Quarterly Market Review

Third Quarter 2017

Homestead Funds

Summary

- Stock markets continued to rally in the third quarter. Signs of broad-based global growth supported stocks, and company reports of sales and earnings were generally better than expected. Investors were also optimistic about the prospect of domestic corporate tax reform. These positive trends outweighed a spike in geopolitical tension with the Korean Peninsula, and economic effects of the series of natural disasters, including hurricanes, that struck in the period.

- Macroeconomic reports were strong. Though hurricanes did have an effect on job market numbers, job creation is expected to rebound. Inflation measures remained stable, while oil prices rose in the period closer to the $50/barrel mark.

- The Federal Reserve paused its rate-hike actions in the third quarter, though it is widely expected to enact one more hike for the year in December. Government bond interest rates were stable. Credit spreads for corporate issues tightened a bit on ongoing improvement in company profitability.

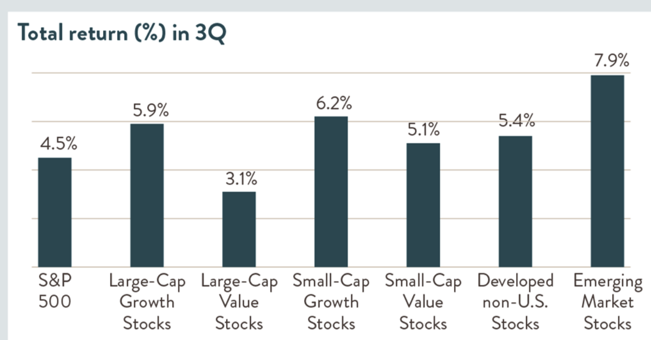
A Global Rally

Stock markets around the world enjoyed strong performance in the third quarter. In the U.S., the S&P 500 Index posted a nearly 5% gain, though similarly robust numbers were marked by growth stocks, value stocks, large and small caps. Developed-market stocks outside the U.S. performed just as well, while emerging market stocks delivered closer to 8% gains in the quarter. In other words, it was a rosy period for stocks around the globe.

This strong performance largely reflects the strength of global growth today. The U.S. has had periodic episodes of decent growth since the financial crisis, but that has not been true of all regions of the world. The E.U. has faced extensive challenges between its massive debt issues and bailouts, and then the anemic growth that followed. In recent periods, E.U. growth numbers have been surprisingly robust, even in troubled areas like Spain. China and other Asian economies hit turbulence in late 2015-early 2016 related to currency devaluation issues and slightly tighter monetary policy in developed markets, but have been on a surer trajectory this year. As China-driven growth supports more stable oil and commodity demand, other emerging markets have regained ground and started to post better growth numbers, too.

While the actual growth rates of many regions are still humble, the trend is refreshingly broad-based and stable today. This is reflected in oil prices, which rose in the quarter, and in trade volumes, which have also been on an upward path.

Strong Stock Performance Around the Globe in 3Q



Source: eVestment. Large-cap growth stocks are represented by the Russell 1000 Growth Index, large-cap value stocks are represented by the Russell 1000 Value Index, small-cap growth stocks are represented by the Russell 2000 Growth Index, small-cap value stocks are represented by the Russell 2000 Value Index, developed non-U.S. stocks are represented by the MSCI-EAFE Index and emerging market stocks are represented by the MSCI-EAFE Emerging Markets Index. Index definitions on page five.

Hurricanes and Other Catastrophes

As usual, the period was eventful in other ways. A series of storms, including two hurricanes and a tropical storm, ravaged the Gulf and southeast U.S. coast. High winds and flooding inflicted widespread damage on Houston, Puerto Rico, and Florida, among other locales. The affected communities are reeling from the deaths and injuries borne by area populations, and are only beginning to quantify the property losses caused by the string of weather events.

