Quarterly Market Review

First Quarter 2018

Homestead Funds

Summary

- Volatility returned to the stock market in the first quarter. Stocks posted strong gains in January on the momentum of U.S. tax reform, but tumbled in February and March on signs of higher wage inflation and trade conflict between the U.S. and China.
- The longer-term outlook remains positive with most countries around the world enjoying moderate economic expansion, maybe even approaching 4% global GDP growth in 2018, the highest since 2011. In the U.S., job creation remained strong, driving high consumer confidence levels. Company earnings continued to be healthy. Technology companies were on the hot seat over data privacy issues, increasing the chances that they face industry regulation going forward.
- The Federal Reserve enacted its sixth interest rate hike in the cycle, on track to complete three rate hikes in 2018, potentially four. New Fed chair Jerome Powell appeared keen to disregard stock market noise when possible as he oversees the ongoing interest rate increases.

Volatility Returns to Stocks

If the stock market surfed into 2018 on a cheery wave of tax breaks, it soon hit choppy waters. The first quarter of the year was a volatile one, with stocks rising in January on the momentum of tax reform legislation, then tumbling in February and March on inflation worries and the beginnings of trade conflict between the U.S. and China. U.S. stocks posted mixed results for the quarter, with value stocks down and growth stocks up. The S&P 500 had mild losses for the period.

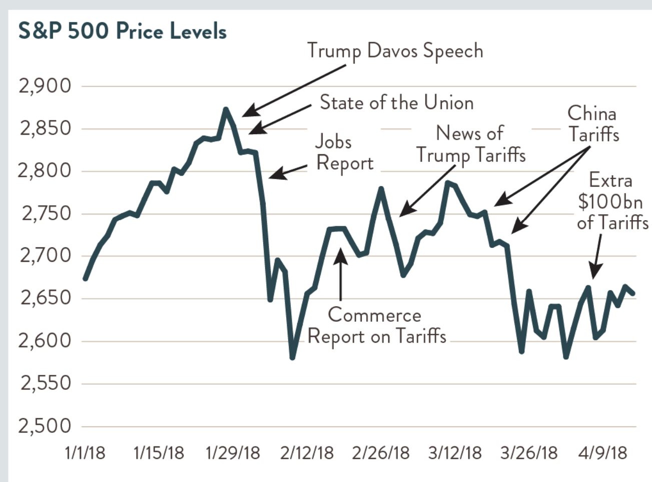
Inflation, Trade Conflict Both Ramp Up

Inflation, one source of market pressure, did show signs of gaining strength. The January jobs report showed that strong new job creation was accompanied by 2.9% wage inflation (year-over-year), higher than expected.[1] While overall inflation remains slightly below the Fed's 2% target, interest rates reacted with an upward turn. The 10-year U.S. Treasury rate moved from around 2.5% to 2.8% between mid-January to mid-February; stocks responded by declining.

Trade war worries in March began with President Trump's announcement of steel and aluminum tariffs intended to penalize China, followed a few days later by a series of border

Equity Markets Do Not Like Trade Wars

The first quarter was a play in three acts, with stock price trends reflecting shifting viewpoints on the potential impact of trade conflicts.



Source: Strategas.

[1] https://www.nytimes.com/2018/02/02/business/economy/jobs-report.html

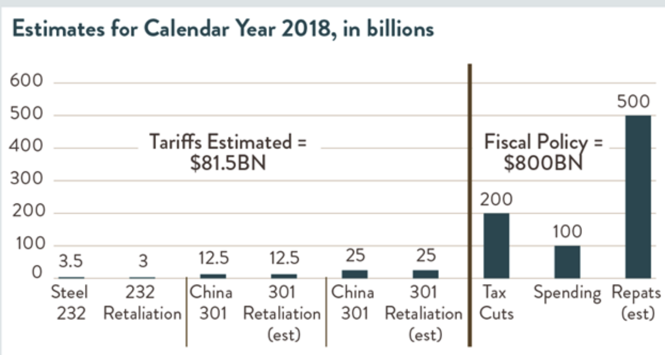
taxes on Chinese goods. Unsurprisingly, both moves sparked international pushback. U.S. allies like Canada and Mexico, who supply the majority of steel and aluminum imports, protested the unilateral treatment; the White House later announced exemptions to the steel and aluminum tariffs for ally countries. China reacted to border tax news by countering with tariffs of equal magnitude. At quarter-end, tariff policies were still evolving, stoking fears of an all-out trade war.

