Quarterly Market Review

Fourth Quarter 2015

Homestead Funds

Summary

- The fourth quarter delivered generally positive news on the state of the macro economy, though not without setbacks. The Federal Reserve's decision to raise interest rates for the first time since 2006 is one indicator of the overall stability in the economy, despite risks.
- The bond market saw an unusually active quarter, between the interest rate policy change and a re-pricing of risk for high yield bond issues in particular. A mid-sized high yield mutual fund announced a sudden freeze on redemptions, setting off a round of fears in the credit market and bringing about a swift expansion of credit spreads for many bonds. The market has since recovered a bit, but yields in low-credit issues in particular are back to 2011 levels.
- Equity markets regained ground following the correction in the third quarter, to finish the year modestly up in some segments. Market volatility and growth fears in China continued to dominate headlines, and there was wide dispersion of returns among sectors for the quarter.

Macroeconomics

The economy is a cyclical beast. One of our challenges as investors is to identify the turning points in those cycles, so that we can fully understand the implications for individual companies.

Macroeconomic indicators in the fourth quarter were marked by a push-and-pull of positive and negative signals. The U.S. is enjoying slow but decent growth in GDP, yet the manufacturing sector is teetering on contraction. Oil prices drifted even lower, which is good for consumers and many businesses, but energy-related stocks and bonds have buckled under the adjustment. The Federal Reserve finally declared an initial rate increase, but the high yield market suffered a considerable setback. Every bit of good news seems to come with a piece of not-so-good news.

This kind of push-pull balance is somewhat typical of the later stages of economic expansion cycles. On balance, we believe the good news continues to win out, but we are keeping vigilant watch for the cyclical turning point.

China, commodities and manufacturing weakness

One of the most prominent issues for the quarter, and indeed for the year, was the ongoing volatility and slowdown in China. The heart of the problem is China's GDP growth rate, which has adjusted downward and may be in "hard landing" territory. While GDP growth is still positive, Chinese authorities have been more frank in recent months about the aftermath of overbuilding and the downshift of manufacturing activity there. These trends have led to problematic bank loans within the country; perhaps more relevant to global investors is the effect that the slower manufacturing pace is having on commodity prices.

Of course, the current pressure on commodities is not just a function of lower demand, but also of higher supply. Robust U.S. production of oil and gas has contributed to a global oversupply of energy commodities. What's more, OPEC, which has traditionally sought to support energy prices by tweaking production, has elected not to cut production in the face of higher supply. Commodity producers around the world have invested heavily in extracting, mining and refining resources, and those weighty investments imply a resistance to cutting production even as demand wavers. These convening forces continued to push energy and other commodity prices down in the fourth quarter.

Macroeconomics continued

Manufacturing in the U.S. is also slowing slightly. One key indicator is the Institute of Supply Management's PMI Index, which gauges manufacturing activity on a monthly basis. The PMI Index came in just above 48 in December; any reading below 50 indicates contraction territory.

Low commodity prices are part of this weakness within the U.S. too, as the energy sector and related companies, like the makers of equipment for energy producers, are suffering. More broadly, the strength of the dollar has been a prominent headwind to many U.S. manufacturers throughout 2015. The dollar continued to rise against a basket of currencies in the fourth quarter, though at a slower pace, gaining about 4% or so over the period versus the euro. In terms of overall impact, the dollar's strength in 2015 is estimated to have trimmed U.S. company earnings by about $10 per share in aggregate.[1]

Strength in jobs, wage inflation and merger activity

But on the bright side, the service sector in the U.S. is holding up, and the overall jobs picture in the U.S. continues to be positive. Job numbers for December were surprisingly strong, offering a salve for U.S. consumers even as other economic gauges show signs of weakness. Over the course of 2015, approximately 2.7 million jobs were added to the U.S. economy. Latest figures[2] peg the overall unemployment rate at about 5%, and there has been some reassuring strength in wage inflation.

