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Homestead Funds
Q2 Market Update
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Summary:

- Both risk-on and risk-off assets performed well in the quarter, a rare scenario. Weaker global growth data, downward trends in manufacturing and continued trade conflicts between the U.S. and China weighed on the broader outlook. However, these factors drove the possibility that the Federal Reserve will actually cut interest rates in the month to come, supporting a risk-on sentiment.

- Stock markets continued to rally, despite lackluster expectations for second-quarter company earnings. With falling earnings and higher stock prices, relative valuations inched higher over the period.

- The Treasury yield curve fell significantly as the likelihood for rate cuts grew. Medium-term yields, especially the 2- to 5-year segment of the curve, fell the most. Bonds rallied as rates fell, and the risk-on sentiment also drove modest compression in credit spreads, resulting in fair to slightly rich bond valuations.

Darryl Keeton: Good morning, everyone. I want to welcome you to Homestead Funds' Second Quarter Investment Call. My name is Darryl Keeton, and I serve as head of distribution for Homestead Funds. Joining me for today's call are Mauricio Agudelo, senior fixed income portfolio manager, and Jim Polk, senior equity portfolio manager.

Our agenda for today's call will focus on a few different things: first a general economic update, a performance update on some of our fixed-income and equity offerings, some of the investment team's current thoughts on funds positioning, and lastly a discussion on general outlooks around fixed income and equity.

After the commentary, we reserved a bit of time for Q&A, and we ask that you submit your questions using the chat feature on the WebEx platform. We'll try to tackle as many questions as we can during the time allotted, so let's get started.

Mauricio, let's begin with you. Can you give us a recap on the second quarter? What were some of your observations that took place during that time frame?

Mauricio Agudelo

Looking at the second quarter, we saw a continuation of the global slowdown. That being said, the U.S. economy is in a better position than our peers in Europe and China, but we've seen global manufacturing numbers come down. Looking at the JP Morgan Global PMI, which we hit the 54 type mark back in October of 2018, it ran about 50, suggesting expansion is running below 50, suggesting that contraction in the manufacturing sector, and that number crossed below the 50 mark in May. Certainly in Europe, in Germany, they are having some issues, and in China as well. The trade issues with the U.S. are not helping the situation.

In the U.S., the growth is right around the mid-twos. The employment picture remains robust with the unemployment rate still near multi-decade lows, below 4%. In the inflation picture, which is closely watched by the Fed, you're looking at core price consumer expenditures (PCE) with a mate one handle. Core PCE, again, toward the later part of 2018 rates the Fed's 2% target. So there are some pockets of strength, but we're seeing, certainly, some aspects where things are softening at this stage.

Darryl Keeton

Second quarter was a fairly atypical period, where we saw the "risk-on and risk-off" trades, both of the bonds and equity markets, garner some level of success.

Jim, can you talk a little bit about some of the dynamics for equity that took place in the quarter and whether either of you can recall a period of time when you've seen something like this happen?

Jim Polk

Let's start with that last part. It's been over a decade or so since the bottom, and the market has gone through these periods of risk-on and then risk-off. So this was an atypical quarter, where you had both risk-on and risk-off kinds of stocks working. I think a lot of it has to do, quite frankly, with just the market dynamics.

You have a couple of things going on: One, you have some people who have been trying to call the end of the cycle. There's a lot of confusion out there. We talked about this last quarter: There's a lot of skepticism in this market, and I think the market is climbing a wall of worry.

I would also say to that, both risk-on and risk-off, in the fourth quarter you had that big sell-off. And then, if you recall, we had that big market rally in the first quarter, and I think the second quarter was a continuation of that — again, going into that the notion of people trying to figure out, given some of this mixed economic data, what's going on.

As Mauricio said, there are pockets of strength, but you've got some issues on the manufacturing side, you've got good employment data. I'm of the belief that we are in this muddle-along economy, but I think people are really trying to figure it out.

Also in the quarter, I'd be remiss not to mention, and again we talked about this last quarter as well, the Fed has become forefront of what's going on in the market, and whether or not the Fed will cut rates. And so people are trying to discount a Fed cut. Clearly, they should not have raised in the fourth quarter, and so people are trying to get a sense of how much they will cut.

And then, obviously, China is the other big question mark out there, and these tariffs talks. There are two parts to it: One is China has a growth engine and a place to export goods to, and so what's going on there? And I know we're talking about the second quarter, but the data came out this morning that China's growth is slowing to years lows, and so that's been a concern that's out there, but also what these tariffs will do to supply chains and to manufacturing that U.S. companies are doing in China. So there's a lot of potential disruption to supply chains that come out of China.