Looking to Bonds for Reaction

Bond prices reacted strongly to inflation signs in February, but showed a more limited reaction to tariff conflicts in March. Bond market reactions are often considered a better gauge of economic impact than stock market reactions. To put the current trade tensions in perspective, the immediate cost of the announced tariffs is dwarfed by the potential positive impact of the 2017 tax legislation. Current tariff actions against China are estimated at a cost of about $81.5 billion to the U.S. economy. But the new tax legislation is forecast to generate an $800 billion boost for the economy between direct tax cuts, increased capital spending and an influx of cash from repatriated international profits.

Comparing Tariffs to Tax Cuts

The U.S. has proposed new tariffs on steel (relying on section 232 of the Trade Expansion Act of 1962) and other imports from China (invoking section 301 of the Trade Act of 1974).



Source: Strategas.

The economic benefits of fiscal stimulus are estimated to far exceed the costs of the tariffs.

A Rosy 4% for 2018?

Still, most measures of the economy are in good shape. A number of economists even see the possibility of a 4% growth rate for global GDP this year; if reached, it would be the highest global rate since 2011.[2]

Global purchasing manager indexes (PMI), which measure order volumes and pricing among purchasing managers, reflect this broad-based expansion. Index levels reached a seven-year high in December and have remained robust since. At the latest reading, the J.P. Morgan Global Manufacturing PMI was just below 55; anything over 50 indicates expansion from the previous month. This strength was reported across nearly all countries and sectors. PMI readings in the U.S. were at a 34-month high.[3]

This momentum filters down to the employment market and to the confidence levels of businesses and consumers. The unemployment rate in the U.S. remained steady at 4.1% over the quarter, and jobs reports across the period were positive. The Bureau of Labor Statistics reported nearly half a million new jobs created over January and February.[4]

There's also the matter of the newly passed tax legislation. Stock markets rallied in anticipation of the final deal – in fact, the boost from tax cuts may already be incorporated into stock prices. However, the package includes incentives for businesses to do more capital spending, something that has been woefully weak over the recovery of the last 10 years. Upcoming infrastructure spending, whatever form it may ultimately take, also stands to boost future economic activity.

Amid Noise, an Unruffled Fed

Alongside trade war worries, other contentious politics continued to plague markets at home and abroad. Overseas, ongoing violence in Syria raised worries of more direct American engagement in the region. Back at home, turmoil in the White House continued, with the special counsel's investigation continuing to circle the president and several in his inner circle. The administration's short-notice policy moves have become "the new normal" to markets, but do leave open questions about how such policy moves, like the trade tariffs, affect company decision-making looking forward.

[2] https://www.bloomberg.com/news/articles/2017-11-28/goldman-barclays-see-as-good-as it-gets-global-growth-of-4
[3] https://www.markiteconomics.com/Survey/PressRelease.mvc/cfe31b1e1f424d4ba54db08a f4f30a36
[4] https://data.bls.gov/timeseries/CES0000000001?output_view=net_1mth

Amid this turmoil, new Fed chair Jerome Powell has been indicating to markets that he intends to guide interest rate policy with as little market noise as possible. When Trump announced import tariffs, for instance, Powell noted in a press conference that it was too early to say what impact, if any, the policies might have on inflation and Fed actions.

Bonds

Most U.S. bond indexes posted losses in the quarter, though international bonds had positive returns. U.S. interest rates generally climbed, with short-term rates rising faster than longer-dated issues, flattening the yield curve. Credit spreads widened somewhat, pressuring investment-grade and high-yield bond performance.

The Federal Reserve raised its target interest rate again by 0.25% to a range of 1.5% to 1.75%. It was the sixth increase since the Fed began raising rates in the cycle, and the first hike since new chair Jerome Powell took over from Janet Yellen. Strong economic growth and inflation data over the period increased the outlook for faster rate hikes ahead. The Fed's most recent communications indicated three hikes in 2018; market-watchers are beginning to anticipate the possibility of four increases. While wage inflation showed signs of climbing in recent months, it has been uniquely stubborn in this economic cycle. The Fed's preferred inflation measure, the price-consumption expenditure (PCE) deflator, stayed in a range of 1.77% - 1.97% (annualized) between October 2017 and February 2018, still short of the 2% Fed target.[5]

In this context, the Homestead Short-Term Government Securities Fund (HOSGX) returned 0.10% in the first quarter. It outpaced its benchmark, the ICE BofAML 1-5 Year Treasury Index, which fell -0.38%.