While the scope of human suffering is on scale with any natural disaster in recent memory, it does seem that economic damage was limited. Job market numbers took a hit in the period, as hiring activity ground to a halt in affected areas. A number of companies, from retail chains to restaurants to airlines, noted the effect of storms on sales and earnings, as most businesses shut down for some period. However, many analysts believe the effects will be a temporary blip that will rebound in later periods. Insurance companies with exposure to affected areas expect to take earnings hits as they process payouts, but suggested in management communications that the impact would be manageable. On the other hand, the widespread property damage does suggest a future boost for homebuilding and supply industries in rebuilding efforts. Puerto Rico, for instance, now faces a long-term need to rebuild its entire electrical grid, an update that was badly needed anyway.

Policy Issues Under Debate

Politics continue to dominate domestic headlines. The primary issues affecting stock markets in the third quarter were the ongoing attempts to repeal and replace the Affordable Care Act (ACA), and the prospect of corporate and individual income tax reform.

Though Republicans went back to the drawing board several times to propose alternate legislation to the ACA, they were not able to garner enough support to pass new policy on the issue. Changes to the health insurance market could affect the number of Americans with coverage and the cost they pay, the demand for health care services, and the payouts to providers like doctors and hospitals.

Investors were more optimistic about the prospect of tax reform. U.S. corporate tax rates are high compared to international peers, and the general intent to reform tax law enjoys broad support. Reform proposals were at the early stage in the quarter, so it remains to be seen what a final outcome would look like. Some market-watchers are skeptical that tax reform will pass, given the headwinds the current administration has faced on other initiatives, but segments of the market remain quite hopeful that business-friendly changes are on the horizon. According to a survey conducted by tax specialist Ernst & Young, 62% of business tax professionals believe that tax reform will be passed in 2017 or 2018.[1]

Business Tax Professionals Expect Reform	62% of business tax professionals believe that tax reform will be passed in 2017 or 2018

Corporate tax reform would primarily benefit those companies paying the highest effective tax rates (including smaller companies and those that do the most business within U.S. borders). Tax reform could also include a tax break for companies to repatriate profits currently stashed overseas. In terms of individual income taxes, any breaks for earners could be good for consumer businesses, from staples to leisure businesses. We anticipate that the fourth quarter will bring more clarity to the issue.

Still-High Valuations, But Strong Earnings

When we look at stocks at the index level, they still seem richly valued on measures like forward price/earnings (P/E ratio). But real earnings growth is present at many companies – markets are not just rising because investors are paying more for a static dollar of earnings. For the 2017 calendar year, the current consensus for S&P 500 companies is forecasting earnings growth of 9.1% and sales growth of 5.8%, compared to 2016.[2] Our portfolio teams note that they are finding good opportunities among some stocks today, ranging from pharmaceutical companies to retail companies to energy firms – not all companies have rich valuations in the current environment.

[1] http://www.ey.com/Publication/vwLUAssets/ey-tax-reform-business-barometer-sept-2017/$FILE/ey-tax-reform-business-barometer-sept-2017.pdf
[2] https://insight.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_101317.pdf (page 10)

Homestead Funds

Bonds

Most bond indexes posted gains in the quarter. Short-end rates like the 3-month and 2-year U.S. Treasury issues climbed very mildly over the quarter, while longer-dated interest rates were essentially flat. Corporate bond issues and long-dated bonds rallied on tighter credit spreads.

After two consecutive quarters with rate hikes, the Federal Reserve paused its actions and left the target rate range for overnight deposits unchanged at 1% - 1.25%. Markets are widely anticipating one additional hike this year at the December Fed meeting. Relative to the end of the second quarter, interest rates for government bonds are essentially flat. Compared to the immediate post-election environment, short-term rates have risen, reflecting Fed hikes, but longer-dated rates have eased a bit. High expectations for a better growth rate and accompanying inflation have moderated since the start of the year.

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The Fed certainly seems committed to weaning the economy off the extraordinary measures of liquidity that it implemented to combat the financial crisis. We expect that it will continue to shrink its balance sheet and gradually raise interest rates over the coming years, as long as inflation and growth measures are strong enough to support such moves. The latest Fed communications suggest that it plans to hike rates about three times in 2018, with two additional moves in 2019, targeting a "terminal rate" of about 2.75%. While that rate is considerably lower than historical standards, it's still markedly higher than the near-0% rates which have been in place for nearly a decade. As long as rate changes are small and slow, the bond market could absorb the additional moves without a major disruption in prices.

