Quarterly Market Review

Fourth Quarter 2016

Homestead Funds

Summary

- The fourth quarter opened with continued signs of improving economic activity in the U.S. and abroad, but the real driver of performance in the period was the surprise election of Donald Trump for U.S. president and a Republican majority in both houses of Congress. Though the incoming administration could adopt some protectionist measures and policy details are not yet known, the market rallied on the outlook for lower corporate tax rates, easing regulatory burdens and other pro-business changes.

- Interest rates continued to climb, also boosted by the pro-business environment and its implications for stronger GDP growth and accompanying inflation. The Federal Reserve (Fed) enacted its second rate hike of the cycle in December.

- Most segments of the U.S. equity market rose, led by small-cap and value stocks. Sectors that benefit from higher interest rates, lower taxes and higher capital spending performed especially well.

A Surprise Boost, But More Uncertainty Ahead

U.S. election results propelled markets forward in the fourth quarter, presumably driven by the outlook for pro-business policy changes. Yet, positive trends in real-time economic activity also supported the market rally.

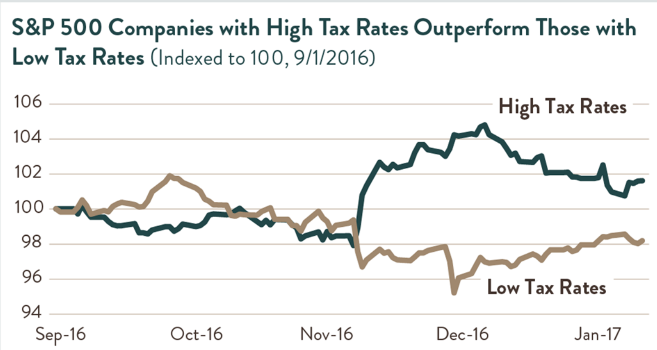
The fourth quarter of 2016 was something of a grand finale for the “year of the long shot.” Following the upset of the Brexit result in summer and even the Chicago Cubs’ World Series win in the fall, markets and pollsters were stunned by the election of Donald Trump for U.S. president. Markets nervously fell ahead of the election on signs that polls were tightening, but jumped within a day of the election results and rallied strongly into year-end.

Reading the Tea Leaves of a Trump Administration

On the heels of a particularly divisive election cycle, the incoming administration will have a lot of work to do to reunify the broader population and the polarized politicians now regrouping for the fights ahead. On the campaign trail, Trump was clear about his intention to enact a more protectionist stance in trade relationships, a position that most economists agree could set off trade wars and damage exports. Likewise, his anti-immigration position may appeal to popular sentiment, but could be a headwind for U.S. companies that rely on immigrant populations for labor, especially as labor markets near full employment.

Still, as markets digested the news, they clearly priced in upside to the political change. It appears that one of the biggest rally drivers was the outlook for lower corporate tax rates. Indeed, S&P 500 companies with high current tax rates, which stand to gain the most if taxes do fall, have since outperformed the S&P 500 companies with low current tax rates. Likewise, small-cap stocks outperformed following the election. Smaller companies typically pay higher tax rates than larger companies, who often have overseas operations and a wider range of tax maneuvers at their disposal.

Figure 1: Post-Election, Investors Bet on Lower Corporate Tax Rates



Source: Strategas

The post-election upside cannot be separated entirely from the pre-election trends in real economic activities, which were roundly positive. Economic growth strengthened in the U.S. throughout 2016, and fourth-quarter activity only reinforced that course.

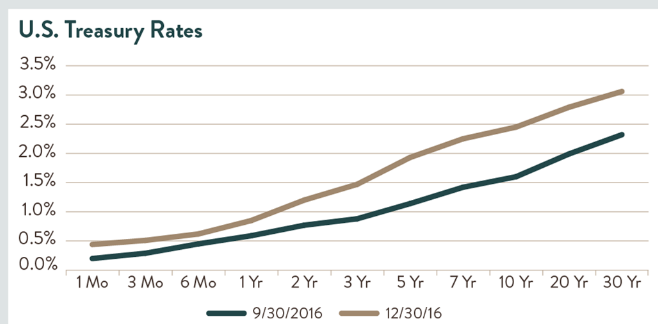
Companies also benefited from the outlook for easing regulatory burdens, which have increased sharply over the past eight years. The Trump administration has voiced a clear intention to decrease regulation across the economy, which lowers companies' costs and adds to their profits. It may even encourage new investment in the industrial sector, if companies anticipate less red tape to get new projects off the ground. Decreasing regulatory costs could provide a substantial boost to GDP.