The question of inflation is central to the Federal Reserve's decision to increase interest rates for the first time since 2006 at its December meeting. After delaying an expected increase in September, the central bank finally raised interest rates by 0.25% in the final month of the year. While higher rates pose some initial headwinds for bonds, the move is a sign that policymakers are sufficiently confident in economic momentum to take the first steps back to a more normal range of interest rates.

Overall inflation continues to be well below the Fed's desired range, thanks in large part to the downward pressure on commodity prices. But the green shoots in wage inflation are perhaps more important than the overall picture, since that metric tends to be very sticky and hard to budge, yet persistent once it gets going. High inflation is often frightening for investors and consumers, but we are nowhere near that zone today. Instead, better inflation would be a sign of strength in the employment market and in overall demand for goods and services. Market watchers will be monitoring inflation trends closely in 2016, as the Fed's path and pace for interest rate increases depends on these core numbers.

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Other bright spots emerged over the quarter. Merger and acquisition activity continued at a tremendous pace, also typical of late-stage expansion cycles. Auto sales for the quarter were at a record high, a good sign that the strength in employment is flowing through to consumer spending decisions.

We believe these signals gave the market enough confidence to recover the losses of the third quarter. While sentiment is decidedly anxious going into the new year, we believe there are too many signs of fundamental strength in the economy to write off the current cycle of economic expansion just yet.

Bonds

The bond market had an unusually active quarter, between interest moves by the Federal Reserve and credit shocks within the high yield market. Many indexes were negative for the period.

After delaying an increase in September, the Federal Reserve finally took the first upward step in December. Accordingly, the yield curve flattened, with short term rates climbing more than longer-term rates. This first move toward a normal rate range is a reassuring sign that policymakers see enough strength in the economy to stomach a normal rate zone.

[1]Source: FundStrat Global Advisors
[2]Bureau of Labor Statistics

Bonds continued

Meanwhile, the price of credit adjusted rapidly in the quarter, particularly in the high yield market. Credit spreads for energy, metals and mining issuers have been in an extended phase of re-pricing, as weakness in the energy market continues to alter the cash flow picture for many energy-related industries. As we would expect, this lowers the credit quality of individual energy issuers, and their bond prices have fallen.

The surprise came in early December, when markets were shocked by a sudden announcement from a firm called Third Avenue. The firm disclosed that it was shuttering a mid-sized high yield mutual fund because it was unable to meet daily liquidity requirements. The fund in question was known for specializing in low-credit and illiquid bond issues, which can be a worst-case scenario in periods where liquidity dries up in the bond market. As our fund managers note, the high yield market is a place where "everyone's buying or no one is buying," such that liquidity management is a key issue for any manager who operates in the less-traded corners of the market. Ultimately, the fund's closure came from the mismatch between the things they invested in (illiquid issues) and the mutual fund structure they chose for their investment vehicle (requiring daily liquidity).

Though the event was contained, it did aggravate a significant shift in the credit markets. In the span of 1-2 weeks, high yield bonds generally reverted back to 2011 levels, with spreads widening on the order of 2-3%. Credit spreads in the investment grade market also adjusted, but to a lesser degree. Our managers viewed this adjustment as a "return to reason," given that high yield bonds do entail more risk than investment grade credits, and the default rate is headed back to an average level after years of extremely low defaults.

In short, all areas of the bond market faced headwinds this quarter. As a result, returns for many bond indexes were negative. The Homestead Short-Term Bond Fund (HOSBX) fell by -0.03% in the fourth quarter, while its benchmark, the Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index, was down by -0.54% in the period. The Homestead Short-Term Government Securities Fund (HOSGX) was down -0.59%, and its benchmark, the Bank of America/Merrill Lynch 1-5 Year Treasury Index, fell by -0.66%. Both funds outperformed their benchmarks thanks to holding shorter-duration positions.

Equities

Stock markets were up for the fourth quarter, recovering some of the losses from the broad correction in summer and early fall. Macro news dominated investor sentiment, with more volatile swings.

We tend to use the word "volatility" only when markets fall, but a spike back upward is also a form of volatility, and that continued into the end of the year. Much of the volatility throughout 2015 was driven by investor sentiment, which ricocheted from high to low and back again on macroeconomic news discussions. Earnings news from third quarter reports was generally good, although energy companies continued to struggle and overall revenue growth was minimal.

