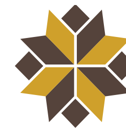
Quarterly Market Review

Second Quarter 2016



Homestead Funds

Summary

- Global growth remains muted, though the U.S. economy is leading the world in stability these days. Anxieties are high, but many broad measures of health in the U.S. economy are actually very good.
- The bond market saw yields fall yet again, with 10-year U.S. Treasuries setting a new record low. Negative rate policy outside the U.S. is a factor, and the ever-lengthening timeline for higher rates here at home is putting downward pressure on yields.
- Stocks had another bumpy quarter, including a swift fall on news of the U.K.'s referendum vote to leave the EU, but managed to finish the period with respectable gains.

While there are many issues to worry about in today's environment, you may be surprised to learn that there's also a lot to be confident about.

Macroeconomics

In the battle between anxiety and confidence, you might be surprised to learn that confidence actually won out this quarter.

Brexit. Uncertain interest rate policy. Weak oil prices, a slowing China, and political unrest across the globe. Anxiety continues to rule the economy and the markets — or does it?

This quarter was another bumpy ride for investors, but despite the issues we read in headlines every day, U.S. stocks and bonds both posted respectable returns in the quarter, judging by most broad market indexes. While there are many issues to worry about in today's environment, you may be surprised to learn that there's also a lot to be confident about.

Brexit and the Worried Investor

One of the key sources of anxiety this quarter was the U.K.'s referendum vote on whether to leave the European Union (EU), known as "Brexit." In the final days of the quarter, global markets were shocked at the final referendum result to Leave (as opposed to Remain). Polls had predicted the opposite. Nearly all markets tumbled the next day, with stocks across the eurozone taking the biggest hit. But in the days that followed, many markets recovered almost completely, suggesting that the fallout from the decision may not be as extreme as investors feared.

It's far too early to know what the full impact will be of the U.K.'s decision. For the U.K. employment outlook, banking sector, housing and construction industries, there are immediate concerns. But the near-term impact on our U.S.-based investment markets is likely to be limited. U.S. company exports to the U.K. are only a small share of total exports; on the other hand, a relatively stronger dollar could take a bite out of U.S. company profits.

In the long term, it could get far more complicated. A plan for Britian's exit is still to be mapped out and the negotiations are complex. A protracted period of uncertainty could dampen investment in the EU region and have potentially global spillover effects. There is also the possibility of an

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unravelling of the EU itself, and this has cast a pall over the prospects for Europe's contribution to global economic growth. Already, a large share of global gross domestic product (GDP) is currently not growing much.

Muddling through 2016

Country	Global Share of 2015 Nominal GDP	2015 Nominal GDP Annualized Growth	Strategas' 2016 Real GDP Forecast
Eurozone	15.8%	1.6%	1.5%
China	15.0%	5.6%	6.9%
Japan	5.6%	0.6%	0.5%
U.S.	24.5%	2.4%	1.8%
U.K.	3.9%	2.3%	0.0%

Nominal GDP is the value of all goods and services produced at current market prices; real GDP is the inflation-adjusted value.

Source: International Monetary Fund, Strategas

Jobs and the Confident Consumer

Yet, there's plenty of good news to consider, too. U.S. economic growth continues to be modest, in the 1-2% range annually, but reassuringly stable. Most of the growth is coming straight from consumers. After a slow start to the year, consumer spending jumped 1.1% in April and another 0.4% in May (the most recent numbers available),[1] with robust growth in the sales of big-ticket items like cars, refrigerators, and electronics.[2]

Consumer confidence is behind the willingness to spend, and consumers have reason to feel confident; the job market is in relatively good shape. Jobs data was generally strong in the quarter, although there was a minor blip in new job creation in May (June numbers came roaring back). The number of employed people continues to climb since bottoming in the financial crisis, while measures of "underemployment" have also shown improvement. Indeed, the strength in the labor market is flowing through to wages and salaries. Weekly and hourly income measures continue to rise at a slow-but-steady pace, more good reason for consumers to be confident.[3]

In Neutral: Global Growth, Oil Prices, and Corporate Profits

Somewhere in between the Brexit lows and the jobs highs, other measures are in a more neutral zone, like oil prices. After bottoming in the $30s in January, barrel prices topped $50 during the second quarter before settling back in the mid-$40s.

That may not be the most welcome news for consumers, who have enjoyed the steep drop in energy costs. But it's reassuring news for energy companies, their employees and investors, for sure. Actually, oil prices aren't as high as that cohort would like, but the stability is a welcome change after nearly two years of falling prices. It also serves as a measure of relative confidence, signaling that we may have finally moved past the phase where every bit of bad news shaves dollars off both the oil market and the stock market.

Energy companies in aggregate are expected to post losses for the quarter, but not as severe as in recent periods. Of the other nine sectors in the stock market, five are expected to register profit declines in the second quarter, with only four sectors expected to report growth in earnings. As a whole, the companies in the S&P 500 are on track for minor profit declines in aggregate, which marks the fifth straight quarter of declines.[4] Yet, the economy at large has enjoyed growth in that period, and broad stock indexes are up. In the industry this is known as an "earnings recession."