An Upbeat Outlook for Real Economic Activity, Too

The post-election upside cannot be separated entirely from the pre-election trends in real economic activities, which were roundly positive. Economic growth strengthened in the U.S. throughout 2016, and fourth-quarter activity only reinforced that course. Comparing September numbers to December reports, we saw an uptick in manufacturing activity, auto sales, home sales and wages. Unemployment and underemployment rates continued downward, to the point that economists are suggesting that we're nearing full employment. Oil prices showed some weakness around the election, but jumped late in November with the announcement that Saudi Arabia and OPEC had reached an agreement to cap oil production, another long-shot outcome that boosted markets. Growth and inflation in Europe even showed signs of life, with strong reports of manufacturing activity in particular.

What's more, we see a virtuous cycle ahead for GDP growth. As demand rises, hiring activity tends to get more competitive and this puts upward pressure on wages. That typically leads to higher inflation, which raises the likelihood of more interest rate increases in the year ahead. This can result in a steeper yield curve, meaning that interest rates for longer-dated debt rise more than interest rates for short-term debt. A steeper yield curve is great for profits at financial institutions, which have eked by in an environment of near-zero rates for years.

Figure 2: Interest Rates Rise and Yield Curve Steepens



Source: treasury.gov

We may also – finally – be poised for higher capital spending among companies. The capital stock, such as the plants and machinery in manufacturing operations, has been aging as companies have invested at a below-average rate for many years. In the uncertain deflationary environment following the financial crisis, companies have consistently chosen to spend extra cash on things like share buybacks, dividends and mergers rather than investing in capital expenditures. The pro-business Trump boost, in combination with more stable inflation and rising interest rates, may be the push that company managements need to place long-term investment orders.

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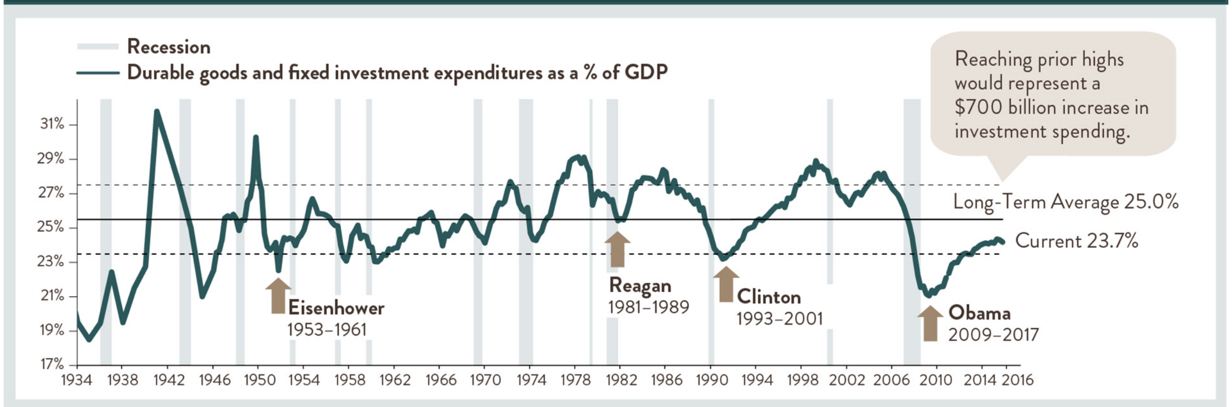
Figure 3: Investment Spending Still Near "Recession" Levels



Source: FundStrat, Strategas

Too Far, Too Fast?

Our biggest concern currently is that the Trump-driven optimism may have captured the big gains already, leaving little on the table for 2017. The tax, regulatory and capital spending outlooks are justifiably optimistic, but the policy details, negotiations and compromises that serve to make them a reality have yet to come into view. Tax and regulatory reforms are time-consuming processes. Perhaps dollars could flow through to infrastructure or defense initiatives more quickly, but there would still be budget realities and spending caps to contend with in addition to the practical considerations (e.g., project details, contracts, laborers, etc.). The political environment, never entirely stable or predictable, is at present extremely uncertain.

Bonds

Most bond indexes fell in the quarter as interest rates climbed higher. High yield issues were an exception, as rising interest rates were offset by further compression in credit spreads.

