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Q2 2022: Bears Rule the Day

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Mark Santero: Welcome to the Homestead Funds second quarter 2022 market review. Although it's a very nice picture of a bear, the bears rule the day for the first half of 2022. And we'll hear from our two senior portfolio managers, Jim and Mauricio, about not only how the markets behaved in the first half of the year, also the funds, and most importantly, what we see ahead.

My name is Mark Santero, and it's a pleasure to welcome you on our webcast today. I'll be your moderator. As I mentioned, with me today is Mauricio, head of fixed income, and Jim, who's the head of equities, and also senior portfolio managers in both their respected asset classes.

What's our agenda today. We're going to discuss, as I mentioned, the macroeconomic conditions and factors within the first half of the year. We'll look at our funds' performance, not only on an absolute but also on a relative basis. We'll dive into the drivers of return for each of those portfolios. And last, but certainly not least, what do we see going forward? And how have we positioned the funds for the latter half of this year going into 2023?

Without further ado, let's talk about the market review and outlook. And I'm going to turn it over to Jim Polk, senior portfolio manager on the equity side, to unfortunately talk about how bears have ruled the day.

Take it away, Jim.

Jim Polk: All right, thanks, Mark. I extend my welcome to this webinar. It was a rough quarter, obviously for both stocks and bonds — stocks actually touching bear market territory [slide 6]. Really the biggest theme throughout the quarter was inflation and what was happening with the different inputs that were going in.

Obviously, we've got supply chain issues. We have the Ukraine-Russian war, and you also had some pent-up demand that was adding to the demand side of it. So inflation has been significantly higher than I think we would've expected a year ago, and it's now come down to the Fed. And we saw the Fed raise rates twice, 75 basis points each time. And the concern is that they're going to raise rates too much and that they're going to put us into a hard landing or a difficult recession. And there's lots of noise and lots of sentiment on both sides of it, but that's really what was happening in the second quarter, was a lot of concerns that data points that we were getting — economic data points that we were getting — were showing a good economy with relatively strong demand but supply chains that were not able to accommodate it and commodity prices that were continuing to go up, although towards the end — and we can talk about that later — were coming down. And so you had a real inflationary environment and how the Fed is going handle it.

On the positive side, if there was one to talk about, is that you have seen multiples on the equity side come down. And the market started around 22 times at the beginning of the year, and by the end of the quarter, it was roughly 16 times earnings. Again, we could talk about whether the earnings are right or not, but we've seen a lot of multiple compression in the market. And with that, I'll turn it over to Mauricio.

Mauricio Agudelo: Thank you, Jim. On the fixed-income side, same story as the first quarter [slide 7]. Difficult market in terms of the adjustments for interest rates rising during the quarter. We saw the yield curve at the end of our Q1 into the beginning of our second quarter invert when we're looking at the two year and 10 year, and then it steepened a little bit at some point during the second quarter. And then, you know, it flattened and inverted again, for the reasons that you just mentioned.

The Fed did raise interest rates by 75 basis points this week. Certainly some of the economic data that's coming in is softening. When you look at housing, for instance, we saw new home sales that are softening.

The employment picture still remains robust. We still have unemployment at 3.6% or so. And the Fed is now taking it one data point at a time as they shape up monetary policy in the future. Chairman Powell this week indicated that the Fed has now gotten to what they call a neutral position, but it is to be determined how much headway we can make into bringing inflation down.

If we head now into a review for the quarter, the Short-Term Bond Fund underperformed the market by 53 basis points [slide 9]. Unfortunately spread widening, the risk-off environment that we saw, detracted from performance. On the positive side, we did benefit from the inversion, from the flattening of the yield curve we had anticipated the Fed that would be on the more aggressive side and therefore putting more pressure on the two-year part of the curve.

