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A Quarterly Newsletter for Homestead Funds' Shareholders

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Amid Extremes, Where to Next?

Stocks have been setting new record highs and the U.S. stock market has been trending up for eight years, the second-longest period on record.[1] But interest rates are poised for further hikes, and global politics seem loaded with event risk. Where to from here? Is there room for more gains, or are the risks piling up?

Rising Rates Can Be Benign

Traditional thinking holds that rising interest rates are always bad for stocks. This theory rests on the idea that higher borrowing costs hurt company profitability, while also cutting into discretionary dollars among consumers.

But studies show that stocks can perform just fine during a typical period of rising rates. In fact, when interest rates are going up, it's usually because inflation is ticking up and the

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The Future Is Hazy, Unless You Ask the Markets

These days, it seems the news is being written at twice the normal pace. From the moment of Donald Trump's election, the public conversation has raced between inauguration celebrations and protests, through controversies over cabinet picks and executive orders, into diplomacy surprises and parsed presidential tweets.

We're all in uncharted territory. A great deal remains uncertain about how policies will actually change in the four years ahead. And we are tracking a president who differs so much in behavior and approach from any past examples.

Yet, since Trump's election, markets have really only gone in one direction: up. If the course of the future is hazy and complex, why has the market reaction been so unambiguous?

One theory is that it's all "animal spirits" — valuations based on high-flying confidence, rather than clear and complete nitty-gritty plans for policies. Confidence counts for a lot in markets, and just because the future is hazy doesn't mean the optimism is misplaced.

Another theory is that the market optimism is not only Trump-related, but a marker of improvement in underlying economics, the slight uptick of company earnings *and* improving commodity prices *and* manufacturing indicators *and*...so on and so forth. As we noted in our last quarterly market update, conditions were on the upswing *before* Trump's election.

A third option: it's too early to know. The factors driving short-term market moves are usually impossible to attribute precisely to this reason or that.

Regardless, emotions are running high. And emotional reactions have no business guiding investment decisions. Instead, investment decisions should be based on your long-term goals and risk

Stephen Kaszynski, CFA
Director, President and CEO

profile. In this issue, we take a moment to consider whether market factors are truly at extremes today and talk with one of our client services associates about how to keep emotions out of your investment plans. We also offer some reminders about the current tax season — and what could be less emotional than taxes?

We believe the best investment decisions are made only with a long-term plan in mind, and we are here as a resource to help you stick to your plan.

Homestead Funds

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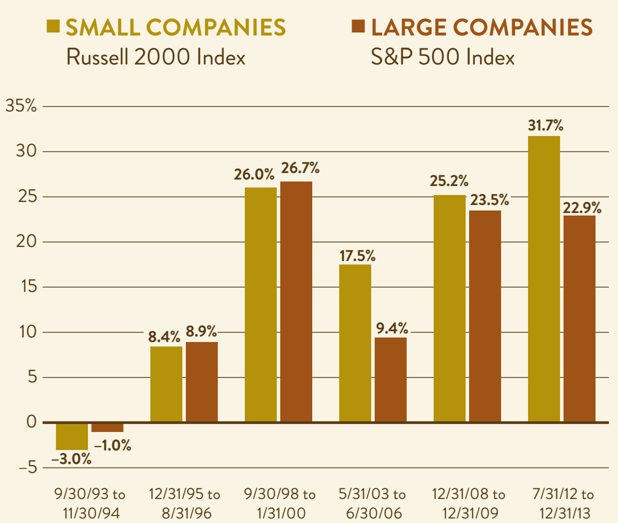
economy is humming along. This is an excellent backdrop for overall company profitability and growth, and this stage of an economic cycle can go on for quite a while. The exception is a period when inflation is in a "runaway" pattern — a time when policymakers don't just raise rates, they hike them far and fast to gain control over the inflation situation. The economy is nowhere near this scenario today.

Stocks Can Thrive in Rising Rate Periods

Annualized returns in periods where the 10-year U.S. Treasury yield was rising



Source: Strategic Research Partners LLC

What's more, gradually rising rates do not spell doom for long-term investors with short-term bond holdings. Remember, there are two components of a bond's total return: income and price change (appreciation or depreciation). While bond prices typically decline in response to a rise in rates, yields typically go up. Over long holding periods, that rising level of income can more than offset a decline in price.