In this environment, the Homestead Short-Term Government Securities Fund (HOSGX) returned 0.43% in the third quarter. It outpaced its benchmark, the Bank of America/Merrill Lynch 1-5 Year Treasury Index, which rose 0.29%. Year-to-date, the fund has outperformed its benchmark.

The Homestead Short-Term Bond Fund (HOSBX) rose 0.40% in the quarter, lagging its benchmark, the Bank of America/Merrill Lynch 1-5 Year Corporate/Government Bond Index, which was up 0.44%. However, the fund is ahead of its benchmark for the year-to-date period.

Stocks

Global stocks benchmarks again touched record highs, reflecting gains for the quarter. As in the first half of the year, growth stocks led returns.

Though political tensions with North Korea did have some dampening effect on markets, the effect was overpowered by strong earnings reports, signs of growth globally, and the potential for business-friendly tax policy changes. Growth stocks continued to outpace value stocks in the period, though there was little differentiation in performance according to company size. Emerging and developed stock markets outside the U.S. also had a strong quarter.

The Homestead Value Fund (HOLVX) returned 6.04% in the second quarter, outperforming its benchmark, the S&P 500 Value Index, which rose 3.48% in the period. Positioning in the information technology sector was a key contributor to fund returns, thanks to both an overweight allocation to the sector and from outperformance among stock picks. Stock choices in the health care sector also drove returns. Conversely, stock choices and an underweight allocation in the financial sector 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, materials, and industrials sectors. The fund is most underweight in consumer staples and financials stocks.

Homestead Funds

Our portfolio teams note that they are finding good opportunities among some stocks today – not all companies have rich valuations in the current environment.

The Small-Company Stock Fund (HSCSX) rose 5.81% in the quarter, outperforming its benchmark, the Russell 2000 Index, which was up 5.67%. An overweight allocation to the industrials sector drove outperformance, and stock choices within the sector were also additive. The fund's materials sector stocks also outperformed. Conversely, stock choices in the consumer discretionary sector weighed on returns. On a year-to-date basis, the fund is trailing its index.

Relative to its benchmark, the Small-Company Stock Fund is notably underweight in the health care, real estate and information technology sectors. The portfolio is especially overweight in industrials stocks.

Total Returns as of 9/30/2017

		Average Annual				
	Q3	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* (HOSGX)	0.43%	0.08%	0.84%	0.53%	1.81%	3.18%
BofA ML 1-5 Year U.S. Treasury Index	0.29%	-0.06%	1.20%	0.84%	2.37%	4.03%
Expense ratio 0.78% (gross) 0.75% (net) (12/31/16)						
> *Short-Term Bond Fund* (HOSBX)	0.40%	1.25%	1.31%	1.54%	3.19%	4.35%
BofA ML 1-5 Year Corp./Gov. Index	0.44%	0.53%	1.54%	1.26%	2.77%	4.59%
Expense ratio 0.76% (12/31/16)						
Equity Funds						
> *Value Fund* (HOVLX)	6.04%	18.28%	9.79%	14.62%	6.74%	10.23%
S&P 500 Value Index	3.48%	16.47%	8.93%	13.21%	5.57%	NA
Expense ratio 0.62% (12/31/16)						
> *Small-Company Stock Fund* (HSCSX)	5.81%	22.61%	10.09%	13.41%	10.31%	9.57%
Russell 2000 Index	5.67%	20.74%	12.18%	13.79%	7.85%	7.58%
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

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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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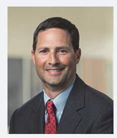
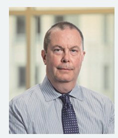
Mauricio co-manages RE Advisers' fixed-income strategies. He received a Bachelor of Science degree in finance from the University of Maryland, Robert H. Smith School of Business. He minored in business culture and language, with a concentration in Spanish. He holds the Chartered Financial Analyst designation.



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®
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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.

Index Definitions: 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 **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.

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