Caught in the Middle: The Fed

Stuck with the task of balancing these many inputs and setting the course for interest rate policy, the Federal Reserve (Fed) has been in a perpetual wait-and-see stance on its plan to raise rates. Though the Fed is wary of making a move too soon, the key measures it watches are actually moving in the right direction. Inflation, a key input for interest rate decisions, is approaching the Fed's target rate of 2% annually. Core consumer prices (minus the more volatile food and energy components) are rising at a rate of about 1.6%.[5] Oil prices are finally stabilizing, and wage growth is slowly rising. As long as these measures remain positive, we believe there's still a good chance of rate hikes in coming quarters.

Yet, most other countries are still in lower-lower-lower interest rate mode, with some central banks going into negative territory. Central banks in the eurozone, Denmark, Switzerland, and Japan are all using some form of negative interest rate policy, where lenders are actually charged for

[1] http://www.bea.gov/newsreleases/national/pi/2016/pi0516.htm
[2] http://money.cnn.com/2016/05/31/news/economy/us-economy-personal-spending-best-since-2009/?iid=EL
[3] Source: Bureau of Labor Statistics
[4] Source: https://www.factset.com/websitefiles/PDFs/earningsinsight/earningsinsight_7.8.16
[5] http://www.bea.gov/newsreleases/national/pi/2016/pi0516.htm

Macroeconomics continued

loans rather than receiving interest. The Brexit shock only reinforced that trend, and as a result, rates here in the U.S. just keep drifting lower. The 10-year U.S. Treasury touched a record low in the quarter.

On the bright side, global rate policies reflect the innovation that central bankers around the world are now deploying to soften economic blows. If and when another recession appears, we have confidence that the Fed will continue to do whatever it can to ease downward shocks.

Bonds

The bond market enjoyed a positive quarter overall, with interest rates falling and credit spreads compressing slightly. Long-term bonds outperformed short-term issues, as the yield curve flattened in the face of a longer timeline for rate increases. Energy companies led the market in spread compression, with rising oil prices boosting their outlook for cash flows.

Interestingly, credit spreads did not have the extreme reaction to Brexit news that stock markets did, suggesting a less fearful view of the event. A number of other positive signs also indicate that debt markets are relatively healthy. Issuance continues at a high volume, primarily to fund merger and acquisition deals, which have also continued. Liquidity has not been an issue in the bond markets.

Most bond indexes were positive for the quarter. The Homestead Short-Term Bond Fund (HOSBX) rose 0.96% in the quarter, while its benchmark, the Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index, was up 0.98% in the period.

The Homestead Short-Term Government Securities Fund (HOSGX) was up 0.36% for the second quarter. It slightly trailed its benchmark, the Bank of America/Merrill Lynch 1-5 Year Treasury Index, which returned 0.81%.

Both Homestead bond funds trailed their benchmarks slightly, 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 underperform in environments where interest rates are falling, like they did in the second quarter.

Equities

Despite another bumpy quarter, most broad stock indexes finished the period with gains.

U.S. stock markets led performance, outpacing international markets. Within the U.S., small-company stocks outperformed large-company stocks, while value-oriented stocks outperformed growth stocks, broadly speaking. A mix of traditionally defensive sectors led benchmark performance in the quarter with energy, telecommunication services, utilities and health care posting the highest sector returns. The information technology and consumer discretionary sectors had mild declines in aggregate.

The Homestead Value Fund (HOLVX) returned 3.40% in the quarter, outpacing its benchmark, the S&P 500 Index, which rose 2.46% in the period. Stock selection was the primary driver of outperformance, though sector allocation also boosted returns. The fund's performance in the health care sector was particularly good; stock choices in energy and information technology sectors also enhanced performance. Conversely, stock selection in industrials and materials holdings detracted from returns.

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

The Small-Company Stock Fund (HSCSX) rose 2.84% in the second quarter. It trailed its benchmark, the Russell 2000 Index, which rose 3.79% in the period. Sector allocation detracted from relative performance, though it was partially offset by positive security selection. Positioning in consumer discretionary and health care stocks detracted from performance. However, selection in the industrials sector provided a relative boost.

Relative to its benchmark, the Small-Company Stock Fund is overweight in industrials and consumer discretionary sectors. The fund is underweight in health care, financials, and information technology stocks.

Homestead Funds

Equity Team

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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.

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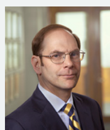
Prabha co-manages RE Advisers' large- and small-cap value strategies. She is a graduate of the University of Madras, where she received a Bachelor of Arts degree in Economics. She received her Bachelor of Science degree in Business Economics and an MBA with distinction in Finance from American University.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



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Fixed-Income Team

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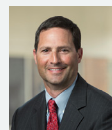
Mauricio co-manages RE Advisers' fixed-income strategies. He received a B.S. in finance from the University of Maryland, Robert H. Smith School of Business. He minored in business culture and language, with a concentration in Spanish. He is a Level III candidate for the Chartered Financial Analyst (CFA) designation.



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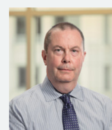
Marc manages the Daily Income Fund portfolio and analyzes risk, return and volatility attributes of RE Advisers' fixed-income strategies. He is a graduate of Villanova University, where he received a Bachelor's degree in General Arts. He received his MBA from Northeastern University and holds the designations of Certified Financial Planner, Chartered Financial Consultant and Chartered Alternative Investment Analyst.



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