Darryl Keeton: Mauricio, all investors right now are watching the Fed and trying to figure out a signal on how things will proceed going forward. You live and breathe this stuff on the fixed-income side. Can you talk a little bit about some of the credit spreads and how you guys position the portfolio, right now, relative to what the market is telling you?

Mauricio Agudelo: In terms of credit and spread performance for the quarter, spreads were relatively flat. For the year, credit spreads have tightened quite a bit from the levels coming off of the fourth quarter of 2018. **What this has given us is the opportunity to go up in quality, be very liquid and take advantage of that tightening to certain positions, and be in a more defensive stance right now.**

Darryl Keeton: So, that's actually probably a nice time for us to move on and talk specifically about the portfolios that you two manage. On the Short-Term Bond portfolio, Mauricio, why don't you give us some specifics on some of the things that took place on that portfolio over the last quarter?

Mauricio Agudelo: When looking at the performance for the second quarter, it is basically a continuation of Treasuries rallying and yields falling in anticipation of the Fed easing monetary policy. **For the quarter, the Homestead Short-Term Bond Fund had a positive return of 1.49% versus what 1.92% for the benchmark.**

Now, looking at the next portfolio, for performance, **the new Intermediate Bond Fund — which we launched on May 1 of this year, so this only shows two months' worth performance — as you can see, a return of 2.54 versus 3.03 for the benchmark, the Bloomberg Barclays US Agg.** So, we are seeing some really strong returns in fixed income as well. Like I said, the majority of them have been driven by the fall in yields throughout the year.

Darryl Keeton: Jim, I think we would be remiss if we didn't congratulate you and the team on the recent recognition by Barron's as a portfolio team and portfolio to watch, especially with the Value portfolio. So, why don't you talk to us a little bit about what took place with that portfolio this last quarter and some of the dynamics that you see impacting that portfolio going forward.

Jim Polk	Thanks for calling out the Barron's article, and, obviously, Prabha did a great job. If you're on the line and you haven't had a chance to read it yet, please do. It talks really about the legacy of the fund, and she just did a great job on that. As far as the quarter is concerned, we were up about 3.71%, which was about 30 basis points behind the benchmark, but which put us in about the second quartile and about the 40th percentile. Two sectors that we've been overweight for awhile, tech and health care, were actually big contributors in the quarter. And big overweights in both Microsoft and Visa helped us significantly in the quarter. We also on the health care side had bought a couple of names in the first quarter — Boston Scientific, which was a good performer in the quarter, and Allergan, which received a buyout offer from AbbVie — both contributed positively in a quarter. I would just mention that the underperformers really tended to be across the board, some cyclical stuff, some of the materials and energies names, or some of the more controversial health care names. On the Small-Company side, we were up 6.5%, which was about 4.41% ahead of the benchmark. We really just had a very good quarter. It put us in the top 1% competitively; it just was a good quarter across the board. We tend to be longer-term stock investors, so a good or bad quarter at any given point in time is a very narrow window. But the fact that this is a quarterly update call, it was a good quarter. We were very pleased with it. And, really, financials, health care and tech were the key sectors that outperformed, and we have some good stock picks in the second quarter.
Darryl Keeton	So, some pretty key economic data came out, and I know neither one of you are big macro guys. But I'd be interested to understand how you interpret this information. In the most recent GDP report, U.S. business investment actually declined for the first time during the current administration. Mauricio, what's your read on that, and how do you think that impacts your world and the portfolio that you have to steward?
Mauricio Agudelo	We feel like corporations are being more cautious right now, given the impact of the trade discussions with the U.S. and China. This is a situation that going into the last year we were hopeful that the two parts were going to come to a resolution. It is certainly lingering, staying out there longer than most people anticipated, and that brings the level of uncertainty to a higher degree, and that's why we see the Fed involved. And you have to be mindful of that and take a pause on any future investments, until you see some clarity.
Darryl Keeton	Jim, can you comment on that.

Jim Polk

I think Mauricio has it right. Obviously, the uncertainty that exists right now has put a pause in the companies that we talked to and the numbers that you see looming. And I don't know how to handicap this, quite frankly. Looming is this whole notion of spending on infrastructure, so there's a potential stimulus package that could help us somewhere down the line. That obviously hasn't happened yet, but it's clear that there's discussion about it. And how it manifests itself, ultimately, who knows.

But for the short term, Mauricio is absolutely right. I think people are concerned about what regulations would be. CFOs and CEOs and everybody in the C-suite are kind of pulling their horns in a little bit, and I think they're taking a wait-and-see attitude.

