macro trends understandably capture investor attention but have little bearing on the way we manage portfolios. As long-term stock and bond pickers, we expect to ride our holdings through up markets and down ones. In the meantime, we always come back to the fundamentals in the economy and in our holdings: What are the long-term trends in the economy? What are the opportunities and challenges for particular companies or industries? When we look to the fundamentals today, we do see some areas of weakness, but the bigger picture is reassuring.

Positive signs for the biggest issues

Oil prices have been a primary source of anxiety in the markets, and crude oil continued to fall in the first half of the quarter. However, after touching lows of $28, oil prices began to recover; by the end of March, crude oil was right about where it began in January and headed north.[1]

[1] West Texas Intermediate Crude, from the St. Lois Federal Reserve. Accessed April 26, 2016. https://research.stlouisfed.org/fred2/series/DCOILWTICO

Macroeconomics continued

Oil prices are struggling in the face of higher global production, but perhaps the bigger source of uncertainty is global demand. And global demand remains deeply entwined with economic activity in China.

In the first quarter, there were signs that activity in China was stable or maybe even improving a bit. To be sure, China's issues — a structural transition to a consumer-driven economy, bad loans and overcapacity driven by centralized planning — are not easily solved.

But there were some bright spots in the quarter. Chinese manufacturing activity, which had been tepid, showed signs of picking up. Chinese consumer activity continues at a healthy rate. Retail sales there are growing, while real estate prices are rising in some Chinese cities.[2] Industrial profits were up in February for the first time in a year and a half. Meanwhile, the Chinese central bank cut interest rates six times in 2015, as well as trimming the bank reserve ratio to put more liquidity in the system. We don't anticipate any quick fixes to the complex problems facing China, but the short-term measures emerging over the quarter were reassuring.[3]

On the domestic front, the U.S. consumer is also in relatively good shape. Employment numbers have been strong for months, and the number of employed people is now at the highest level since 2009.[4]

A strong employment market has a number of beneficial spillovers. It's generating growth in wages, one of the fundamental sources of inflation that the Federal Reserve looks for as evidence of strength in the economy. Higher employment is also good for consumer spending, and the consumer accounts for about two-thirds of total GDP in the U.S. It's also benefited the housing market, which is broadly better and maybe even starting to overheat in some U.S. cities.

As in China, manufacturing activity in the U.S. has been tepid in recent quarters. But the most updated numbers on domestic manufacturing activity were also positive. The latest reading on the ISM Manufacturing PMI was above 50, indicating expansion, for the first time since September 2015.[5]

Risk of recession remains elevated

But as the jittery investor sentiment suggests, there are a number of issues worth watching. A downward spiral in any of the key metrics today — oil, activity in China, jobs, or other measures of global growth — is likely to push sentiment back into a negative zone. Indeed, a recent Wall Street Journal survey of economists found that the risk of recession receded in March, but remains elevated from a year ago.[6]

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None of these issues taken alone is cause for panic. In our view, the positives in the U.S. economy far outweigh the negatives today, while there are no obvious bubbles ready to topple the economy. More importantly, our portfolio managers continue to find potential opportunities across many investment types.

Bonds

It was another active quarter for the bond markets. Corporates, for example, saw widening credit spreads through mid-February, only to rally and recover by the end of March.

One of the biggest issues was the shifting path for interest rate increases by the Federal Reserve over the course of 2016. After the first rate increase in December, credit markets got off to a rocky start in the new year, putting the Fed back on alert about its intended 2016 increases. Following their February meeting, Fed Chair Yellen announced that the group was likely to raise rates two, rather than four, times over the year.

[2] http://www.wsj.com/articles/china-growth-slows-revival-policies-appear-to-gain-traction-1460687389
[3] http://www.wsj.com/articles/china-factory-indicators-show-pickup-in-economy-1459478899
[4] http://blogs.wsj.com/economics/2016/04/01/the-march-jobs-report-in-14-charts/
[5] https://research.stlouisfed.org/fred2/series/NAPM
[6] http://projects.wsj.com/econforecast/#qa=20160401002

Bonds continued

Overall, the market cheered the announcement, and, for the quarter, the yield curve adjusted, down about 30 basis points for two-year Treasuries, and closer to 50 basis points for five-year Treasuries.

Meanwhile, credit spreads also shifted considerably in the quarter. As stocks plummeted, credit spreads expanded — but when stocks rallied, credit spreads also returned to year-end levels. Oil and gas issuers continue to struggle, and energy bonds are trading at considerably higher yields compared to a year ago.

