Quarterly Market Review

First Quarter 2017

Homestead Funds

Summary

- Broad U.S. equity market indexes rose in the first quarter, touching record highs before pulling back slightly at quarter-end. The failed repeal of the Affordable Care Act deflated some of the post-election exuberance as investors recognized more implementation risk to business-friendly policies, but growth outlooks remained strong and corporate earnings proved healthy.
- On its course to slowly normalize interest rates, the Federal Reserve (Fed) raised its target for the federal funds rate in March. Despite the move, yields on five- and 10-year Treasury securities ended the quarter below their year-end 2016 levels.
- Among stock segments, there was a reversal in performance leadership compared to the fourth quarter. In Q1, large-cap stocks outperformed small caps, and growth styles outperformed value styles.

A Time to Digest

While the end of 2016 was a flurry of new developments for the markets, the beginning of 2017 was a time when markets digested U.S. election results and the evolving picture of economic and policy expectations.

The end of 2016 was chock-full of excitement for both stocks and bonds. On top of an already-healthy corporate earnings picture, the surprise election results fueled a rally in stocks, interest rates, and in even in the confidence levels of businesses and consumers. Suddenly the markets faced a changing picture of the future, driven by President Trump's largely pro-business policy agenda.

Broad Stock Market Benchmarks Touch Record Highs Before Softening

By comparison, the opening months of 2017 were a time when markets began to process this flurry of new developments, and adjust course. How much would the new administration's plans actually change growth? What policies would they be able to implement, when and how? The overall jump in growth expectations proved enduring and paved the way for the Fed to enact another small interest rate hike in March. The move was the third since the Fed began raising rates at the end of 2015, but came right on the heels of a December rate hike.

Ultimately, the post-election rally that began in November drove stocks higher through late February, pushing broad stock indexes like the S&P 500 and the Dow Jones Industrial Average to record highs. In the final month of the quarter, stocks pulled back moderately as it became clear that the administration's first legislative effort, repeal/reform of the Affordable Care Act, would not have enough support to pass.

Broad Stock Market Benchmarks Touch Record Heights Before Softening

Source: wsj.com, as of 4/14/17

Weighing the Data Points

Politics aside, incoming economic data continued to paint a largely positive picture. Corporate earnings reports were strong, marking the third consecutive quarter of year-over-year growth in earnings after a five-quarter string of declines. Consumer and business confidence measures are particularly high, reflecting an uptick in "animal spirits" since election results came in.

But there are signs of cracks. Though businesses and consumers see a brighter future, they're showing some reservations about opening their wallets today. Auto sales may have peaked, and inventory levels are piling up at dealerships. The market for auto loans has suffered nagging loan losses in recent periods, as some borrowers are struggling to make auto payments. Businesses, on the other hand, aren't even borrowing. After the quarter ended, there were signs of an unexplained decrease in business borrowing, suggesting companies are not quite as confident as they report.[1] And retail businesses reported high levels of layoffs, a black mark on an otherwise improving employment market.

The New Risk: Implementation

Our concern at the end of 2016 was that the stock market rally may have gone too far, too fast, given that pro-business changes were all hypothetical. This proved true in the beginning of 2017 as a new risk, the risk of stalled or failed policy implementation, came into view. The contentious fight and ultimate failure of health care legislation efforts was a reality check not only for the new administration, but for markets. Though President Trump has the advantage of a majority position in both houses of Congress, he still faces a polarized and conflicted coalition. Investors are now left to wonder about the timeline and certainty of other pro-growth plans, including proposed tax cuts and infrastructure spending efforts.