Darryl Keeton

What's interesting about this last quarter, and I think even the current environment that we're in, is usually the equity markers, the star companies out there, tend to be the drivers of discussion and what's taking place in the market and how we choose to invest. But it feels like the bond market right now has center stage, and then the equity markets and the folks who are responsible for many of the assets there are taking their cues from what's taking place there.

What's that feel like for you, Mauricio, right now? You all have center stage in trying to figure out our interest rates: Are we in a declining environment, are we in an inverted yield curve, and how is that going to impact not only how you think about investing in each of the individual portfolios, but you also have some other responsibilities for pension plan investments and things of that nature. Can you talk about any of that?

Mauricio Agudelo

It's certainly a challenging environment, because if you look at 2018 the Fed was in a tightening cycle. And the sentiment quickly changed, from we're tightening monetary policy to now we have to reverse some of that. They were doing the quantitative tightening; they ended that recently as well. Two weeks ago the Fed cut 25 basis points on the market expectations out of fear for a hundred basis points of cuts as well. So, it is certainly challenging from that standpoint, and you have to take a more cautious approach based on the fixed-income side, given the dynamics that we see out there.

Jim Polk

I would add a little bit about where we become more and more Fed watchers. We're all glued to what the Fed will do.

One of the discussions that Mauricio and I have had in the equity department, and the fixed income department has had, is whether or not the Fed is behind the curve, and whether there really needs to be a 50-basis-points cut versus a 25-basis-point cut. That has some real implications historically, and I'm not a fixed-income guy, so I don't want to speak for Mauricio, but historically the cycles have ended when the Fed has been raising rates and the curve inverts. And now, we're in a situation where the Fed is cutting rates, and the curve is still inverting. One explanation, certainly, could be that there are concerns about growth, so the long end is coming down.

But as I said before, where the markets may be struggling a little bit is, okay, I've been conditioned to recognize that when a yield curve inverts, that's not good, although there is some time frame before the market usually peaks. The yield curve is inverting, but at this time differently. Are there different circumstances behind it, and if so, how do you invest in that kind of environment, and where do you go?

Mauricio Agudelo I would also add more on the global picture: When you look at the amount of negative yielding that is outstanding, I was just looking at that number this morning, and it's close to 16 trillion, a number that has gone up from just over eight trillion at the beginning of the year. So, you still continue to see this global chase for yielding.

The ECB [European Central Bank] is still heavily involved. There were some reports this week about Denmark issuing negative rates mortgages, so you still see the pressure on yield toward the downside.

Darryl Keeton Mauricio, for the folks who have called in, would you mind quickly recapping what negative interest rates means, and how that possibly impacts the environment?

Mauricio Agudelo What it does is it forces investors to go out and seek yields somewhere else into risky assets. Look at value equity, look at dividend yielding stocks — it forces investors to rethink, am I going to place $10,000 in the bank and end up with less than I put in a year from now.

Darryl Keeton That's a good point, Mauricio. We know that dividend yield on equities right now is averaging about 2%. Jim, as you think about investing, you have two different perspectives, because you guys are managing not only the Value portfolio, which sits in the large value space, but also our Small-Cap, which sits in the lower market cap space.

As you think about those two different portfolios and how a change in interest rates affects both of them, growth has been a leader in not only the large cap space but also the small cap space. But a change in interest rates can impact both of those particular market cap arenas very differently. How do you guys think about that and the pending changes relative to those two portfolio?

Jim Polk We're not trying to make any big changes and any big calls on interest rates. I think particularly on the large cap side, what I think is very interesting is it's in the 50% range of the S&P 500. It now has a dividend yield higher than the 10-year. And I think the long-term number is probably in the teens. And I just think that's creating some interesting dynamics and interesting opportunities in the large cap market, where you can say, I can ride this out with some really good companies that have a decent yield.

On the Small-Company side, there's obviously the higher beta to it. Lower interest rates would be a positive from a funding standpoint, from the ability to garner capital, and so I think you would see it there.

We tend not to look at it that way. We're really more bottom-up, fundamentally driven, on the small cap side and on large cap side. So, I think it's more on a name-by-name basis, on small funds, the Small-Company side.

Darryl Keeton So, if we are indeed at the top of the current cycle, and we're moving to what might be considered as a recessionary environment, it's kind of a Catch-22 for you. You don't want to see a crash coming, but also you've got to be salivating at the prospect of some great opportunities coming your way, based on some of the market conditions. Do you have a target list as you think about names of respective opportunities, in both the Value and Small-Company portfolios?