Most bond indices were positive for the quarter, except inflation-linked measures which suffered as inflation came in lower than expected. The Homestead Short-Term Bond Fund (HOSBX) rose 0.76% in the first quarter, while its benchmark, the Bank of America/Merrill Lynch 1-5 Year Corporate/ Government Bond Index, was up 1.61% in the period.

The Homestead Short-Term Government Securities Fund (HOSGX) was up 1.17% for the first quarter. It trailed its benchmark, the Bank of America/Merrill Lynch 1-5 Year Treasury Index, which was up by 1.57% in the period.

Both Homestead bond funds have a shorter average duration than their benchmarks, meaning the weighted average time to maturity is shorter for holdings in the funds. Shorter duration positions tend to underperform in environments where interest rates are falling, like they did this quarter.

Equities

Across the stock market, many indices were basically flat, ranging from slightly up to slightly down for the quarter. Of course, that belies the wild ride they took along the way, pulling back as much as 10% before rallying in mid-February and recovering the losses.

One notable change in the quarter was that market gains, when they did take hold in recent weeks, were enjoyed by more than 60% of names in the S&P 500 Index.[7] This stands in contrast to the narrow market of 2015, where only a handful of names — primarily consumer tech stocks — generated the lion's share of returns for a mostly lackluster market.

[7]MarketWatch http://www.marketwatch.com/story/most-stocks-rose-during-the-first-quarter-surprised-2016-03-31

Large-company stocks outperformed small-company stocks, while value-oriented stocks outperformed growth stocks, broadly speaking. Traditionally defensive sectors led returns in the quarter, with utilities and telecommunication services stocks posting the strongest gains amid market volatility. Health care stocks lagged; the pharmaceutical industry in particular struggled. Among large-cap stocks, financials stocks declined the most, as the prospect of higher interest rates lost momentum, signaling a downshift for earnings among banks and other financial firms. This effect was less pronounced on small-cap financial firms, which posted moderate gains in the period. Large-cap energy stocks, on the other hand, enjoyed moderate returns in the quarter, but small-cap energy stocks declined.

The Homestead Value Fund (HOLVX) returned 0.58% in the quarter. It lagged its benchmark, the S&P 500 Index, which rose 1.35% in the period. Stock selection in information technology holdings detracted from performance, as did selection in the energy sector. The portfolio also lagged due to holding little or no exposure in utilities and telecommunication services stocks, which were the two top-performing sectors in the benchmark in the first quarter. However, this was offset by stock selection in materials and industrials holdings, as well as by overweight allocations relative to the benchmark in both sectors, which boosted relative returns.

In terms of positioning, the Value Fund is overweight relative to its benchmark in materials, industrials and health care sectors, as well as in cash. The Fund is underweight in consumer discretionary, consumer staples and information technology stocks.

The Small-Company Stock Fund (HSCSX) rose 0.42% in the first quarter. It outpaced its benchmark, the Russell 2000 Index, which declined by -1.52% in the period. Stock selection in health care stocks was particularly strong, and the portfolio also benefited from an underweight to the struggling sector in the quarter. An overweight allocation to the industrials sector also boosted relative returns, as did stock selection in information technology names. Stock selection in financials detracted slightly from performance in the period.

Relative to the benchmark, the Small-Company Fund is notably underweight in health care and financials sectors, as well as moderately underweight to information technology names. The portfolio is overweight in industrials and consumer discretionary stocks.

Homestead Funds

Equities continued

While exposure to sectors as they are labeled in the benchmark is useful to understand, our portfolio managers caution that those sector weights are an incomplete picture of their diversification and exposure across industries. In both stock funds, a number of holdings in the industrials sector are based on investment themes in health care and technology trends. For example, in the Value Fund, the industrials holdings General Electric and Honeywell have substantial technology businesses. And the Small-Company Stock Fund's industrials position includes the specialty chemicals company PolyOne, whose polymer products are deployed across many industries, including health care.[8]

[8]As of 3/31/16, the percent of Value Fund assets invested in General Electric and Honeywell were 4.8% and 3.5% respectively. As of 3/31/16, the percent of Small-Company Stock Fund assets invested in PolyOne was 1.9%.

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.

