Quarterly Market Review

Third Quarter 2018

Homestead Funds

Summary

- U.S. stocks had another strong quarter, despite continued volatility. Strong earnings reports dominated sentiment, overriding investor concerns about the ongoing trade war with China and increasing worries about the effects of higher interest rates.
- It may be premature to say that the bull market cycle is peaking, but we are starting to see increased pressures in the tech sector where stock multiples have moved significantly higher than corporate earnings growth, reminiscent of the late 1990's bubble.
- Economic data was strong, especially from the labor market. Unemployment is at lows not seen in decades, boosting consumer confidence and supporting spending. Small business confidence is also quite high. Oil prices stabilized after a big gain in the second quarter. Inflation numbers held steady, though investors are carefully watching wage pressure, oil prices and the effects of tariffs.
- The Federal Reserve hiked overnight rates again, with another increase in December likely. The yield curve continued to flatten and move toward an inverted position, which would signal a higher risk of recession in the next one to two years.

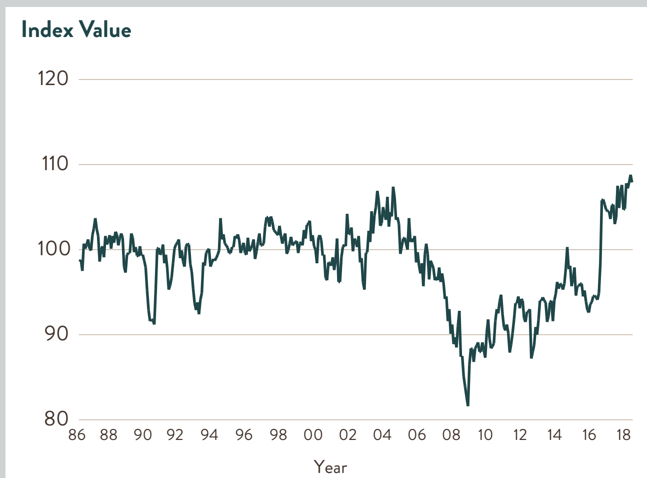
Despite Stresses, Strong Markets

U.S. stocks posted another quarter of strong performance. Continued economic momentum in the U.S. outweighed a list of ongoing concerns, including worries about the trade war between the U.S. and China, and the effects of higher U.S. interest rates, which are exerting pressure on emerging markets in particular. Ultimately, stocks rose on strong company earnings, which continue to enjoy an added boost from the late-2017 tax cuts.

Indeed, the strong corporate performance is a result of strong economic activity generally. The jobless rate in the U.S. is at lows not seen in decades, and measures of job openings remain elevated, but wage growth has continued to be slow. The robust labor market has boosted confidence among consumers, who are feeling optimistic about the future and spending more freely. Small businesses are reporting higher confidence levels as well, and data is showing a higher level of long-term capital investment at companies. Purchasing manager indexes, considered a signal of upcoming business activity, are also posting high numbers, suggesting that momentum could continue for some time.

Small Businesses Optimistic About Economic Conditions

Based on ten survey indicators



Source: Bloomberg

What's This About Recession?

If the economy is so strong, why is the topic of recession on the table? To be clear, we are certainly not in or near a recession today. But there are signals from the markets that a recession could be coming into sight, far off in the distance – namely, an inverted yield curve, where short-term interest rates are higher than long-term rates. The yield curve hasn't fully inverted yet, but at certain points during the quarter, the threat looked awfully real.

According to historical trends, an inverted yield curve typically predicts a recession 12-24 months in the future, with only one instance where an inversion was followed by a milder slowdown, not a full recession. With the Fed expected to continue raising short-term rates, there is an increased chance of the curve inverting. But given the economy's strength, solid employment numbers and rising corporate profits, we could also see long rates move higher, reversing the move toward inversion.

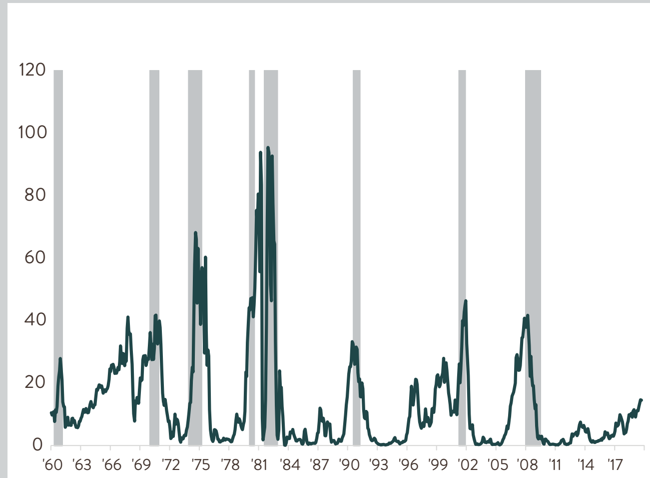
Recession fears seemed to have retreated in late September. Still, a slowdown is not atypical after such an extended period of growth. One measure that demonstrates the maturity of the current expansion is the increasingly tight labor market. While wage pressure has been unexpectedly restrained, many employers say they're struggling to find high-quality labor. A comprehensive small business survey found that labor quality is the number-one concern of small businesses today, ranking above taxes, sales and interest rates/finance.[1]