Notably, returns for the year were dominated by a small group of consumer technology stocks. Known as 'FAANG' (Facebook, Apple, Amazon.com, Netflix and Google), plus Microsoft, these names together account for almost all of the market returns of 2015. Indexes are typically weighted by market capitalization of each component company; if returns were instead reported on an equal-weight basis, the broad indexes would be slightly down for the year.

For the fourth quarter, the S&P 500 Index was up 7.04%. There was wide dispersion of performance among the 10 sectors in the index, though we note that all 10 sectors had positive performance, even the battered energy sector. The top performing sector was materials, followed closely by health care and information technology stocks. Energy and utility stocks were the lowest performers.

The Homestead Value Fund returned 8.34% in the fourth quarter, beating its benchmark (the S&P 500). Outperformance was driven by holdings in the materials, industrials and health care sectors. Stock holdings in the consumer discretionary sector were the biggest detractor in performance for the quarter. For the year, the S&P 500 Index was up 1.38%, while the Homestead Value Fund (HOLVX) was down -1.28%.

Small-company stocks had more modest performance for the period, with the Russell 2000 Index returning 3.59% in the fourth quarter. Within the index, the top performing sectors were again health care and information technology, with particularly robust performance from pharma, health care technology and biotech stocks in the health care sector and

Equities continued

semiconductors in the IT sector. Energy and consumer discretionary sectors were the worst performers in the index over the quarter, both posting losses.

The Homestead Small-Company Stock Fund (HSCSX) returned 1.35% in the fourth quarter, giving up the outperformance it had posted earlier in the year. Top performers in the fund were in the health care and materials sectors, while holdings in consumer staples, energy and financials posted losses for the quarter. For the year, the Russell 2000 Index lost -4.41%, while the Homestead Small-Company Stock Fund was down -5.18%. The fund posted relative underperformance of about 4% compared to the index due to differences in sector weights, but outperformed the index by about 4% for stock selection. The net effect was that fourth quarter performance for the fund and index was very close.

In Q4, only two out of 11 sectors in the Russell 2000 Index generated a positive return: health care and information technology. The fund was underweight in health care, where biotech companies were the performance driver. Small-cap biotech companies specifically and health care businesses more broadly are typically characterized by a lack of earnings, a propensity for binary outcomes (things could go really well or really poorly) and inherent volatility. Those types of stocks would not meet the fund's selection criteria. The fund was also underweight in the information technology sector, where software companies led performance.

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.

Total Returns as of 12/31/2015

		Average Annual				
	Aggregate YTD	1 yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* (HOSGX)	0.46%	0.46%	0.29%	0.88%	2.42%	3.38%
BofA ML 1-5 Year U.S. Treasury Index	0.98%	0.98%	0.67%	1.25%	3.04%	4.27%
Expense ratio 0.71% (12/31/14)						
> *Short-Term Bond Fund* (HOSBX)	0.43%	0.43%	1.20%	2.01%	3.66%	4.53%
BofA ML 1-5 Year Corp./Gov. Index	1.05%	1.05%	0.96%	1.68%	3.35%	4.79%
Expense ratio 0.73% (12/31/14)						
Equity Funds						
> *Value Fund* (HOVLX)	-1.28%	-1.28%	15.06%	11.90%	6.89%	9.93%
S&P 500 Stock Index	1.38%	1.38%	15.13%	12.57%	7.31%	9.95%
Expense ratio 0.62% (12/31/14)						
> *Small-Company Stock Fund* (HSCSX)	-5.18%	-5.18%	11.83%	10.97%	9.77%	9.07%
Russell 2000 Index	-4.41%	-4.41%	11.65%	9.19%	6.80%	6.57%
Expense ratio 0.91% (12/31/14)						

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.

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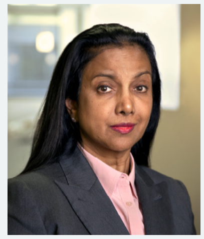

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Past performance does not guarantee future results.

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