[1]https://www.wsj.com/articles/if-everyone-is-so-confident-why-arent-they-borrowing-1491901381

What the Yield Curve Tells Us

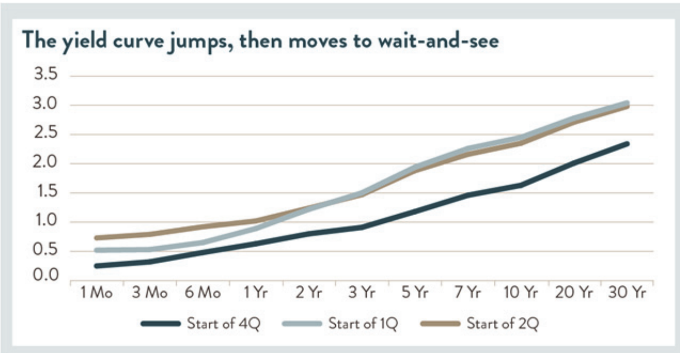
The yield curve can be a helpful guide in moments where the balance of new information is unclear. The yield curve – a connect-the-dots line that shows market interest rates from the shortest-term bonds (like 3-month T-bills and 1-year Treasury bonds) to the longer-dated issues (like 5-, 10-, and 30-year bonds) – may be a barometer of the future.

When the markets expect a future with high growth and high inflation, the yield curve tends to have a steep slope with higher rates for long-dated bonds. Typically, this indicates a future where the Federal Reserve will be raising rates from current levels. On the other extreme, a downward-sloping (or inverted) yield curve is thought to signal a coming recession, a leading indicator that has correctly predicted seven of the last seven U.S. recessions. Generally, an inverted yield curve is a sign that markets expect the Federal Reserve to cut rates in coming periods.

Politics aside, incoming economic data continued to paint a largely positive picture.

Homestead Funds

What Interest Rates Know: The End of 2016 Was Full of New Information, But the Start of 2017 Was Not



Source: treasury.gov

The fourth quarter witnessed a sharp change in level and slope of the yield curve, as we noted in the last quarterly update. This quarter: little change. Longer-dated interest rates drifted downward a bit, suggesting that earlier assessments of future inflation and future rate hikes were a bit overzealous. But, interest rates are not forecasting a coming recession. In a nutshell, the curve of interest rates shows us that the fourth quarter was full of new information for markets, while the first quarter offered few changes to that view.

Stock selection in the materials sector was a top driver of outperformance, boosted by strong performance among holdings in the containers and packaging and chemicals industries.

Bonds

Most bond indexes posted gains in the quarter as interest rates softened a bit from their fourth-quarter climb, despite a rate hike of 0.25% from the Fed in March. High yield and long-dated bond issues rallied the most.

Though rising interest rates tend to push existing bond prices down, such market adjustments seem to have transpired in the fourth quarter when investors came to forecast both a December and a March Fed hike. As such, despite the rate hike, bond prices were resilient.

The Fed had earlier indicated that it might enact three rate hikes in 2017 as part of its plan to "normalize" rates from the extreme lows of the financial crisis, but its ultimate moves will depend on inflation. If inflation levels stay steady or go higher, and overall GDP growth expectations seem secure, we think two more rate hikes this year would be feasible. At quarter-end, the markets were pricing in a 63% likelihood of another rate hike in June. Steady growth prospects also drove credit spreads to tighten a bit over the quarter.

In this environment, the Homestead Short-Term Government Securities Fund (HOSGX) returned 0.48% in the first quarter. It beat its benchmark, the Bank of America/Merrill Lynch 1-5 Year Treasury Index, which rose 0.37%.

The Homestead Short-Term Bond Fund (HOSBX) rose 0.78% in the quarter, leading its benchmark, the Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index, which was up 0.56%.

Both Homestead bond funds posted above-benchmark returns due to modest spread tightening and higher yields.

Stocks

Broad U.S. stock market benchmarks touched record highs in the quarter before retreating a bit at the end of the period. Large-cap and growth stocks led returns.

Stock markets generally performed well in the first quarter, though some sectors retraced gains from the strong returns of the fourth quarter, small-cap value stocks in particular. While the post-election rally of the fourth quarter was driven by the prospect of lower corporate taxes and easing regulatory costs, as well as by a steeper yield curve (which is particularly good news for bank profits), first-quarter returns switched in terms of performance leadership. Large-cap stocks outperformed small-cap stocks, and growth stocks outperformed value stocks, reversing the pattern of the previous quarter.

