Quarterly Market Review

Third Quarter 2015

Homestead Funds

Summary

- While the beginning of the quarter was dominated by Greece's debt problems, attention shifted in August to fears that China's economy had started to decline. Surprised that China's central bank had sharply devalued its currency against the U.S. dollar, global markets swiftly deteriorated. While the market tried to regain its footing, the quarter ended abruptly with the S&P 500 suddenly in negative territory for the first time in 11 quarters.
- The Federal Open Market Committee, too, was mindful of the unsettled markets and reaffirmed its commitment to keeping rates low in the near term. This time, however, the market uptick that typically followed Fed accommodations didn't occur. Investors seemed more concerned that the global growth engine might be losing steam than worried about rates climbing 0.25 percent or so.
- Positive fundamentals told another tale. Key housing, employment and consumer indicators painted a picture of a domestic economy ready to grow. With more hiring underway, better wages and a shortage of skilled workers, many again wondered when the Fed would eventually raise rates.

Macroeconomics

China has been such an outstanding engine of growth, industry and lending for so long, it's worth recalling how it got to its leadership position. The growth dynamics of China may be summed up by two facts: the country has a land mass that is equivalent to the United States, yet has a population that is *six times* larger.[1] Imagine that every person you saw during your busy day could be substituted for six people; six individuals who needed food, clothing, shelter, technology and everything else money could buy.

At that scale, it becomes easier to understand how slower domestic growth could ripple into something more disruptive. In fact, after seeing the global panic it created, China's Central Bank tried a partial revaluation of its currency with mixed results for the period.

In September, the Federal Open Market Committee decided not to raise interest rates, despite unemployment falling from 5.6 percent at the start of the year to 5.1 percent in August.[2] Weak domestic inflation was part of the story, but the Fed also pointed to "recent global economic and financial developments" that may have the potential to restrain economic activity and "put further downward pressure on inflation in the near term." Fed chair Janet Yellen highlighted concerns about the slowdown in China and other emerging markets as well as the disinflationary influence of further appreciation in the U.S. dollar.

In contrast to the downbeat finish to the quarter, three key metrics indicate to us that the U.S. economy is showing significant improvements in several critical areas:

- **The boom in household formations may help build future wealth.** After seven sluggish years, housing finally turned a corner late last year. "Prices of existing homes and housing overall are seeing strong growth and contributing to recent solid growth for the economy," according to the Chairman of the Index Committee at S&P Dow Jones Indices in a recent report.[3] As every homeowner who has hired help knows, each house is an economic engine that supports job creation and growth.

[1] http://www.indexmundi.com/factbook/compare/china.united-states
[2] http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20150917.pdf and http://www.bls.gov/opub/ted/2015/unemployment-rate-declines-in-december-2014.htm
[3] http://www.housingwire.com/articles/35185-spcase-shiller-july-sees-amazing-annual-home-price-gains

Macroeconomics continued

- **Historically, stocks may have more room to grow**. While we view the key stock valuation metric, the price/earnings ratio, as currently high, we don't see it is as extremely high. Compared to stock price/earnings ratios during longer bull markets, the price/earnings ratios for many of our selections are significantly lower. This may signal that our selections remain undervalued and have more room to grow.

- **Rising rate environments often accompany economic growth**. Many younger people have never experienced what normal interest rates, say in the range of 3 percent to 5 percent, are like. While high interest rates can create inflationary problems, gradually rising rates are not necessarily bad news. When rates rise from very low levels, price/earnings multiples tend to increase as well to the benefit of equities and overall economic expansion.

We view price drops in the range of 10 percent to 15 percent as not necessarily a negative for long-term investors. From our view as portfolio managers, dips can create opportunities to establish or add to positions at attractive prices, and many mutual fund investors have discovered the advantages of suddenly being able to access a greater number of fund shares at opportunistic, short-term lower prices.

While maintaining a focus on the long-term may seem like an overworked phrase, it goes to the heart of Homestead's investment approach. By "knowing what we own," and understanding the fundamentals of the companies we favor or ignore, we can help investors stay on course.

U.S. economic data for the period also underscored a number of positive growth indicators:

- With unemployment at 5.1 percent the labor market[4] clearly strengthened almost to the point of the Fed's 4 percent unemployment bogie set two years ago in the midst of Quantitative Easing.

- We may be closer to a bottom in energy prices than we thought last quarter; although we may be well into the second half of 2016 before the price of oil has moved up in a significant way.

- Positive numbers for U.S durable goods orders, consumer confidence, and new home sales all suggested to us that the economy appears to be on track.

- Pent-up capital expenditures could represent as much as $1.4 trillion in new spending following the years of under-investment after the recession of 2008-2009.[5]

With meetings and announcements scheduled in late October and mid-December, Fed officials still have time to decide whether to play Santa or the Grinch this Christmas.

The volatility that chased away investors in the third quarter is setting the stage, we hope, to help them stay calm during the financial news cycles ahead. Once the market starts to increase after a decline; and then rallies, we think investors may benefit from a greater acceptance around the idea that what they thought they were afraid of was something that had already been factored into the market.

Bonds

Bond investors who favored higher-rated investment-grade bonds gained some ground relative to lower-rated, investment-grade corporate bonds during the quarter.

The benchmark Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index returned 0.59 percent for the quarter, up 2.01 percent for the year, while the Bank of America/Merrill Lynch 1-5 Year U.S. Treasury Index likewise gained 0.70 percent for the quarter, while returning 2.15 percent for the year.

Overall, durations for the Homestead Short-Term Bond Fund (HOSBX) and the Homestead Short-Term Government Securities Fund (HOSGX) remained below those of their relative benchmarks for the period.

