Quarterly Market Review

Third Quarter 2016

Homestead Funds

Summary

- Data on the economy points to a generally positive backdrop. U.S. GDP continued to expand, gaining some steam in the quarter. The labor market showed continued strength, which supported modest growth in consumer spending. Inflation remains below the Fed's target rate but is slowly trending higher.
- The bond market saw interest rates climb incrementally. Though the Federal Reserve left key rates unchanged in the period, expectations are up that they'll make another 25 basis point rate hike before year-end.
- Broad U.S. stock indexes moved higher in the third quarter. It was a "risk on" period, with more volatile sectors like technology and financials outperforming traditionally defensive sectors like utilities and telecom.

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Blue Sky, for Now

It may not be exciting, but it's good news: the economy is plodding along.

After the periodic anxieties of 2015, including tumbling oil prices and signs that China was screeching to a halt, the slow, positive growth of 2016 has been a welcome change. And it's right in the mid-range of what many economists forecast — the "base case scenario." Not great, not terrible, and occasionally in a three-steps-forward, two-steps-back pattern — but still, it's forward motion.

GDP growth, the most common yardstick for economic health, is up. The reported rate for the second quarter was revised upward to 1.4 percent, while third quarter numbers are expected to be slightly better thanks to a boost in exports. The labor market also continues to look healthy. Monthly job creation and unemployment figures stayed steady, and wages continued to climb, though at a slightly slower pace than the Federal Reserve (Fed) would have liked.

Stability in the job market has supported slow and steady growth in consumer spending. Larger purchases like autos were particularly strong in early spring and summer, though spending activity seemed to moderate a bit in the third quarter. But consumer sentiment measures have held steady, and consumers are about as optimistic today as they were during the 2001 — 2007 expansion.[1]

After Stabilizing Oil, Signs of Growth

While the news has been generally good, real momentum has been slow to gather in economic activity since sluggishness set in during 2015. But our investment teams believe there are green shoots in a number of areas, many as follow-on effects from the stabilization of oil, coal and other commodity prices.

In China, for instance, producer prices edged up for the first time since 2012, one of several signs that China's manufacturing sector could be shifting back to growth mode.[2] What's more, global purchasing manager indexes, a leading indicator for economic activity in coming months, are trending higher.[3]

[1] http://www.wsj.com/articles/consumer-sentiment-climbed-in-september-1475244581
[2] http://www.wsj.com/articles/chinas-factory-gate-prices-snap-multiyear-negative-streak-1476417778
[3] J.P.Morgan Global Composite PMI accessed at https://www.markiteconomics.com/Survey/PressRelease.mvc/a93f290366b94a27b208f46448d59630

Stable commodities are also good news for profits and revenues at U.S. companies. In aggregate, the companies in the S&P 500 Index have posted year-over-year earnings declines for five straight quarters, led by substantial losses in the energy sector. But as energy companies regain footing, the tide is starting to turn on aggregate profits. Though earnings are still forecast for year-over-year declines in the third quarter, the figures are actually positive when energy companies are excluded. What's more, aggregate revenues for S&P 500 companies are expected to post year-over-year growth for the first time in 18 months, even including the energy sector.[4]

Higher Rates Ahead?

Yet, interest rates remain historically low, but the Fed could take one more step toward a more normal zone before the year is up. The Fed has been on hold since implementing the first rate hike at the end of 2015. There was some talk of a September rate hike, which never came. But what Fed bankers did get was another string of strong employment numbers, and slightly more robust inflation.

Though rates were mostly stable in the third quarter, they have since drifted up as the probability of a December rate hike grows. If the Fed does raise rates, we expect it will be the same 25 basis point increase as before. With such a long runway for anticipation, our investment teams do not expect a December hike would trigger the same level of volatility as last year's Fed move. Interest rates will most likely adjust upward before the hike takes place, with existing bond prices falling a bit in response.