The Homestead Value Fund (HOLVX) returned 4.57% in the first quarter, outperforming its benchmark, the S&P 500 Value Index, which rose 3.29% in the period. We note that beginning on January 1, 2017, the fund's primary benchmark was changed from the S&P 500 Stock Index to the S&P 500 Value Index, which we believe more closely reflects the sectors and type of stocks in which the fund invests than the broader market benchmark.

Stock selection in the materials sector was a top driver of outperformance, boosted by strong performance among holdings in the containers and packaging and chemicals industries. Stock choices in the industrials sector also enhanced returns. Conversely, selection in the health care sector, particularly in pharmaceutical stocks, detracted from relative performance, though the effect was largely offset by the gains from an overweight allocation to the rebounding sector.

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

The Small-Company Stock Fund (HSCSX) declined -0.46% in the quarter, trailing its benchmark, the Russell 2000 Index, which was up 2.47%. Stock selection in consumer discretionary stocks detracted from relative performance, particularly in multiline retail holdings. Selection in the information technology sector also weighed on performance. Conversely, strong performance among industrials stocks boosted relative returns for the portfolio.

Relative to its benchmark, the Small-Company Stock Fund is notably underweight in the health care, information technology and real estate sectors. The portfolio is especially overweight in industrials stocks.

Total Returns as of 3/31/2017

		Average Annual				
	Q1	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* (HOSGX)	0.48%	-0.23%	0.77%	0.63%	1.99%	3.23%
BofA ML 1-5 Year U.S. Treasury Index	0.37%	-0.10%	1.14%	0.92%	2.65%	4.09%
Expense ratio 0.78% (gross) 0.75% (net) (12/31/16)						
> *Short-Term Bond Fund* (HOSBX)	0.78%	1.77%	1.26%	1.80%	3.33%	4.40%
BofA ML 1-5 Year Corp./Gov. Index	0.56%	0.56%	1.43%	1.38%	2.98%	4.64%
Expense ratio 0.76% (12/31/16)						
Equity Funds						
> *Value Fund* (HOVLX)	4.57%	16.72%	8.87%	12.95%	6.58%	10.11%
S&P 500 Value Index	3.29%	18.66%	8.88%	12.66%	5.70%	NA
Expense ratio 0.62% (12/31/16)						
> *Small-Company Stock Fund* (HSCSX)	-0.46%	17.80%	6.19%	12.17%	9.82%	9.41%
Russell 2000 Index	2.47%	26.22%	7.22%	12.35%	7.12%	7.34%
Expense ratio 0.89% (12/31/16)						

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.

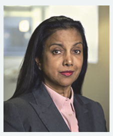
The expense ratio shows the percentage of fund assets deducted annually to cover operating expenses. Fund expense ratios shown here do not include acquired fund fees and expenses. If applicable, these additional costs are disclosed in the prospectus.

Homestead Funds

Equity Team

Mark Ashton, CFA
Senior Equity Portfolio Manager

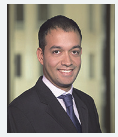
Mark co-manages RE Advisers' large- and small-cap value strategies. He is a graduate of the University of Utah, where he received a bachelor's degree in finance. He received his MBA with specialization in marketing research from the University of Southern California and also holds the Chartered Financial Analyst designation.



Prabha Carpenter, CFA
Senior Equity Portfolio Manager

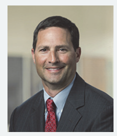
Prabha co-manages RE Advisers' large- and small-cap value strategies. She is a graduate of the University of Madras, where she received a Bachelor of Arts degree in economics. She received her Bachelor of Science degree in business economics and an MBA with distinction in finance from American University.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

Fixed-Income Team



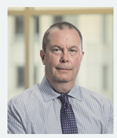
Mauricio Agudelo, CFA
Senior Fixed-Income Portfolio Manager

Mauricio co-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.



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.

Prepared: April 10, 2017

Past performance does not guarantee future results.

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.

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.

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 Standard & Poor's 500 Value Index measures the performance of the large-capitalization value sector in the U.S. equity market. It 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. 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.

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

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.

Homestead Funds