Quarterly Market Review

Second Quarter 2017

Homestead Funds

Summary

- Stock markets continued their upward trajectory in the second quarter. Shares rallied on strong earnings reports and seemed unfazed by increasing political uncertainty, which clouds the outlook for tax reform and other pro-growth initiatives. Valuation measures for stocks are not at "dot-com" peaks, but are at above-average levels.

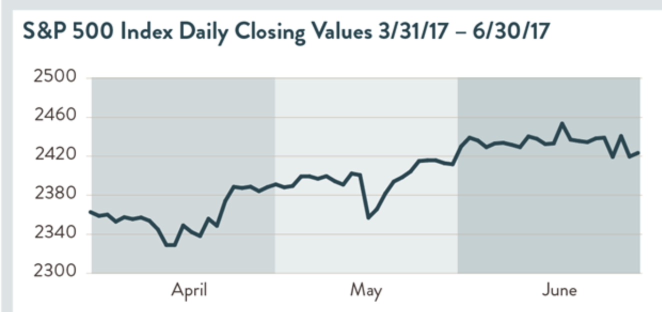
- Macroeconomic reports were generally good in the period. Job markets posted gains, and the unemployment rate climbed incrementally down. Retail industries and auto sales faced some pressure.

- Short-term interest rates rose as the Federal Reserve (Fed) raised the federal funds target rate in June. Longer-term interest rates softened as growth and inflation outlooks moderated, but the Fed reiterated its goal of gradually removing record-level stimulus at a measured pace.

Lofty Heights

Another quarter, another record high for the stock market. The S&P 500 and Dow Jones Industrial Average stock indexes touched new highs in late June before pulling back slightly, both finishing the quarter with healthy positive returns. In fact, stock charts for the period show a fairly steady upward march, barely a downward blip in sight. If the markets have much doubt about the direction of stock prices, the numbers certainly don't show it.

Stocks Reach New Highs in the Second Quarter



Source: Factset

Equity Valuations Above Historical Averages

It's not only the dollar value of stocks that's high today. When we look at comparative measures of valuation, like the price-to-earnings (P/E) ratio, stocks are expensive. A ratio like price-to-earnings takes into account the relative price of a given stock or index, asking: how much are investors paying per dollar of company earnings? (The most commonly used version is forward earnings, calculated by dividing today's stock price by the forecasted earnings for the next 12 months.)

On a forward P/E ratio basis, the S&P 500 currently trades around 18x earnings, the highest level since about 2004. How does that compared with other historical periods? Over the last five years, the average forward P/E was closer to 15x. But if we take the average over a longer period, such as 20 years, it's around 17x earnings.[1] However, that includes the data from the dot-com boom, a stock market era where average forward P/E ratios reached the high-20s, driven by astronomical valuations for technology stocks in particular.

[1] http://www.businessinsider.com/sp-500-forward-12-month-price-to-earnings-most-expensive-since-2004-2017-2

Ultimately, there is no "correct" amount to pay per dollar of earnings, and there's no guarantee that stock prices will revert to bring this measure closer to its long-term average. What we can say, however, is that stocks today are not a comparative bargain, and could stay at their current valuations for an extended period.

Other Reasons for Prudence

Valuations are not the only yellow flag in markets today. The pro-growth policies that ostensibly fueled a post-election rally in stocks and interest rates seem to be in a holding pattern, stalled by the politics of the moment. If stocks surged at year-end on expectations for lower corporate taxes, regulation rollbacks and a hefty infrastructure spending program, there could be downside ahead if these plans never come to pass, or if the final versions fall short of expectations.

The energy markets also took a left turn in the quarter. Oil prices, which were in the mid-$50s per barrel through the first quarter, lost steam and retreated back to the mid-$40s[2]. An agreement by certain OPEC countries to limit production seems to have had little effect on the total global inventory of oil, which is being replenished by U.S. shale markets at a healthy clip. And the nagging weak spots we mentioned in the first quarter, namely retail sales reports and default rates for auto loans, continued to drag along at iffy levels.