When you look at the following slide [slide 10], during the quarter, we made some adjustments to our portfolio duration, basically adding to duration in the portfolios, mostly in the form of adding to our Treasury holdings. Some of these rates that we saw in the quarter to us were very compelling, somewhere in the 3% to the 3.25% for the two-year, the three-year and even the five-year Treasury yield. We saw it as a good opportunity to close that gap and continue to play a little bit of a defense from that side.

The Intermediate Bond Fund — similar story versus the Short-Term Bond. These two accounts, they are run in a similar fashion and strategy, under-performing during the quarter by 33 basis points [slide 12]. The story is the same: Credit investment-grade spreads widened during the period; basically they went from 116 basis points to 155 basis points.

We still think that corporates are in a good spot [slide 13]. In 2021, corporations were able to issue debt and extend out the maturity profile at really attractive levels. But we've been calling for this level of volatility in the markets. And this is exactly what we are experiencing.

We also added duration to this portfolio, which is closing that gap versus the benchmark. We still remain slightly underweight duration for the time being.

For the Rural America Growth & Income Fund, the fixed-income sleeve performed in line with the benchmark; the shorter underweight in duration helped. That being said, the allocation to credit detracted from performance on the fixed-income side [slides 15 and 16].

And Jim, I will turn it over to you for more insights on the equities sleeve.

Jim Polk: Thanks, Mauricio. As a reminder, this fund invests in companies with exposure to rural America and really addresses our larger mission of serving rural communities. There are similar themes that happen throughout all three of the portfolios I'll talk about. I would mention that on the Rural America Fund, because of its mandate, there are little nuances to it, but the equity sleeve outperformed the benchmark in the quarter [slide 17]. And if you imagine a market that's down as much as it was, in general it would be really the more defensive sectors that would outperform: staples, utilities and health care. And we tend to be underweight those sectors, so that worked a little bit against us.

On the positive side, some stock selection, particularly some names out of the consumer discretionary sector — which was actually the worst-performing sector, as you can imagine in kind of a rough time and kind of concerns about the economy, but names like Ollie's and Dollar General had a major impact.

If you go to the next slide [slide 19] to the Value Fund — the fund was down for the quarter, a little over 11%. And that's against the benchmark that was down a little over 12%. So outperforming there; again, the same themes [slide 20]. It's going be those defensive names, also underweight utilities, staples and energy. Energy's kind of an interesting one, because it has some different dynamics than just defensive characteristics.

There's obviously a supply constraint that's going on now, that's been going on for a while, and that's really driven a lot of performance in the energy sector. Unfortunately, we tend to be underweight utilities, staples and energy. But we are overweight health care, which was also a pretty good-performing sector. It has defensive characteristics. Big pharma, which has good dividend yields, cheap valuation — kind of the safety trade — did well as well as some managed care organizations. I would just say, if you look at the portfolio metrics, this portfolio snapshot, this really gets to kind of what we're trying to achieve in the portfolio: basically benchmark-like earnings, with higher valuation, with better companies, faster growth. We haven't really changed that strategy over time; very consistent in that strategy.

If you go to the Small Company [slides 22 and 23], you do see, again, a down market. Small cap's going to be higher volatility, so down. The benchmark down a little bit, over 17%; the fund outperforming by almost 300 basis points in the quarter. Same things: Underweight — staples and utilities — which were the best-performing sectors in the market. Small cap tends to benefit more from stock selection, and that was the case again this quarter for us. We had an industrial name, ManTech, that was purchased that helped a lot in the down quarter. Anytime you have a stock that gets taken out, that's a positive, but we tend to stay away from the high flyers. We own more reasonably priced technology names . And some of the high flyers in that sector were down anywhere from 60% to 80%. If you look at what the benchmark did, that's significant underperformance, and we tend to not be there.

Picking up on the equity side, all three equity portfolios outperformed their benchmarks in Q2. Defensive sectors — again staples, utilities — were the best performing, which were underweight, but we tended to make it up in sectors that we lean into a lot more. In the Rural America Fund, it was consumer discretionary. In the Value Fund, it was tech and health care. And in the Small Company Fund, it was tech and industrials.

