Quarterly Market Review

Fourth Quarter 2018

Homestead Funds

Summary

- Despite continued strength in company earnings, U.S. stocks tumbled during the quarter. Pressure convened from several sources, including evidence that China's growth is slowing, continued trade war tensions, falling oil prices, worries about interest rate policy missteps, and signals from the bond market that weaker growth is ahead.
- Labor market data was a bright spot, showing better-than-expected hiring. Other economic metrics were dimmer though, including weakening inflation as oil prices fell, and lower-than-expected measures of industrial activity in the U.S. and overseas.
- The Federal Reserve hiked its interest rate target a fourth time for the year as expected. However, some comments from the Chairman were seen as overly optimistic given contradictory signals that inflation and growth were softening. Interest rates fell and the yield curve flattened further, coming closer to an inverted position.

A Shock to the System

Investors faced two things in the final quarter of 2018: excellent economic reports, and sharply plunging stock markets. On the surface, these two trends seem diametrically opposed. However, they can easily co-exist; we just have to remember that the economic news we see is essentially backward-looking, while stock markets are always (and only) forward-looking.

This is precisely the reason why stocks pulled back even as employment numbers were great and company earnings hummed along – recent activity has been strongly positive, but in the fourth quarter, there was a shock to the outlook for the months ahead.

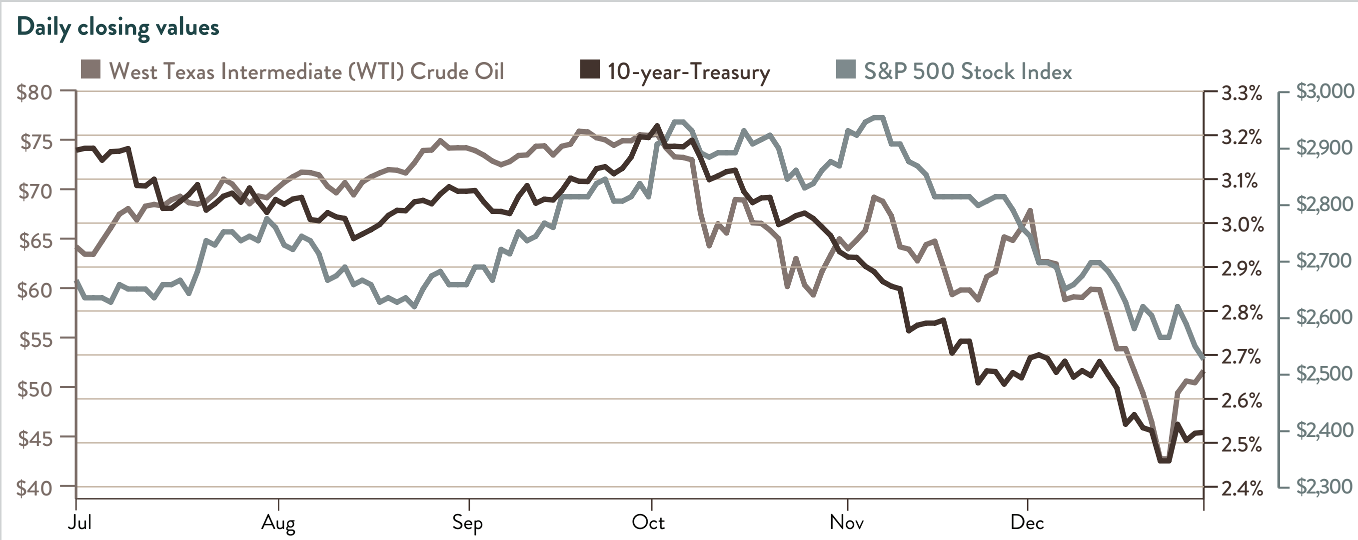
Looking Back: Strong Fundamentals

It really was an outstanding year for company earnings in 2018, and the fourth quarter was no exception. With momentum from tax cuts, U.S. companies saw earnings grow at a pace of around 20% through the year. Fourth-quarter earnings reports are expected to show a slower year-over-year growth rate, more in the range of 10-15%, but the sum total for the year is nonetheless robust.

In an economy with unemployment at cyclical lows, inflation right around the Federal Reserve's preferred 2% target, and businesses and consumers spending happily through much of the year, there was enough good news through most of 2018 for investors to shake off looming worries. Still, the list of stressors was considerable: an enduring trade war and hints of slowing growth in China, a mid-year solvency crisis in select emerging markets, signs of slowing growth in non-U.S. developed markets and signals from the bond market that the risk of recession had increased.

Recent activity has been strongly positive, but in the fourth quarter, there was a shock to the outlook for the months ahead.

A Dramatic Q4: Tumbling Stocks, Declining Oil Prices and Falling Rates



Source: Bloomberg

The country is undertaking some long-term economic changes, and policymakers' hands are somewhat tied in terms of trying to stimulate its domestic economy.