Jim Polk We've got an informal target list, is the way I would put it. We're always looking at new ideas, and new ideas relative to existing holdings. As you see this market go through its gyrations, more recently you are seeing a lot of stuff start to look more and more interesting, at least from a valuation standpoint.

That said, we feel like the markets bifurcate a little bit to higher-quality companies, and you're paying up for them and some companies that are struggling more. A good case in point is, just today Macy's missed the number — and as everybody knows, it's a department store — and the stock's down 15%; it's eight times earnings or seven times earnings, or something like that. Where normally, you would say, Wow that's really kind of intriguing, we've been a little reticent to go into those deeper-value things. It's all the things we've talked about: concerns about the cycle, and China, and what the Fed might do, and for them, particularly, just because the business itself is under a lot of pressure.

And so, we're finding we want to go slowly. We are at a point in the cycle where more ideas are coming to the surface, but we want to go slowly. In the Value Fund in particular, we are overweight health care and tech. We like being there. That's a good place to be right now. In Small Company, it's a little bit more eclectic.

Darryl Keeton So before we move into outlook for you all going forward, Mauricio, you have been doing this for a while, and as you think about the current environment we're in, a 10-plus-year bull market, in our industry we talk very often about past returns are no indication of future results. But does this look like any other space in time, from the market standpoint, that you've ever seen before or had to manage money in before? Does this resemble any period?

Mauricio Agudelo The challenge with this expansion is that the central banks have been heavily involved. We were just talking on the fixed-income side about the Fed's tightening cycle: Was it normal? Did it get to a normal stage? They have raised rates, what, nine, 10 times, 11 times, which basically leaves the Fed with very little room to cut rates in the future. So, it certainly has a feel from past experiences, but how we come out of this in the future could be different.

Darryl Keeton — Thanks, Mauricio.

Now we'll move on to the Q&A portion of the call. And remember callers, please submit your questions using the chat feature of the WebEx platform.

Mauricio, while we wait for questions to come in, I know one of the things that you have really been excited about this last couple of months is the introduction of our Intermediate Bond Portfolio. Can you talk a little bit about some of the dynamics that made that portfolio possible, and why you thought this was a unique time for us to present it to the public?

Mauricio Agudelo — We certainly think it is a very exciting and unique offering for the Homestead lineup. It fills a gap for our shareholders between short-term fixed income and equities. It gives you an opportunity for greater income, and in this Intermediate portfolio, which is Bench verses the Bloomberg Barclays US Agg — which by itself carries a longer dated duration — it has certainly helped us in this environment of fallen interest rates.

Darryl Keeton — So, it sounds like, as you're thinking about outlook, you've positioned the portfolio fairly defensively, and around some of the uncertainty around monetary policy and the abundance of geopolitical events, such as the trade war with the tense things that are taking place in Hong Kong. Jim, can you talk about your outlook on both the Value and the Small-Cap portfolio?

Jim Polk — So again, just a reminder that we're bottom-up, fundamentally driven. So, this macro talk, while important and while serving as a backdrop for what we do, is just that: a backdrop. We really are trying to look longer term. As I mentioned with the quarter itself, we really want to potentially take advantage of some things that are going on here.

However, that said, what we are wrestling with is really the Fed cutting, and usually stocks do well in a Fed-cutting environment versus some of the things that Mauricio was talking about in terms of mixed economic data and the yield curve inversion, etc.

When we began the year, and this is really true for both the Value fund and the Small-Company Fund, we were looking at de-risking the portfolio and bringing some of the names that had done really well and pairing those back. And so, we've continued to do that.

Darryl Keeton — Mauricio, a question came in for you: Long-term Treasury yields have fallen pretty sharply. What do you think this means, with respect to the inverted yield curve right now? Is it something temporary or likely to change in the near term?

Mauricio Agudelo — The yield curve historically has been a very good indicator of future outcomes for the economy, so we're certainly watching this. We have positioned the portfolios, on the fixed-income side, in a very defensive stance. If you look at the Homestead Short-Term

Bond Fund, we had just over 10% of Treasuries at the end of 2018. At the end of June, per the slides, we're in the mid-forties. We've *done the quality* trade, as well, and happy in liquidity, so that we can certainly take advantage of opportunities when they present themselves.

Darryl Keeton: Jim, the next question is for you. With some of the sectors that are impacted by the trade war, are you looking more heavily in some of those areas for value place?

Jim Polk: I think with value-biased investors we have to. Some of those names that are getting beaten up by the trade war are showing themselves to be relatively cheap. And, we are taking a go-slow look at some of those names.

Darryl Keeton: Thank you. Today's call, the slide deck and related materials will be posted on our website soon — our revamped website, by the way. And you can find us at homesteadfunds.com.

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