Market Cycles Don't Die of Old Age

Perhaps you've seen statistics or news stories about how the present bull market (period when stock prices are rising) just turned eight years old, the second-longest bull market in history. First, that is only true if we all agree on when a "bull market" ends. The conventional definition is that a bull market is over when stocks fall by 20% or more, marking a "bear market." But what if they fall 18%? Or stay flat for a prolonged period? Since the stock market first recovered after the financial crisis, beginning in March 2009, there has not been a single pullback of 20% or more. But stocks have had a number of mid-sized pullbacks, including a retreat of more than 14% between May 2015 and February 2016 amid tumbling oil prices and fears of a slowing China.[2]

We caution our investors not to focus overly on predictions for a bull or bear market. Fundamentals — including factors like company sales, profits, and relative stock valuations — are far more important in determining the long-term course of stock prices than the duration of the cycle.

The Trump Trade

As Homestead Funds CEO Steve Kaszynski notes in his page 1 commentary, many details of the administration's plans are not yet known. Still, Trump has announced a number of policy ambitions that could be positive for company earnings. Lower corporate taxes are widely anticipated, and have a direct effect on the bottom line for companies. His plans to ease regulatory burdens for a number of industries are also viewed as a business-friendly move.

And clearly company managements are taking note. In fourth-quarter earnings calls, more than half of S&P 500 companies mentioned "Trump" or "the administration" as they discussed earnings and outlooks. Over a quarter of the calls included discussions of "tax policy," while one in five mentioned "regulation" in the context of company performance.

Company Managements Are Talking About Trump Policies

Percent of fourth-quarter earnings calls for S&P 500 companies that mentioned...

"Trump" or "the administration"	52%
"Tax policy"	27%
"Regulation"	20%

Source: insight.factset.com/hubfs/Resources/Research%20Desk/Earnings%20Insight/EarningsInsight_021017.pdf

Many Signs of a Healthy Economy

By many measures, the economy remains healthy, rather than extreme. GDP growth, the broadest measure of overall economic health, came in at a 1.9% annual rate in the fourth quarter, following a robust 3.5% rate in the third quarter. Inflation has rebounded to a healthy zone, with the January Consumer Price Index reading showing 2.5% year-over-year growth in prices, boosted by stable commodities and wage increases. The latest unemployment rate was 4.8%, continuing a steady track downward since spiking to 10% during the financial crisis, while company earnings grew at a 5% year-over-year rate in the fourth quarter, the second consecutive

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quarter of increases after a long run of dwindling profits. And merger and acquisition activity, which broke records in 2015, continued at a strong pace in 2016 and is forecast to grow another 6% globally in the first half of this year.[3] While markets may seem positioned at the extremes today, the fundamental measures of economic activity are actually in a moderate and positive place. ✸

[1] money.cnn.com/2016/04/29/investing/stocks-2nd-longest-bull-market-ever/

[2] time.com/money/4399887/today-will-determine-if-the-bull-market-is-still-alive/

[3] finance.yahoo.com/news/global-m-activity-predicted-increase-133000352.html

Avoiding the Pitfalls of Emotional Investing

Our emotions can sabotage our good intentions when it comes to making investment decisions. CFP Raymond Scott offers tips for taking the emotions out of your financial actions.

Raymond Scott, CFP®
Senior Client Services Associate

Q: How do emotions materialize in investors?

In my client service role, I see it firsthand in the phone calls from our shareholders. The emotion that prompts the most calls is anxiety – our investors see a piece of bad news, or feel worried about politics or even seeing a weak return on their account statement for a particular quarter. Often, the question is along the lines of "I'm worried about x. Should I sell my investments?"

Q: What is your response when that happens?

Well, regardless of the exact market environment, the answer for shareholders is: focus on long-term goals. We can never be certain about what the market will do next, good or bad, and research shows that nearly everyone gets market timing wrong. In fact, the investors who set up their accounts with long-term goals in mind, and then forgot about their investments may have strong returns! I think it is often helpful to go back to your overall goals, and remember why you set up the long-term plan that you did, before making a change.

Q: Has emotion been a bigger driver in the current political environment?

Actually, while the election cycle and the incoming administration have been a time of high emotions, the volume of shareholder calls has been steady. We've seen an even balance of some investors who felt that stocks would go down, and some who felt that stocks would go up, regardless of which political view they had.

But one thing we think has made investing decisions more emotional is modern-day technology and availability of news. Someone turns on cable news, or opens Facebook, and there are constant headlines and opinions telling them it's a good time to invest or a terrible time to invest.

Q: Do you see other ways that emotions play into financial decisions?