While the bond market generally did not return much to investors during the period, both funds finished in positive territory. While the Homestead Short-Term Government Securities Fund was hurt less from its shorter duration relative to the benchmark, the Homestead Short-Term Bond Fund contained some exposure to bonds issued by the Puerto Rico Sales Tax Financing Corp. which subtracted 0.20 percent from the portfolio for the quarter and approximately 0.40 percent for the year.

[4] http://www.reuters.com/article/2015/09/04/us-usa-economy-idUSKCN0R40CT20150904
[5] http://money.cnn.com/2015/03/20/investing/stocks-companies-record-cash-level-oil/

Heightened market volatility, concern over China's economy and its effect on domestic growth, an uncertain Fed outlook and weak commodity prices all contributed to wider credit spreads during the quarter; particularly the noticeable widening in lower-tier investment-grade corporates relative to U.S. government obligations.

While the outlook for shorter duration bonds is a little more attractive given the recent widening in credit spreads, there is a lingering risk that a further downturn in the high yield markets and commodity-related assets could lead to tighter credit overall, especially among smaller borrowers, and more meaningful spread widening.

Equities

Going 10 for 10, S&P 500 Index ends its 10-quarter winning streak with 10 percent correction

While the S&P 500 Index declined 6.44 percent and 0.61 percent for the third quarter and one-year period, the small-cap benchmark, the Russell 2000 Index, lost 11.92 percent for the quarter and gained 1.25 percent for the one-year period.

The S&P 500 Index experienced its worst quarterly performance since its 14.3 percent decline in the third quarter of 2011. Among sectors, energy and materials detracted the most from performance. Health care stocks followed close behind, losing nearly 11% for the quarter.[6]

In the third quarter, Homestead Value Fund's (HOVLX) results trailed its benchmark, the S&P 500 Index, due primarily to its positions in the energy and information technology sectors. An overweight to energy subtracted from performance as oil prices faded in the third quarter following a brief rebound in the first half of the year.

Fund selections in information technology subtracted from performance as software and services firms outperformed the hardware-oriented firms the fund favored. The portfolio will continue to hold its hardware selections as long as they remain attractively valued and show genuine prospects for increasing their dividends.

Financials and industrials also contributed to performance during the period. Banks outperformed relative to the sector, while insurance also contributed to performance.

While industrials remained mixed for the period, our expectations for the next 12 months are favorable partly due to the outlook for continued low prices for commodities and energy, which would benefit companies in this sector.

Health care positions detracted slightly from performance during the period. But within that sector, the fund's minimal exposure to biotech and greater weighting in pharmaceuticals and health care equipment and supplies helped the fund's overall health care position to decline less than that of the index's sector position.

Homestead Small-Company Stock Fund (HSCSX) outperformed its benchmark, the Russell 2000 Index for the period. The portfolio's selections in industrials contributed to performance due to holdings in construction, engineering, and firms associated with telecom infrastructure capital expenditures. Lower fuel prices boosted the portfolio's selections in the transportation sector. The fund's underweights to health care and biotechnology in the third quarter softened the impact of the August biotech sell-off and added to performance.[7]

In our view, a 10 percent correction would not be unusual considering the extraordinary run-up in equities we have experienced over the past 2.5 years. But we think it's also possible that the improving domestic economy could help sustain a continued advance. According to recent market commentary from Fundstrat Global Advisors, "The U.S. has been quietly leading global markets for the past seven years." When contrasted with overseas markets, U.S. outperformance, "reflects the strengthening of U.S. fundamentals — pent-up consumer demand as well as strong bank balance sheets."[8]

We believe this kind of "quiet leadership" is evident, positive and likely to support the markets over the near term.

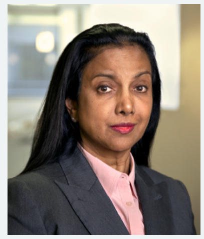
Homestead Funds' client services team would be happy to talk with you about your goals and current investment program. Give us a call at 800.258.3030.

[6] Performance attribution from FactSet
[7] Performance attribution from FactSet
[8] Thomas J. Lee, Fundstrat October 2, 2015

Contributors

Doug Kern, CFA
Senior Fixed-Income Portfolio Manager

BA in Business Administration and MBA in Finance, Pennsylvania State University. Doug has been with RE Advisers since the company's launch in 1990.



Prabha Carpenter, CFA
Senior Equity Portfolio Manager

BA, Economics, University of Madras; MBA with distinction in Finance and BS in Business Economics, The American University. Prabha joined RE Advisers in 2002.

Mark Ashton, CFA
Senior Equity Portfolio Manager

BS, Finance, University of Utah; MBA, Marketing Research, University of Southern California. Mark joined RE Advisers in 1999.

Gregory Halter, CFA
Senior Equity Portfolio Manager

BBA, Finance, Cleveland State University. Gregory joined RE Advisers in 2014.

Prepared: October 7, 2015

Past performance does not guarantee future results.

The views expressed in this market commentary are those of the individual as of the date noted and may have changed since that date. The opinions stated may contain forward-looking statements and may discuss the impact of domestic and foreign markets, industry and economic trends, and governmental regulations of the funds and their holdings. Such statements are subject to uncertainty, and the impact on the funds might be materially different from what is described here.

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.

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.

Homestead Funds' investment advisor, RE Advisers Corporation, and distributor, RE Investment Corporation, are indirect, wholly owned subsidiaries of NRECA.
RE Investment Corporation, Distributor. 10/15

Homestead Funds