Quarterly Market Review

Second Quarter 2018

Homestead Funds

Summary

- Volatility continued in the second quarter, though most U.S. stock indexes posted gains. Escalating trade tensions between the U.S. and China were a key headwind for stocks, but strong company profits and rosy economic data in the period drove stocks higher anyway.
- Though the economy and stock markets are increasingly showing signs of a cycle peak, the good news could continue for some time. Global growth pulled back a bit from the first quarter, but remains healthy. U.S. job creation continued apace, driving good spending behavior among consumers. Oil prices were especially strong, and energy stocks led market performance. On the other hand, trade tensions and higher labor and fuel costs pressured industrials.
- The Federal Reserve hiked overnight rates again, and market-watchers anticipate a third hike for the year in September and a possible fourth in December. Interest rates rose, with short-term rates climbing more than long-term rates, driving a flatter yield curve.

Teetering at the Top

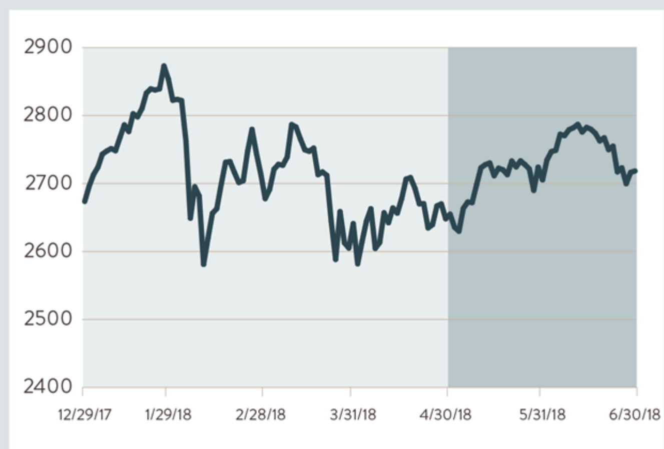
Stocks were generally up in the second quarter, though the bumpy ride continued. After struggling through February and March on inflation worries and trade tensions, the second quarter was more of the same, though the nature of market worries shifted. But ultimately, robust company earnings and strong economic data over the period were enough to overcome the headwinds. All told, most broad U.S. stock indexes posted gains in the three-month period, with small-cap stocks outpacing large caps. Among large-cap stocks, growth names heartily outperformed value names; in other segments, the two styles had similar performance. Though gains were strong in the U.S., international stocks generally declined, particularly in emerging markets.

U.S. Companies Report Strong Profit Growth?

There were plenty of good reasons over the quarter for stocks to climb. The period was a prosperous one for many U.S. companies, which posted first-quarter earnings growth at nearly 25% on a year-over-year basis.[1] Forecasts for second-quarter earnings predict a slightly slower pace, but still expect a whopping 20% growth rate. Over long periods, stock prices tend to rise along with company profits.

Stocks On A Bumpy Ride In 2018

The S&P 500 Index



Source: Bloomberg

[1] https://insight.factset.com/earnings-insight-q118-by-the-numbers-infographic

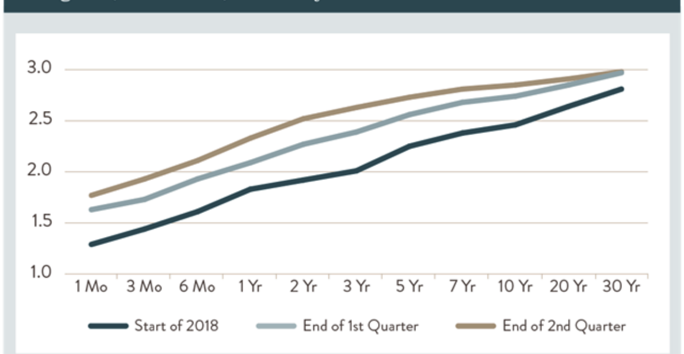
The U.S. consumer is one of the key forces driving these strong sales and earnings at companies. In the second quarter, job creation continued at a clip of about 200,000 new jobs per month, driving the unemployment rate briefly below 4%, the rate widely regarded as "full employment."[2] The unemployment rate ticked up at quarter-end as more job seekers returned to the labor market. Some industries are facing considerable labor shortages, including trucking and technology, and we've seen anecdotal reports that companies have had to widen their search parameters to source new hires.[3] Strong labor markets tend to drive confidence — and spending — among consumers.