In an overheating economy, other stresses could be the straw that breaks the camel's back, so to speak. And there are other stresses present: trade war effects could cause inflation in the supply chain and in consumer goods prices. China's economy is slowing, dampening commodity demand and pressuring metals prices. And higher U.S. interest rates filter not only through the domestic economy, raising mortgage rates and lowering home-buying activity; higher rates also contribute to a strong U.S. dollar, which is causing distress in emerging markets, where a lot of bonds are issued in U.S. dollars.

Small businesses are reporting higher confidence levels, and data is showing a higher level of long-term capital investment at companies.

Very Tight or Negative Spreads Have Historically Signaled a Coming Recession

Line plots the difference between the 10-year and 3-month Treasury rates. Recessions are shaded.



Source: Strategas

Inflation and Upcoming Fed Moves

These dynamics could soon put the Fed between a rock and a hard place. Strong activity is generating incrementally more inflation, and the Fed's preferred measure of inflation, the Personal Consumption Expenditure price index, is measuring right around its stated 2% target today. Added pressure from wages or tariffs could complicate things, especially if the longer-term outlook shows signs of softening.

Still, the good news is broad-based, and the outlook heading into the holiday season is cheery. We expect earnings strength to continue. Additionally, most sectors are generally in a strong position today. The energy and retail sectors have gone through their own mini-recessions in recent years, and have worked through some structural imbalances. Energy companies had to cut costs, consolidate, and recapitalize when oil prices plummeted in 2015-2016, and retail companies are several innings into a reckoning with the consumer shift toward online shopping. The banking sector is strong, and we think many U.S. companies are in good health today.

[1]https://www.nfib.com/surveys/small-business-economic-trends/

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Bonds

U.S. bond indexes again posted mixed performance for the quarter. Treasury and government agency issues generally posted mild losses, while investment-grade and high-yield corporate segments had moderate gains. Interest rates climbed a bit in the period, with short-term rates climbing more than long-term rates, further flattening the yield curve. Credit spreads tightened, boosting returns among corporate bonds.

As expected, the Fed raised its target interest rate again by 0.25% to a range of 2.00% to 2.25%, its eighth increase in the cycle. Investors widely expect another hike in December, and the Fed has suggested it will continue increases at a moderate pace in 2019 if economic data continues to be strong. Inflation ticked up incrementally, supporting Fed tightening.

Against this backdrop, The Homestead Short-Term Government Securities Fund (HOSGX) returned 0.38% in the third quarter. It outpaced its benchmark, the ICE BofAML 1-5 Year Treasury Index, which rose 0.05%. The fund maintains a shorter duration than the benchmark, which contributed to outperformance in the period.

The Homestead Short-Term Bond Fund (HOSBX) rose 0.54% in the quarter, and also outperformed its benchmark, the ICE BofAML 1-5 Year Corporate/Government Bond Index, which returned 0.28%. The fund's shorter average duration was a contributor in the rising-rate environment, as was exposure to credit segments including asset-backed securities and corporate issues.

Stocks

U.S. stocks performed well in the third quarter. Non-U.S. markets were weaker, especially emerging markets, which posted another quarter of losses. In terms of style, growth stocks outperformed value stocks across large-, mid- and small-cap stocks.

The volatility that has characterized the first half of the year continued into the third quarter. Trade conflict raged on between the U.S. and China, deepening anxiety among investors, though the strong earnings numbers at companies were sufficient to drive stocks higher. Oil prices stabilized after their second-quarter jump, and policymakers announced successful trade negotiations to replace NAFTA. Health care stocks led performance in the S&P 500 Value Index, with strong performance from medical devices and pharmaceutical companies in particular. The materials sector struggled as construction materials and metals and mining companies lagged, pressured by falling home purchases and lower commodity prices, respectively.

The good news is broad-based, and the outlook heading into the holiday season is cheery. We expect earnings strength to continue. Additionally, most sectors are generally in a strong position today.

The Homestead Value Fund (HOLVX) returned 9.46% in the third quarter, outperforming its benchmark, the S&P 500 Value Index, which rose 5.86%. Positioning in the industrials sector was a key contributor, with the gains driven by stock selection. An overweight in the sector was also additive. Conversely, the fund's avoidance of stocks in the consumer staples sector detracted marginally from performance.