Another emotion-driven tendency is the idea of holding a lot of cash, "just in case." We can understand why that gives investors some peace of mind. But we also remind them of the costs of inflation. When you hold cash, the purchasing power falls over time because inflation is driving prices up a little every year. It doesn't feel like a loss, but it is.

Q: How can people work around emotional pitfalls?

Well, technology can aggravate investor emotions, but it can also help remove emotions from the process. My favorite tool is the use of automatic investing plans, which can make scheduled purchases, redemptions or exchanges for you.

I recall one study which said investors made better decisions when they kept a picture of a family member next to their computer — a visual reminder to go back to your original goals for your accounts. There's also evidence that using a financial advisor may help investors make better decisions mainly because they have an outside resource to help prevent emotional reactions. We are always happy to be that resource to our shareholders — our phone lines are always open. ✸

5 Facts About Compound Interest

The market may be a product of many complex forces. But the process of growing wealth relies on one spectacularly simple concept: compound interest. Want to learn a bit more about the power working to grow your wealth while you play, work and even sleep? Here are five facts about compound interest.

***Compound interest:** Earning interest on your interest. For instance, your savings account earns $50 in year one, then that $50 earns interest the next year, then that interest earns interest the following year.*

1 It's not only interest.

It doesn't matter what the source is for new dollars in an investment account — bond coupons, stock dividends or interest paid on deposits. Any form of return on a saved dollar has the power to earn new returns in each following year. The concept is alternately called "compound returns."

2 Reinvestment is the key.

Returns begin to compound only if they are reinvested. This is the magic behind compounding — each dollar that comes in as a return must be reinvested in a new return-earning asset. Fortunately, it's easy to set your distribution preferences so that dividends and capital gains are automatically reinvested. Investors choose whether to reinvest distributions or receive them in cash when they complete an account application. For investors in IRA accounts, distributions are automatically reinvested. You can check or change your distribution settings by logging into your account online or calling us.

3 10% return doubles your original investment in 7–8 years.

Without saving any additional dollars, an investment that's earning 10% annually will double between year seven and year eight. A 6% annual return doubles in about 12 years, while a 2% annual return takes 35 years to double.

4 Inflation works in reverse, eroding the value of dollars in cash.

Inflation is like a *negative* return on dollars. That's why money in cash doesn't have a 0% return, it actually has a return of –2% to –3% in an average year, thanks to the drag of inflation. The effect of compounding then works in reverse — the value of cash will fall by 50% in 35 years, if inflation is about 2% annually.

5 Compounding is what makes *time* such a valuable investing tool.

Sometimes you'll see projections of how much you have to save each month to reach a retirement goal, and if you start in your 30s, the monthly savings number is *far lower* than if you start in your 50s or 60s. This is because compounding can do a lot of the heavy lifting for you, if you let time do the work.

Watch Online: Turning Your Savings to Worker Bees

Visit us at **homesteadfunds.com** to see our new video where your dollars turn into honey-making worker bees to illustrate the principle of compound interest.

Key Dates for Your Tax Plans

IF YOU WERE BORN BEFORE...

JULY 1 1947

You'll be 70½ before the end of 2017. As such, you must take required minimum distributions (RMDs) from your traditional IRA accounts from this year onward.

Good news: Roth IRAs are not subject to RMDs. You can leave money in your account where it continues to benefit from compounding, no matter what your age.

JULY 1 1958

You'll be 59½ before the end of 2017, which makes you eligible for penalty-free distributions from your traditional and Roth IRAs from this year on.

Bonus tip: Though you don't have to pay the 10% early withdrawal penalty, you are still responsible for income taxes on distributions from traditional IRAs.

DECEMBER 31 1967

Since you'll be 50 before the end of 2017, your contribution limit for traditional and Roth IRAs has now gone up to the "catch up" level. That means an annual limit of $6,500 instead of $5,500.

A 401(k) catchup, too: When you're over 50, you can also contribute an additional $6,000 per year to your employer-sponsored retirement plan, like a 401(k), over the regular $18,000 annual limit for a total of $24,000 per year.

OTHER DATES TO NOTE:

Today

You should have received all of the IRS 1099 forms needed to file your 2016 tax return. Missing a form? Log on to your account and view the information provided on the form online or give us a call.

APRIL 17 2017

APRIL 17

Thanks to this year's calendar, you have two extra days to file taxes in the U.S., with all regular filings due on April 17th instead of the 15th. It's also the last date for you to make an IRA contribution for tax year 2016.