The rate environment globally is seeing a shift as well. A number of central banks, including the European Central Bank (ECB) and Bank of Japan, have been experimenting with negative interest rates as a tool to stave off deflation. But ECB policymakers fired a "warning shot" of sorts in the quarter, hinting that the negative rate experiment may be nearing an end. Negative rates, where a borrower receives interest rather than paying it, are meant to encourage lending. But negative rates make it nearly impossible for banks to be profitable. If banks are unprofitable for too long, they actually start to lend less, not more.

[4]https://www.factset.com/websitefiles/PDFs/earningsinsight/earningsinsight_9.30.16

Watching for Storm Clouds

The market seems to be searching for a good reason to worry, though none of the recent negative episodes has had staying power. For example, there were several regulatory announcements that grabbed headlines in the third quarter, including the Department of Justice's fine on Deutsche Bank related to its actions before the financial crisis, setting off a mini-panic about the prospect of another Lehman Brothers-type bankruptcy. But the episode was short-lived, as Deutsche Bank's capital position and financing ability were understood to be very different than Lehman's. It just wasn't worrisome enough to stick, much like the reaction to news of Brexit in the second quarter.

Geopolitical risks remain high around the world, not to mention the political uncertainty of the looming U.S. presidential election.

Still, blue skies in the investment world are never permanent. Geopolitical risks remain high around the world, not to mention the political uncertainty of the looming U.S. presidential election. Rising interest rate environments can be fertile ground for market volatility. Perhaps the most salient point is that an environment of low growth is inherently precarious, being awfully close to zero. A significant bump in any number of measures — employment, manufacturing activity, consumer spending, trade activity, etc. — could send that slow growth off course.

Bonds

The bond market was mixed, with short-term interest rates climbing slightly but credit spreads compressing in some sectors. A mixture of competing factors pushed and pulled on bond returns in the period. The longest- and shortest-term bond issues posted generally positive returns, while mid-range maturities had mild declines. The high yield sector enjoyed particularly high returns.

Homestead Funds

The prospect of another rate increase before year-end drove short- and mid-term interest rates up incrementally, which tends to push bond prices down. The middle of the interest rate curve rose more than the shortest- and longest-term rates.

Energy and metals and mining sectors drove compression in spread sectors in the period. Higher and more stable commodity prices have laid the groundwork for profit recovery in energy companies, lowering the default risk for some issuers. Like the Brexit news last quarter, news of Deutsche Bank's hefty regulatory fine created brief anxiety in stock markets but did little to rattle credit markets, and the effect passed quickly.

Bond indexes were mixed for the period. The Homestead Short-Term Bond Fund (HOSBX) rose 0.37 percent in the quarter, while its benchmark, the Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index, was up 0.05 percent.

The Homestead Short-Term Government Securities Fund (HOSGX) had a return of 0.00 percent for the third quarter. It outpaced its benchmark, the Bank of America/Merrill Lynch 1-5 Year Treasury Index, which declined -0.19 percent.

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Both Homestead bond funds outperformed their benchmarks 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 outperform in environments where interest rates are rising, as they did this quarter.

Equities

The stock market was generally up, in a "risk on" period.

U.S. small-cap stocks outperformed large caps, and lower-quality companies outperformed higher-quality companies, in a classic "risk on" pattern. Emerging market stocks outpaced developed international stocks, and growth stocks outperformed value stocks. Traditionally defensive sectors, like utilities and telecommunication services, underperformed in the period after leading the market for the first half of the year. Information technology stocks posted the best third-quarter returns, followed by financials stocks.

The Homestead Value Fund (HOLVX) returned 3.24 percent in the quarter, lagging its benchmark, the S&P 500, which rose 3.85 percent in the period. Stock selection weighed on performance, though it was offset by a boost from sector allocation. Positioning in the health care sector was a key detractor, while an underweight in consumer staples and stock choices in consumer discretionary enhanced performance.