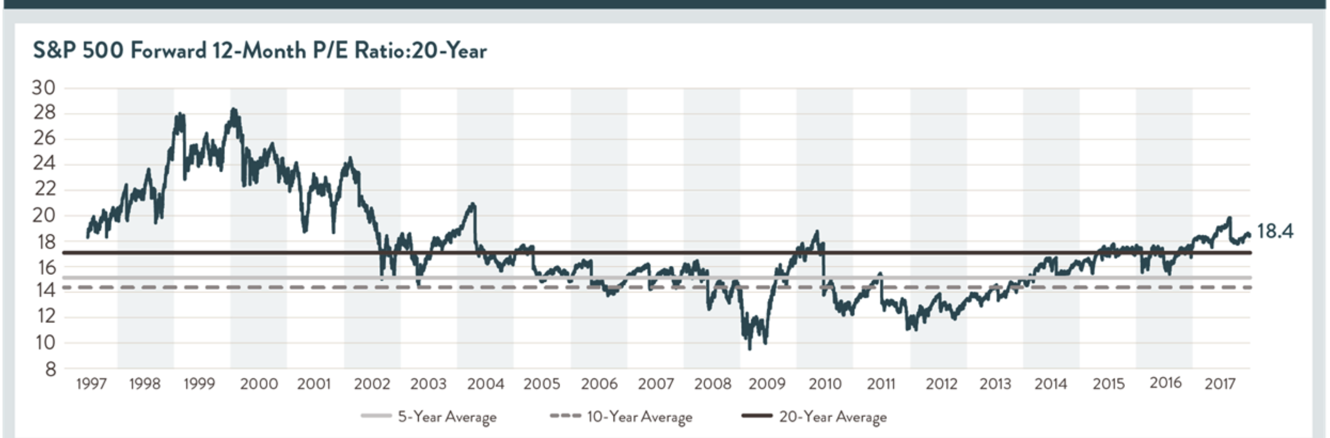
Good News, Too

Still, the news that investors seem more focused on today is the good news: company earnings are particularly strong. In fact, 75% of companies in the S&P 500 announced higher-than-expected first-quarter earnings (released during the second quarter), and 64% of companies announced higher-than-expected revenues.[3] The rate of earnings growth was well into the double-digits.[4]

We believe these strong earnings reports are connected to the robust employment market, which continued to expand in the quarter. The unemployment rate, which peaked around 10% during the financial crisis, was 4.4% in June 2017.[5] While job gains have not been evenly spread across the country, the continued job creation has driven spending activity and confidence measures among consumers on average.

Additionally, growth beyond U.S. borders is looking healthier, which bodes well for U.S. companies who do business abroad. GDP growth in the European Union, for instance, has slowly but steadily recovered since hitting a recessionary patch in 2012 – 2013.[6] In fact, central bankers there have begun to publicly discuss the outlook for trimming back the extraordinary monetary easing they pumped into the economy during the financial crisis and again during the more recent period of contraction. This telling development illustrates a strengthening confidence among policymakers.

Relative Measures Such as Forward P/E Ratio Are High



Source: FactSet, Strategas

[2] http://quotes.wsj.com/futures/CRUDE%20OIL%20-%20ELECTRONIC
[3] https://insight.factset.com/hubfs/Resources/Research%20Desk/Earnings%20Insight/EarningsInsight_062317.pdf?t=1500312643493
[4] https://insight.factset.com/hubfs/Resources/Research%20Desk/Earnings%20Insight/EarningsInsight_062317.pdf?t=1500312643493
[5] https://www.bls.gov/
[6] https://tradingeconomics.com/european-union/gdp-annual-growth-rate

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Room to Run

Stocks today are certainly not "on sale." But relative valuations on measures like forward P/E ratio are not into nonsensical territory just yet. In order to experience more upside into year-end, we believe markets would need to see continued earnings and revenue growth at companies, and some progress in the pro-growth policy initiatives championed by the administration.

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Bonds

Most bond indexes posted gains as longer-term interest rates softened a bit further from their post-election highs, despite an additional rate hike of 0.25% from the Fed in June. High yield and long-dated bond issues rallied the most.

The Federal Reserve (Fed) raised its target for the overnight deposit rate by another 0.25% in June to a range of 1% - 1.25%, the fourth such move since it began hiking rates at the end of 2015. While the March hike was a bit of a surprise for markets, the June move was highly anticipated and bond prices had largely adjusted ahead of the actual move. Shorter-term interest rates, such as 3-month and 2-year-terms, rose incrementally in the quarter. However, longer-term rates, like 5-year and 10-year issues, were flat or down in the period as markets dialed back some of the post-election hopes for higher long-term growth.

The Fed has clearly communicated its intention to wean the economy off the extremes of low-cost borrowing and flood of money supply it put in place following the financial crisis. Though its preferred inflation measure, the Personal Consumption Expenditure (PCE) deflator, has posted lackluster growth in recent months, Fed officials believe deflationary forces are isolated and pose little threat at present to plans for interest rate normalization. The Fed has cautioned markets to expect another one or two rate hikes before the year is out. (The PCE deflator is a measure of changes in the prices consumers pay for goods and services.)