Looking Forward: A Confluence of Shocks

In the fourth quarter, we essentially witnessed a tipping point for the market stressors. China and oil prices continued to be a troublesome duo, reminiscent of the market pullback in 2015-2016. A pileup of data points about a weakening economy in China – lackluster loan growth, tighter credit conditions, slower-than-expected retail sales and industrial output – reinforced the case for downgraded global outlook that investors worried over throughout the year.

And as a major industrial producer, China's growth rate is a key input for global oil demand. Oil prices tumbled from an October peak of about $75 per barrel peak in October to about $45 at year-end, a 40% drop. The trade war between the U.S. and China, meanwhile, continued on with no end in sight. It is certainly contributing to China's slowdown, but other factors are also at play. The country is undertaking some long-term economic changes, like its effort to deleverage excessive loans from past years, and policymakers' hands are somewhat tied in terms of trying to stimulate its domestic economy.

Inflation Deflates, Fed Worries Markets

As oil prices tumbled in the fourth quarter, the outlook for domestic inflation did the same. After spending much of the year in the ideal 2% range, a key measure of expected inflation, the 10-year breakeven rate for Treasury Inflation Protected securities, tumbled from a peak of 2.17% to a low of 1.71% at year-end. As these dynamics were evolving, the Federal Reserve enacted a fourth rate-hike for the year – something they usually do only when inflation is stable or climbing – and made comments about their likely actions in the year ahead that many felt were too optimistic given the changing market environment. The Fed chairman later qualified and softened the comments, reassuring investors that they were not headed for a policy misstep, but the series of events had markets on edge.

Downside Surprises in the Quarter

China, oil, and Fed policy worries were not the only signs of a shifting outlook during the quarter. In one report, analysts showed that four out of six key sector measures showed downside surprises in the fourth quarter – that is, they measured weaker than expected by analysts. Housing and real estate markets showed the biggest downside shock, but the industrial and retail sectors were also slower than expected, as was an aggregate measure of surveys and business cycle indicators. Only the labor market and the personal/household sectors showed better-than-expected activity.

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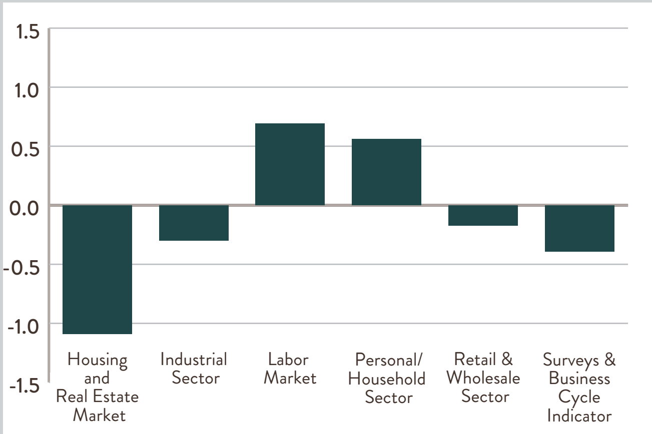
Economic Surprise Indexes by Sector

As of December 31, 2018



Source: Bloomberg

Room for Improvement

After a rough quarter, there is reason to be moderately optimistic for the year ahead. Most analysts already expected slower earnings and GDP growth for 2019, and those measures could continue to be positive even with recent shocks. The Fed also has newfound “wiggle room” in its policy options, having raised rates in recent years up to a more normal level and retreated from the extreme liquidity they used during the financial crisis.

Many are also happy to see lower valuations for stocks generally. After the pullback, stock prices as a ratio of expected earnings are down into a more attractive zone. Ultimately, this phase in a market cycle is a time when sentiment among consumers, business and investors is key. Positive outlooks drive good economic activity, while negative sentiment can be self-fulfilling.

Bonds

As U.S. bond indexes were mixed for the fourth quarter. Treasury and government agency issues generally showed gains amid safe-haven buying, while investment-grade and high-yield corporate segments had losses. Interest rates declined for most bond maturities and the yield curve flattened further. Credit spreads widened, pressuring returns among corporate bonds.

As expected, the Federal Reserve raised its target interest rate again by 0.25% to a range of 2.25% to 2.50%, its ninth increase in the cycle. However, investors fretted over the chairman’s comments about the year ahead, viewing his remarks as too optimistic amid a market environment where stocks were plunging and inflation was weakening. Fed Chairman Jerome Powell later clarified and softened his remarks, reassuring investors.

Against this backdrop, the Homestead Short-Term Government Securities Fund (HOSGX) returned 0.77% in the fourth quarter and trailed its benchmark, the ICE BofAML 1-5 Year Treasury Index, which rose 1.72%. The Short-Term Government Securities Fund maintains a shorter duration than the benchmark, which detracted from performance in the quarter. For the year, the fund returned 1.20%, while its benchmark posted gains of 1.52%.

The Homestead Short-Term Bond Fund (HOSBX) rose 0.55% in the quarter, trailing its benchmark, the ICE BofAML 1-5 Year Corporate/Government Bond Index, which returned 1.43%. The fund’s shorter average duration was a detractor in the falling-rate environment. However, exposure to credit segments, especially asset-backed securities, helped returns. For the calendar year, the fund returned 1.69%, outperforming its benchmark, which returned 1.40%.