Gone Missing: Steeper Yield Curve

With such strong economic momentum, it could be that higher inflation is officially "the alligator closest to the boat" for U.S. policy makers. Gung-ho growth typically leads to higher inflation as resources and labor are in high demand, which typically propels central bankers to hike interest rates up as a counterbalance. If the market expected a rosy future, we would expect to see a "steep" yield curve, where longer-dated interest rates are quite a bit higher than short-term rates, reflecting an expectation for future rate hikes.

Well, the Federal Reserve (Fed) did hike its target overnight rates by 0.25% in June, as expected. But instead of seeing a steep rate curve, the yield curve only flattened during the period — so much in fact that investors are warily watching to see if in fact the yield curve will invert, an unusual state where long-term rates fall *below* short-term rates. We note that the market is not there just yet — but we are watching this signal carefully. An inverted yield curve reflects the market expectation that a slowdown is coming.

A Higher (and Flatter) Treasury Yield Curve



Source: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2018

[2]https://bls.gov/web/empsit/ceshighlights.pdf
[3]https://barrons.com/articles/the-great-labor-crunch-1520655014

Though the economy and stock markets are increasingly showing signs of a cycle peak, the good news could continue for some time.

Looking for the Top

Why is the shape of the interest rate curve so relevant to stock markets? The yield curve has inverted before every recession in modern history, making it one of the most reliable market signals of a pending recession. But we note that the reverse doesn't hold: there isn't a recession every time the yield curve inverts.

As such, we have to consider this possible marker in the context of the rest of the economy to judge whether we are actually at (or near) peak levels. Sure enough, when we consider the bigger picture, we see the scales tipping toward a conclusion that our economy is running at peak levels. Robust profit growth: check. Tightening labor market: check. Higher oil prices: check. Signals from the bond market: possible early-stage check. High merger and acquisition activity: check. It is understandable why stocks have enjoyed the momentum.

Staying in Peak Form

Reaching peak levels does not imply that stocks are about to come tumbling down. In fact, economic activity and company profits could continue in this zone for quite some time. But at these elevated levels, we are cautious of the risks. In particular, we are watching the developments around global trade tensions, an issue that continues to escalate between the U.S. and China. Both countries are dependent on trade and dominant in the world economy. Though the issue is contained for the moment, we believe it could push the market cycle to a tipping point.

Homestead Funds

Bonds

U.S. bond indexes had mixed performance in the quarter. Investment-grade benchmarks generally posted mild losses, while high-yield segments had marginal gains. Interest rates climbed a bit in the period, with short-term rates climbing more than long-term rates. Credit spreads continued to widen incrementally, pressuring performance among non-Treasury bonds.

As expected, the Federal Reserve raised its target interest rate again by 0.25% to a range of 1.75% to 2.00%, its seventh increase in the cycle. Market-watchers anticipate another hike in September and increasingly predict a hike in December. Inflation was fairly steady in the quarter, neither pushing policymakers toward more aggressive changes nor causing them to pause rate actions.

In this context, the Homestead Short-Term Government Securities Fund (HOSGX) returned -0.05% in the second quarter. The fund's return lagged its benchmark, the ICE BofAML 1-5 Year Treasury Index, which advanced 0.13%.

The Homestead Short-Term Bond Fund (HOSBX) rose 0.53% in the quarter, outperforming its benchmark, the ICE BofAML 1-5 Year Corporate/Government Bond Index, which was returned 0.17%. While the fund's shorter weighted average duration was a contributor in the rising-rate environment, the main boost came from the fund's positions in Puerto Rico-based issuers that rallied when bondholders reached a favorable agreement to settle debt that was in default.