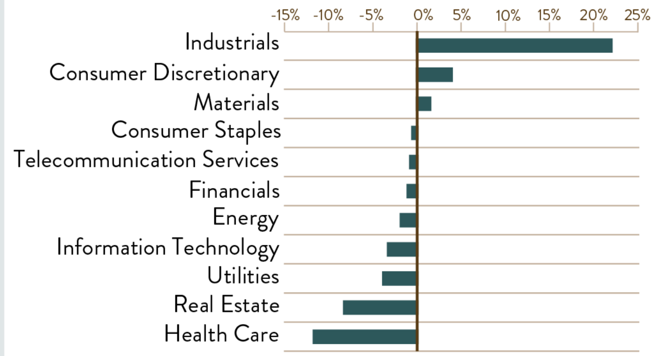
Fund positioning is mostly unchanged from the second quarter. The Value Fund is overweight relative to its benchmark in materials, industrials and health care sectors. The fund is most underweight in consumer discretionary and consumer staples stocks.

The Small-Company Stock Fund (HSCSX) rose 0.55 percent in the quarter. It trailed its benchmark, the Russell 2000 Index, which rose 9.05 percent in the period. Stock selection was the primary driver of underperformance, though sector allocation also detracted slightly. Stock-specific underperformance in the industrials and consumer discretionary sectors had the biggest impact on relative returns. The investment team continues to have conviction in the long-term potential of underperforming holdings, which can rotate in and out of favor depending on short-term market environments.

Homestead Funds

Relative to its benchmark, the Small-Company Stock Fund is notably underweight in health care and real estate sectors, as well as moderately underweight to utilities and information technology names. The portfolio is overweight in industrials and consumer discretionary stocks. Overall positioning is largely unchanged since the second quarter.

Small-Company Stock Fund Sector Weights Relative to Russell 2000
Percent as of 9/30/2016



Total Returns as of 9/30/2016

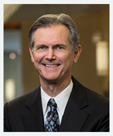
	Aggregate		Average Annual				
	3Q	YTD	1 yr	3-yr	5-yr	10-yr	Since inception
Bond Funds							
> *Short-Term Government Securities Fund* (HOSGX)	0.00%	1.54%	0.94%	0.94%	0.80%	2.28%	3.33%
BofA ML 1-5 Year U.S. Treasury Index	-0.19%	2.20%	1.52%	1.43%	1.11%	2.97%	4.22%
Expense ratio 0.77% (12/31/15)							
> *Short-Term Bond Fund* (HOSBX)	0.37%	2.11%	2.07%	1.49%	2.12%	3.53%	4.47%
BofA ML 1-5 Year Corp./Gov. Index	0.05%	2.66%	2.10%	1.78%	1.69%	3.29%	4.75%
Expense ratio 0.74% (12/31/15)							
Equity Funds							
> *Value Fund* (HOVLX)	3.24%	7.36%	16.31%	10.15%	16.34%	6.56%	9.93%
S&P 500 Stock Index	3.85%	7.84%	15.43%	11.16%	16.37%	7.24%	9.97%
Expense ratio 0.59% (12/31/15)							
> *Small-Company Stock Fund* (HSCSX)	0.55%	3.84%	5.24%	5.10%	15.16%	9.22%	8.91%
Russell 2000 Index	9.05%	11.46%	15.47%	6.71%	15.82%	7.07%	6.92%
Expense ratio 0.87% (12/31/15)							

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 costs. For some funds, the investment advisor has agreed voluntarily or contractually (for at least the current fiscal year) to waive or reimburse a portion of expenses. The net expense ratio is the expense ratio minus the portion of expenses waived or reimbursed. Please see the current prospectus for additional details.

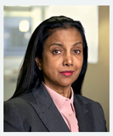
Homestead Funds

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.



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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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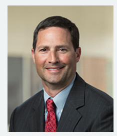
Fixed-Income Portfolio Manager

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 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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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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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. Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, performance of indices do not account for any fees, commissions or other expenses that would be incurred. Returns do not include reinvested dividends.

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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