And so with that, I'll turn it back to Mark.

Mark Santero: Thanks, Jim. Thanks, Mauricio. Certainly a first half of the year that we hadn't seen in quite some time when it comes to both asset classes being underwater.

Having said that, when you look at asset classes in general, on the first half of 2022, hardly any place to hide as an investor. But as long-term investors, when there's volatility in the market, there's also opportunity in the market. Although we talk about how we performed and how the markets were in the first half of the year, equally important, probably more so, given all the forces that are against the market from a volatility standpoint: inflation, labor cost, supply chain issues, war in the Ukraine, still battling with pandemic issues and lockdowns in China. What do we see going ahead as an investment firm?

To tee it up for Jim and for Mauricio, the U.S. economy is a consumer-driven economy. Over 70% of our economy is driven by the American consumer, and consumer sentiment is at an all-time low, as you can see from the slide [slide 25]. Having said that, although consumer sentiment is at all-time lows, we also see the American consumers still spending. Now, their spending has shifted over the course of this year due to inflation, meaning in coming out of the pandemic in '21, we saw robust spending on major purchases — appliances, furniture, autos — as opposed to this year. Now, with rising costs, you're seeing the consumer continue to spend, but more on staples, like food, groceries; certainly energy prices have increased. The U.S. economy is experiencing low consumer sentiment, but the consumer is still pumping money throughout the system.

So what do we see going forward for the remainder of '22? I'm going to ask Jim and Mauricio to comment. Who wants to go first out of the two of you?

Mauricio Agudelo: I can take it, Mark. This is Mauricio again. To your point, Mark, we expect volatility to remain elevated [slide 26]. In fact, this week and Wednesday, July 27, during the Fed announcement, the Fed basically removed forward guidance for the path of monetary policy. That means that we are taking it one data point at a time. So we'll

continue to see volatility as market participants reassess the outlook. The next Fed meeting is I believe the third week of September.

And so right now, the market is going to be repricing. What is next for the next potential rate hike? Are we doing 25 basis points? Are we doing 50 basis points? Are we doing 75 basis points? It seems like we're going to be dancing around this question for the next few weeks. We do expect inflation to peak around these levels, and we expect the normalization to be slow and gradual over the long term.

We are keeping a close eye on commodities. We still have oil lingering around the $100 mark — that's something to watch. The consumer still continues to spend. We saw it this morning with the release of PCE, personal income being higher than expected. And personal spending was also higher than the market expected. We're watching all these signals as it shapes up the rest of 2022. With volatility comes opportunity.

And that's the way that we are positioned right now, looking to capture the opportunities that we see ahead in the future. Let me turn it over to Jim for some thoughts on the equity market.

Jim Polk: Thanks, Mauricio. Just a couple of thoughts from the equity side. Mauricio, to your point about the Fed removing forward guidance is a good thing, but I think you're going to see a lot of noise in the market as people try to figure out whether or not the Fed's going to stick the landing. And I think that's been going on a lot. It's created a lot of the volatility, and I think for the next few weeks at least and into September, you are going to get a lot of noise in the market. And we think that can create some opportunities because we think that the economy remains in relatively good shape.

The market actually digested the 75-basis-point increase that the Fed did the other day very, very well. I would say unemployment does remain low, and you're seeing commodity prices falling. Which should augur well for inflation in the future and should potentially make the job for the Fed a little bit easier.

The negative, of course, are supply chains remain tight, and unless there's some resolution to the Ukrainian-Russian war, or China ends their lockdown, or of course on the demand side, we go into some deep recession, which seems hopefully unlikely but that nonetheless remains inflationary, I think you've still got an inverted yield curve.

So that's a concern. I think that's out there. And as I said, I think that people are going to worry about for a while now about whether or not the Fed is going to be able to engineer a soft landing.