Stocks

U.S. stocks declined sharply in the fourth quarter. Non-U.S. markets also declined, but marginally outperformed U.S. markets. In terms of style, value stocks outperformed growth stocks across large-, mid- and small-cap stocks.

A darkening outlook for the year ahead pressured stock returns in the fourth quarter, despite strong company earnings and a robust labor market. Continued trade conflict and a clearer picture of slower growth in China pressured markets, driving oil prices down and eroding the inflation outlook in the U.S. Negative signals from the housing, industrial and retail sectors also pressured returns. Energy and industrials stocks were hit especially hard, while utilities stocks fared the best.

The Homestead Value Fund (HOLVX) returned -12.55% in the fourth quarter, trailing its benchmark, the S&P 500 Value Index, which fell -12.04%. The fund’s lack of exposure to utilities and consumer staples stocks detracted from performance amid market declines. Conversely, stock selection in the health care and energy sectors contributed to returns. For 2018, the fund’s -6.36% one-year return was above the benchmark’s -8.95% drop.

In terms of fund positioning, the Value Fund continued to be overweight relative to its benchmark in the information technology, health care and materials 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

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standard (GICS) sectors, though our portfolio managers caution that they are sector-agnostic and consider diversification at a company-specific level. For instance, a number of their information technology holdings are focused on the industrials end market, while an industrials holding makes equipment for the telecommunications services sector. As such, they assemble a diversified portfolio according to their own analysis of risk and return exposures.

The Small-Company Stock Fund (HSCSX) declined -24.47% in the quarter, trailing its benchmark, the Russell 2000 Index, which fell -20.20%. Stock choices in the industrials sector pressured relative returns. Selection in the financials sector also detracted from performance, though the fund's overweight in financials helped returns. Stock choices and an underweight in health care stocks aided fund performance, as did an underweight in the energy sector. The fund also lagged the index in 2018 with a one-year return of -26.18% compared to -11.01%.

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. The portfolio is especially overweight in industrials stocks. 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.

Total Returns as of 12/31/2018

		Average Annual				
	Q4	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* **(HOSGX)**	0.77%	1.20%	0.84%	0.83%	1.23%	3.05%
ICE BofA ML 1-5 Year U.S. Treasury Index	1.72%	1.52%	1.09%	1.09%	1.33%	3.86%
Expense ratio 0.81% (gross) 0.75% (net) (12/31/17)*						
> *Short-Term Bond Fund* **(HOSBX)**	0.55%	1.69%	1.70%	1.41%	3.64%	4.21%
ICE BofA ML 1-5 Year Corp./Gov. Index	1.43%	1.40%	1.43%	1.37%	2.17%	4.42%
Expense ratio 0.76% (12/31/17)						
Equity Funds						
> *Value Fund* **(HOVLX)**	-12.55%	-6.36%	8.70%	7.58%	12.46%	9.80%
S&P 500 Value Index	-12.04%	-8.95%	7.23%	6.06%	11.21%	NA
Expense ratio 0.60% (12/31/17)						
> *Small-Company Stock Fund* **(HSCSX)**	-24.47%	-26.18%	-0.58%	0.12%	12.38%	7.62%
Russell 2000 Index	-20.20%	-11.01%	7.36%	4.41%	11.97%	6.68%
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.

*RE Advisers has contractually agreed, through at least May 1, 2019, to limit the Fund's operating expenses to an amount not to exceed 0.75%. This waiver agreement will terminate immediately upon termination of the Fund's Management Agreement and may be terminated by the Fund or RE Advisers with one year's notice.

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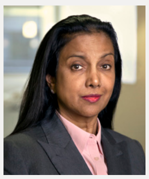
Equity Team

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.



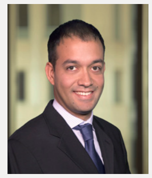
Prabha Carpenter, CFA®
Senior Equity Portfolio Manager

Prabha co-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.

Jim Polk, CFA®
Senior Equity Portfolio Manager

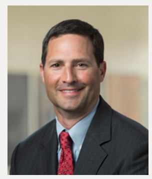
Jim co-manages RE Advisers' large- and small-cap value strategies. He received a BA in English from Colby College and an MBA from the Olin Graduate School of Business at Babson College. Jim holds the Chartered Financial Analyst designation.

Fixed-Income Team



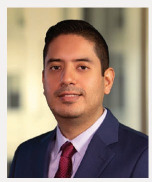
Mauricio Agudelo, CFA®
Senior Fixed-Income Portfolio Manager

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.



Ivan Naranjo, CFA®, FRM®,
Fixed-Income Portfolio Manager

Ivan co-manages RE Advisers' fixed-income strategies. He joined RE Advisers in 2018. Ivan received a BS in finance from the University of Maryland, Robert H. Smith School of Business. He holds the Chartered Financial Analyst and Financial Risk Manager designations.

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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. Index returns do not include reinvested dividends.

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

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