Total Returns as of 3/31/2016

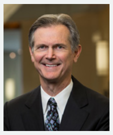
		Average Annual				
	Aggregate YTD	1 yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* (HOSGX)	1.17%	0.97%	0.66%	1.14%	2.48%	3.39%
BofA ML 1-5 Year U.S. Treasury Index	1.57%	1.62%	1.15%	1.56%	3.19%	4.29%
Expense ratio 0.77% (12/31/15)						
> *Short-Term Bond Fund* (HOSBX)	0.76%	0.64%	1.11%	2.06%	3.69%	4.51%
BofA ML 1-5 Year Corp./Gov. Index	1.61%	1.66%	1.39%	1.95%	3.49%	4.81%
Expense ratio 0.74% (12/31/15)						
Equity Funds						
> *Value Fund* (HOVLX)	0.58%	-2.13%	9.98%	10.48%	6.32%	9.86%
S&P 500 Stock Index	1.35%	1.78%	11.82%	11.58%	7.01%	9.91%
Expense ratio 0.59% (12/31/15)						
> *Small-Company Stock Fund* (HSCSX)	0.42%	-8.66%	7.99%	8.76%	8.38%	8.96%
Russell 2000 Index	-1.52%	-9.76%	6.84%	7.20%	5.26%	6.38%
Expense ratio 0.87% (12/31/15)						

The total returns shown above represent past performance which does not guarantee future results. Investment return and principal value of an investment will fluctuate. An investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance data quoted. For performance data current to the most recent month-end, call 800.258.3030 or visit homesteadfunds.com.

The expense ratio shows the percentage of fund assets deducted annually to cover operating costs. For some funds, the investment advisor has agreed voluntarily or contractually (for at least the current fiscal year) to waive or reimburse a portion of expenses. The net expense ratio is the expense ratio minus the portion of expenses waived or reimbursed. Please see the current prospectus for additional details.

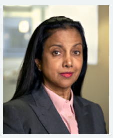
Homestead Funds

Equity Team



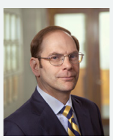
Mark Ashton, CFA
Senior Equity Portfolio Manager

Mark co-manages the company's large- and small-cap value strategies. He is a graduate of the University of Utah, where he received a Bachelor's degree in Finance. He received his MBA with specialization in Marketing Research from the University of Southern California and also holds the Chartered Financial Analyst designation.



Prabha Carpenter, CFA
Senior Equity Portfolio Manager

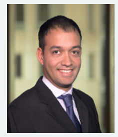
Prabha co-manages the company's large- and small-cap value strategies. She is a graduate of the University of Madras, where she received a Bachelor of Arts degree in Economics. She received her Bachelor of Science degree in Business Economics and an MBA with distinction in Finance from American University. Prabha holds the Chartered Financial Analyst designation.



Gregory Halter, CFA
Senior Equity Portfolio Manager

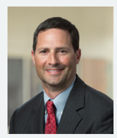
Greg co-manages RE Advisers' large- and small-cap value strategies. He is a graduate of Cleveland State University, where he received a Bachelor's degree in Finance. He holds the Chartered Financial Analyst designation.

Fixed-Income Team



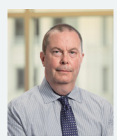
Mauricio Agudelo
Fixed-Income Portfolio Manager

Mauricio co-manages RE Advisers' fixed-income strategies. He received a B.S. in finance from the University of Maryland, Robert H. Smith School of Business. He minored in business culture and language, with a concentration in Spanish. He is a Level III candidate for the Chartered Financial Analyst (CFA) designation.



Marc Johnston, CFP, ChFC, CAIA
Money Market Portfolio Manager and Senior Fixed-Income Analyst

Marc manages the Daily Income Fund portfolio and analyzes risk, return and volatility attributes of RE Advisers' fixed-income strategies. He is a graduate of Villanova University, where he received a Bachelor's degree in General Arts. He received his MBA from Northeastern University and holds the designations of Certified Financial Planner, Chartered Financial Consultant and Chartered Alternative Investment Analyst.



Douglas Kern, CFA
Senior Fixed-Income Portfolio Manager

Doug co-manages RE Advisers' fixed-income strategies. He is a graduate of Pennsylvania State University, where he received a Bachelor's degree in Business Administration specializing in Insurance and Real Estate and his MBA in Finance. Doug also holds the designation of Chartered Financial Analyst.

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Past performance does not guarantee future results.

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Diversification does not ensure a profit or protect against loss. It is a method used to help manage investment risk. 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 percent 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. Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, performance of indices do not account for any fees, commissions or other expenses that would be incurred. Returns do not include reinvested dividends.

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Investors are advised to consider fund objectives, risks, charges and expenses before investing. The prospectus contains this and other information and should be read carefully before you invest. To obtain a prospectus, call 800-258-3030 or download a PDF at homesteadfunds.com.

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