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

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Stocks

U.S. stocks had mostly positive returns in the second quarter. Non-U.S. markets were more challenged, especially emerging markets. In terms of style, growth stocks outperformed value stocks among large and mid caps, but were about equal among small-cap stocks.

The volatility that started in the first quarter continued into the period. Trade conflict continued to escalate between the U.S. and China in particular, eroding some of the positive market sentiment from tax reform and strong company earnings. Energy stocks led performance as higher oil prices drove their outlook. Industrials company stocks struggled in the crosshairs of trade conflict, higher energy and labor costs.

The Homestead Value Fund (HOLVX) returned 0.17% in the second quarter, trailing its benchmark, the S&P 500 Value Index, which rose 1.40%. Positioning in the consumer discretionary sector was a key detractor from the fund's relative returns, due to both stock selection in the sector and to an underweight allocation compared to the benchmark. Stock choices in industrials also underperformed in the quarter. Conversely, the fund's technology stocks outperformed, and an underweight allocation to the financials sector helped relative performance.

In terms of fund positioning, the Value Fund continued to be 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) rose 0.62% in the quarter, trailing its benchmark, the Russell 2000 Index, which returned 7.75%. Stock choices in the industrials sector pressured relative returns, as did the fund's overweight allocation in the sector. Stock choices in the financials sector also weighed on performance. On the other hand, the fund's holdings in consumer discretionary companies outperformed.

Homestead Funds

Relative to its benchmark, the Small-Company Fund continues to be notably underweight in the health care and information technology sectors, as well as real estate companies. 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 and assemble our portfolios with a bottom-up, stock-picking approach.

U.S. stocks had mostly positive returns in the second quarter. Non-U.S. markets were more challenged, especially emerging markets.

Total Returns as of 6/30/2018

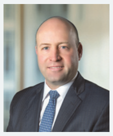
	Q1	Average Annual 1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* (HOSGX)	-0.05%	0.19%	0.38%	0.58%	1.50%	3.07%
BofA ML 1-5 Year U.S. Treasury Index	0.13%	-0.35%	0.51%	0.81%	1.79%	3.87%
Expense ratio 0.81% (gross) 0.75% (net) (12/31/17)						
> *Short-Term Bond Fund* (HOSBX)	0.53%	1.04%	1.37%	1.34%	3.15%	4.25%
BofA ML 1-5 Year Corp./Gov. Index	0.17%	-0.16%	0.87%	1.19%	2.28%	4.44%
Expense ratio 0.76% (12/31/17)						
Equity Funds						
> *Value Fund* (HOVLX)	0.17%	12.05%	9.90%	11.57%	9.46%	10.16%
S&P 500 Value Index	1.40%	7.58%	8.82%	10.45%	8.44%	NA
Expense ratio 0.60% (12/31/17)						
> *Small-Company Stock Fund* (HSCSX)	0.62%	8.71%	6.35%	9.57%	11.90%	9.34%
Russell 2000 Index	7.75%	17.57%	10.96%	12.46%	10.60%	7.86%
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.

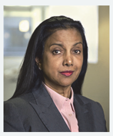
Homestead Funds

Equity Team



Peter Blackstone
Senior Equity Analyst

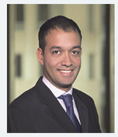
Peter is a senior equity analyst supporting RE Advisers' large- and small-cap value strategies. He is a graduate of Trinity College, where he received a BA in economics and an MBA with a specialization in finance from Boston University.



Prabha Carpenter, CFA®
Senior Equity Portfolio Manager

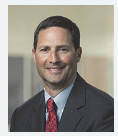
Prabha manages RE Advisers' large- and small-cap value strategies. She is a graduate of the University of Madras, where she received a Bachelor of Arts degree in economics. She received her Bachelor of Science degree in business economics and an MBA with distinction in finance from American University.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

Fixed-Income Team



Mauricio Agudelo, CFA®
Senior Fixed-Income Portfolio Manager

Mauricio 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.

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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.

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.

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.

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