Mark Santero: Well, thank you, Mauricio. Thank you, Jim. My final thought is not to play Monday morning quarterback, because we all don't have crystal balls and nor does the Fed, that the Fed might have been a little slow with their quantitative easing and their bond buyback program. Maybe a quarter or two too late. They also might have been a little slow in tightening and raising rates. Having said that, they have been aggressive as Mauricio and Jim pointed out. If they don’t stick the landing, maybe they raise one quarter too much in the first quarter of ‘23 or they're too aggressive, they now have a toolkit of interest rates to start to use going into ‘23.

So we will see, and we will certainly keep our investors informed. If you'd like more information, please email or give us a call. That's my email. That's my phone number. We always like to hear from our shareholders, our investors; we appreciate your business.

We appreciate your trust in Homestead Advisers, and we hope everyone has a great end to the summer. And we'll talk again in the fall. But don't hesitate to contact us. We're here to help. Thank you.

Top 10 holdings for the Rural America Growth & Income Fund as of June 30, 2022:

Federal Farm Credit Bank, 10/21/25, 0.52%	2.9%
Federal Farm Credit Bank, 04/28/27, 1.20%	2.7%
Zoetis Inc.	2.6%
Jack Henry & Associates, Inc.	2.6%
American Tower Corp.	2.4%
Crown Castle International Corp.	2.4%
Hershey Co. (The)	2.2%
Deere & Co.	2.0%
Paycom Software, Inc.	1.9%
Fastenal Co.	1.9%
Total	23.6%

Top 10 holdings for the Small-Company Stock Fund as of June 30, 2022:

Applied Industrial Technologies, Inc.	3.9%
AMN Healthcare Services, Inc.	3.6%
ManTech International Corp.	3.3%
Encore Capital Group, Inc.	3.2%
Avient Corp.	3.2%
Atkore Inc.	3.1%
Glacier Bancorp, Inc.	3.0%
Medpace Holdings, Inc.	2.9%
Eastern Bankshares, Inc.	2.8%
Summit Materials, Inc.	2.8%
Total	**31.8%**

Absolute return is the return that an asset achieves over a specified period.

Asset-backed securities (ABS) are bonds or notes backed by financial assets.

Basis points (bps) refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

Beta is a measure of the volatility—or systematic risk—of a security or portfolio compared to the market as a whole.

Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market.

Blended Index is composed of the Russell 3000 and the Bloomberg Intermediate U.S. Government/Credit Bond Index in a static 60/40 allocation. The Russell 3000 is a market capitalization-weighted benchmark index made up of the 3,000 largest U.S. stocks, which represent about 98% of the U.S. equity market. The Bloomberg Intermediate U.S. Government/Credit Bond Index is a broad-based flagship benchmark that measures the non-securitized component of the U.S. Aggregate Index with less than 10 years to maturity. Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, performance of indices does not account for any fees, commissions or other expenses that would be incurred. Returns may or may not include reinvested dividends.

Commercial mortgage-backed securities (CMBS) are fixed-income investment products that are backed by mortgages on commercial properties rather than residential real estate.

Duration is the weighted average of the times until those fixed cash flows are received.

Mortgage-backed securities (MBS) are an investment similar to a bond that is made up of a bundle of home loans bought from the banks that issued them.

Personal Consumption Expenditures (PCE) data is compiled by the U.S. government monthly as a way to measure and track changes in the prices of consumer goods.

Price to earnings (P/E) is the ratio of a company's stock price to the company's earnings per share. The ratio is used in valuing companies.

Relative return is the difference between the absolute return and the performance of the market (or other similar investments), which is gauged by a benchmark.

Return on equity is a measure of the profitability of a business in relation to the equity, also known as net assets or assets minus liabilities.

Russell 3000 Index is a market capitalization-weighted benchmark index made up of the 3000 largest U.S. stocks, which represent about 98% of the U.S. equity market.

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.

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