The Homestead Short-Term Government Securities Fund (HOSGX) returned 0.25% in the second quarter. It trailed its benchmark, the Bank of America/Merrill Lynch 1-5 Year Treasury Index, which rose 0.38%. Year-to-date, the fund is slightly behind its benchmark.

In this environment, the Homestead Short-Term Bond Fund (HOSBX) rose 0.41% in the quarter, lagging its benchmark, the Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index, which was up 0.55%. However, the fund is ahead of its benchmark for the year-to-date period.

Stocks

Broad U.S. stock market benchmarks again touched record highs before retreating a bit at the end of the period. As in the first quarter, growth stocks led returns.

It was another strong quarter for many stocks, especially growth-oriented companies. Despite roadblocks for the pro-business policies that reignited markets after the election, company earnings reports were too healthy to ignore. Growth stocks continued to outpace value stocks in the period, but there was little differentiation between large-cap and small-cap stock returns.

The Homestead Value Fund (HOLVX) returned 2.00% in the second quarter, outperforming its benchmark, the S&P 500 Value Index, which rose 1.51% in the period. Stock selection in the industrials sector was a key contributor to outperformance, and an overweight in the sector relative to the benchmark further boosted returns. Avoidance of telecommunications services stocks also contributed to relative returns, as the sector lagged in the period. Conversely, stock selection in the energy sector, particularly among oil, gas, and consumable fuels stocks, detracted from relative performance. On a year-to-date basis, the fund outperformed its benchmark.

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

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The Small-Company Stock Fund (HSCSX) rose 1.71% in the quarter, trailing its benchmark, the Russell 2000 Index, which was up 2.46%. Stock selection among consumer discretionary stocks detracted from relative performance, driven by several holdings in retail stocks. Conversely, stock choices in the materials and financials sectors boosted relative returns for the portfolio. On a year-to-date basis, the fund is trailing the index.

Relative to its benchmark, the Small-Company 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 6/30/2017

		Average Annual				
	Q2	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* (HOSGX)	0.25%	-0.35%	0.64%	0.58%	1.95%	3.20%
BofA ML 1-5 Year U.S. Treasury Index	0.38%	-0.53%	1.08%	0.87%	2.65%	4.06%
Expense ratio 0.78% (gross) 0.75% (net) (12/31/16)						
> *Short-Term Bond Fund* (HOSBX)	0.41%	1.21%	1.22%	1.78%	3.32%	4.37%
BofA ML 1-5 Year Corp./Gov. Index	0.55%	0.13%	1.37%	1.37%	3.00%	4.61%
Expense ratio 0.76% (12/31/16)						
Equity Funds						
> *Value Fund* (HOVLX)	2.00%	15.15%	7.45%	14.20%	5.98%	10.09%
S&P 500 Value Index	1.51%	15.86%	7.79%	13.82%	5.25%	NA
Expense ratio 0.62% (12/31/16)						
> *Small-Company Stock Fund* (HSCSX)	1.71%	16.51%	6.30%	13.02%	9.30%	9.38%
Russell 2000 Index	2.46%	24.60%	7.36%	13.70%	6.92%	7.38%
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.

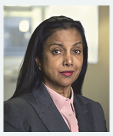
The expense ratio shows the percentage of fund assets deducted annually to cover operating expenses. Fund expense ratios shown here do not include acquired fund fees and expenses. If applicable, these additional costs are disclosed in the prospectus.

Homestead Funds

Equity Team

Mark Ashton, CFA
Senior Equity Portfolio Manager

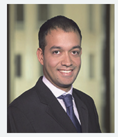
Mark co-manages RE Advisers' large- and small-cap value strategies. He is a graduate of the University of Utah, where he received a bachelor's degree in finance. He received his MBA with specialization in marketing research from the University of Southern California and also holds the Chartered Financial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



Prabha Carpenter, CFA
Senior Equity Portfolio Manager

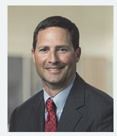
Prabha co-manages RE Advisers' large- and small-cap value strategies. She is a graduate of the University of Madras, where she received a Bachelor of Arts degree in economics. She received her Bachelor of Science degree in business economics and an MBA with distinction in finance from American University.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

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Past performance does not guarantee future results.

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