The Homestead Short-Term Bond Fund (HOSBX) rose 0.06% in the quarter, also outperforming its benchmark, the ICE BofAML 1-5 Year Corporate/Government Bond Index, which was down -0.49%. Both Homestead bond funds maintain shorter average duration than their indexes, which boosted their relative performance in a period where interest rates were rising.

[5]https://fred.stlouisfed.org/series/PCEPI

Stocks

Global stocks were mixed in the period. Emerging market stocks posted gains, as did U.S. growth stocks. Developed international and U.S. value stocks had mild declines.

The first quarter had three distinct phases for stock performance, starting with strong returns in January on the heels of U.S. tax legislation. Stocks faced declines in February on higher-than-expected wage inflation. March was also a month of headwinds as trade conflict heated up between the Trump administration and China. Technology stocks faced pressure over data privacy concerns, increasing the chances that they'll face more industry regulation.

The Homestead Value Fund (HOLVX) declined -2.33% in the first quarter, outperforming its benchmark, the S&P 500 Value Index, which fell -3.57%. Positioning in the information technology sector led the fund's relative returns, thanks to both an overweight allocation in the sector and outperformance among stock picks. The fund's avoidance of consumer staples stocks also boosted returns, as it was the worst-performing sector in the S&P 500 Value Index. Conversely, fund holdings in the industrials sector detracted in the period.

In terms of fund positioning, the Value Fund is most overweight relative to its benchmark in the information technology, materials and health care sectors. The fund is most underweight in consumer staples 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. 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) fell -2.34%in the quarter, trailing its benchmark, the Russell 2000 Index, which declined -0.08%. Stock choices in the information technology (IT) sector weighed on the fund's quarterly returns. An underweight position in the IT sector also hampered returns, as it was the top performer in the Russell 2000 Index. Holdings in the industrials sector also weighed on returns. Conversely, the fund's holdings in the financials sector boosted relative returns, with strong performance from insurance stocks in particular.

Homestead Funds

Relative to its benchmark, the Small-Company Stock Fund continues to be notably underweight in the health care, information technology and real estate sectors. 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.

Both Homestead bond funds maintain shorter average duration than their indexes, which boosted their relative performance in a period where interest rates were rising.

Total Returns as of 3/31/2018

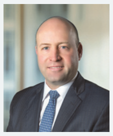
		Average Annual				
	Q1	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* (HOSGX)	0.10%	0.49%	0.41%	0.45%	1.46%	3.10%
ICE BofA ML 1-5 Year U.S. Treasury Index	-0.38%	-0.10%	0.47%	0.64%	1.62%	3.90%
Expense ratio 0.81% (gross) 0.75% (net) (12/31/17)						
> *Short-Term Bond Fund* (HOSBX)	0.06%	0.92%	1.11%	1.20%	3.17%	4.27%
ICE BofA ML 1-5 Year Corp./Gov. Index	-0.49%	0.22%	0.81%	0.99%	2.16%	4.47%
Expense ratio 0.76% (12/31/17)						
Equity Funds						
> *Value Fund* (HOVLX)	-2.33%	14.10%	9.23%	12.12%	9.24%	10.25%
S&P 500 Value Index	-3.57%	7.69%	8.40%	10.87%	7.42%	NA
Expense ratio 0.60% (12/31/17)						
> *Small-Company Stock Fund* (HSCSX)	-2.34%	9.89%	5.74%	10.27%	11.53%	9.43%
Russell 2000 Index	-0.08%	11.79%	8.39%	11.47%	9.84%	7.56%
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.

Homestead Funds

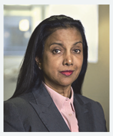
Equity Team



Peter Blackstone

Senior Equity Analyst

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

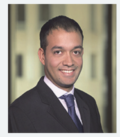


Prabha Carpenter, CFA®

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.

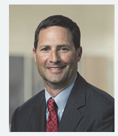
Fixed-Income Team



Mauricio Agudelo, CFA®

Senior Fixed-Income Portfolio Manager

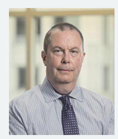
Mauricio co-manages RE Advisers' fixed-income strategies. He received a Bachelor of Science degree in finance from the University of Maryland, Robert H. Smith School of Business. He minored in business culture and language, with a concentration in Spanish. He holds the Chartered Financial Analyst designation.



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 17, 2018.

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.

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.

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