In terms of fund positioning, the Value Fund continued to be overweight relative to its benchmark in the information technology, materials, and health care sectors. The fund is most underweight in consumer staples, a sector where it does not have any holdings, and financials stocks. These over- and underweights are relative to the global industry classification standard (GICS) sectors, though our portfolio managers caution that they are sector-agnostic and consider diversification at a company-specific level.

The Small-Company Stock Fund (HSCSX) declined -0.54% in the quarter, trailing its benchmark, the Russell 2000 Index, which returned 3.58%. Stock choices in the industrials sector pressured relative returns, though the fund's overweight allocation was additive. Stock choices in the materials sector also weighed on performance. On the other hand, the fund's holdings in consumer discretionary companies outperformed.

Homestead Funds

Relative to its benchmark, the Small-Company Stock Fund continues to be notably underweight in the health care sector, as well as the real estate sector, where it does not have any exposure. As noted above, these weights are relative to the GICS measures, though our portfolio managers are sector-agnostic and consider diversification at a company level and assemble our portfolios with a bottom-up, stock-picking approach.

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 9/30/2018

		Average Annual				
	Q3	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* **(HOSGX)**	0.38%	0.14%	0.38%	0.61%	1.44%	3.05%
ICE BofA ML 1-5 Year U.S. Treasury Index	0.05%	-0.58%	0.29%	0.73%	1.58%	3.83%
Expense ratio 0.81% (gross) 0.75% (net) (12/31/17)						
> *Short-Term Bond Fund* **(HOSBX)**	0.54%	1.18%	1.50%	1.38%	3.36%	4.23%
ICE BofA ML 1-5 Year Corp./Gov. Index	0.28%	-0.31%	0.77%	1.11%	2.33%	4.40%
Expense ratio 0.76% (12/31/17)						
Equity Funds						
> *Value Fund* **(HOVLX)**	9.46%	15.65%	16.74%	12.82%	11.00%	10.42%
S&P 500 Value Index	5.86%	10.06%	14.13%	10.88%	9.62%	NA
Expense ratio 0.60% (12/31/17)						
> *Small-Company Stock Fund* **(HSCSX)**	-0.54%	2.19%	9.66%	7.79%	12.39%	9.20%
Russell 2000 Index	3.58%	15.24%	17.12%	11.07%	11.11%	7.94%
Expense ratio 0.88% (12/31/17)						

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 expenses. Fund expense ratios shown here do not include acquired fund fees and expenses. If applicable, these additional costs are disclosed in the prospectus.

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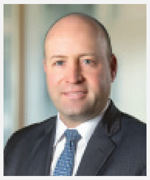
Equity Team



Peter Blackstone
Senior Equity Analyst

Peter is a senior equity analyst supporting RE Advisers' large- and small-cap value strategies. He is a graduate of Trinity College, where he received a BA in economics and an MBA with a specialization in finance from Boston University.

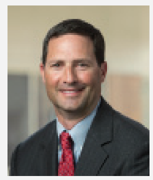
Prabha Carpenter, CFA®
Senior Equity Portfolio Manager

Prabha manages RE Advisers' 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.

Fixed-Income Team

Mauricio Agudelo, CFA®
Senior Fixed-Income Portfolio Manager

Mauricio manages RE Advisers' fixed-income strategies. He received a Bachelor of Science degree 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 holds the Chartered Financial Analyst 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.

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Index Definitions: The **ICE BofA Merrill Lynch 1 – 5 Year U.S. Treasury Index** measures the performance of short-term U.S. Treasury securities. The **ICE BofA Merrill Lynch 1 – 5 Year Corp./Gov. Index** measures the performance of U.S. government and investment-grade corporate debt. The **Dow Jones Industrial Average** measures the stock price performance of 30 actively traded, blue chip companies. The **MSCI EAFE Index** represents the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** represents the performance of large- and mid-cap securities in emerging market countries, including China, South Korea, Taiwan, India and Brazil. The **Russell 1000 Index** is a subset of the Russell 3000 Index and measures the performance of the 1,000 largest companies in the Russell 3000 Index. The **Russell 2000 Index** is a subset of the Russell 3000 Index and measures the performance of the 2,000 largest companies in the Russell 3000 Index. The **Russell 1000 Growth Index** measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell **2000 Growth Index** measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The **Russell 1000 Value Index** measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The **Russell 2000 Value Index** measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. 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 **Standard & Poor's 500 Value Index** is a subset of the S&P 500 Index and consists of those stocks in the S&P 500 Index exhibiting the strongest value characteristics. Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, index performance does not account for any fees, commissions or other expenses that would be incurred.

Investing in mutual funds involves risk, including the possible loss of principal. Past performance does not guarantee future results.

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