The ongoing strength in economic activity and inflation enabled the Fed to undertake another 0.25% rate increase in December, the only hike of 2016 and the second since they began to raise rates in 2015. Rising interest rates tend to push existing bond prices down. U.S. election results also boosted market expectations for GDP growth in the year ahead, strengthening the case for future rate hikes. At year-end, the Fed suggested it may make three rate hikes in 2017, though futures markets were only pricing in the likelihood of two. Stronger growth prospects also drove credit spreads tighter, which tends to drive up the prices of corporate debt and high-yield issues in particular, offsetting the pressure of interest rate increases.

The Homestead Short-Term Government Securities Fund (HOSGX) declined -1.07% for the fourth quarter, slightly outpacing its benchmark, the Bank of America/Merrill Lynch 1-5 Year Treasury Index, which declined -1.09%. The fund returned 0.45% for the calendar year, while its benchmark was up 1.09%.

The Homestead Short-Term Bond Fund (HOSBX) fell –0.35% in the quarter, outperforming its benchmark, the Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index, which was down by -1.02%. For the calendar year, the fund returned 1.75%, while its benchmark was up 1.62%.

Both Homestead bond funds outperformed their benchmarks in the fourth quarter due in part to the durations of the portfolios. Both 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 outperform in environments where interest rates are rising, as they did this quarter.

Stocks

The U.S. stock market rose in the quarter, led by small-cap and value stocks.

Equity markets rallied after the election, though not all sectors had positive returns. The best-performing segments and sectors were those that benefit from lower corporate tax rates, easing regulatory burden, higher industrial activity and rising interest rates. Within the S&P 500 Stock Index, the financials sector was the top performer, driven by strong performance among banks. Energy and industrials sectors were also strong performers in an environment of higher commodity prices and bolstered growth prospects.

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The real estate and health care sectors, on the other hand, were the bottom performers.

Real estate holdings are typically affected by rising interest rates, while the health care sector suffered on the expectation that an incoming Trump administration portends lower health insurance coverage and falling demand for health care services.

The Homestead Value Fund (HOLVX) returned 4.57% in the fourth quarter, outperforming its benchmark, the S&P 500 Stock Index, which rose 3.82% in the period. Stock selection in the industrials and energy sectors was a driver of outperformance, as was an underweight allocation in the consumer staples sector. For the calendar year, the fund returned 12.26%, while the S&P 500 returned 11.96%.

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

The Small-Company Stock Fund (HSCSX) rose 14.46% in the quarter, outpacing its benchmark, the Russell 2000 Index, which returned 8.83%. Stock selection in the consumer discretionary sector boosted relative performance, as did selection in the information technology sector. An underweight in the health care sector also enhanced performance, as the sector lagged in the period. For the year, the fund returned 18.85%, while the Russell 2000 rose 21.31%.

Relative to its benchmark, the Small-Company Stock Fund continues to be notably underweight in health care and real estate sectors, as well as moderately underweight to utilities and information technology names. The portfolio is especially overweight in industrials stocks. Overall positioning is largely unchanged since the third quarter.

Total Returns as of 12/31/2016

		Average Annual				
	Q4	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* (HOSGX)	-1.07%	0.45%	0.69%	0.57%	2.08%	3.24%
BofA ML 1-5 Year U.S. Treasury Index	-1.09%	1.09%	1.10%	0.80%	2.77%	4.12%
Expense ratio 0.77% (12/31/15)						
> *Short-Term Bond Fund* (HOSBX)	-0.35%	1.75%	1.24%	1.98%	3.39%	4.41%
BofA ML 1-5 Year Corp./Gov. Index	-1.02%	1.62%	1.39%	1.39%	3.08%	4.66%
Expense ratio 0.74% (12/31/15)						
Equity Funds						
> *Value Fund* (HOVLX)	4.57%	12.26%	8.00%	14.16%	6.38%	10.02%
S&P 500 Stock Index	3.82%	11.96%	8.87%	14.66%	6.95%	10.03%
Expense ratio 0.59% (12/31/15)						
> *Small-Company Stock Fund* (HSCSX)	14.46%	18.85%	6.76%	14.73%	9.97%	9.56%
Russell 2000 Index	8.83%	21.31%	6.74%	14.46%	7.07%	7.30%
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.

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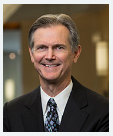
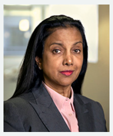
Equity Team



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.

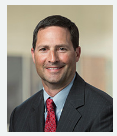
Gregory Halter, CFA
Senior Equity Portfolio Manager

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

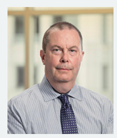
Mauricio Agudelo, CFA
Fixed-Income Portfolio Manager

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.

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Past performance does not guarantee future results.

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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 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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