Quarterly Market Review

Second Quarter 2019

Homestead Funds

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.

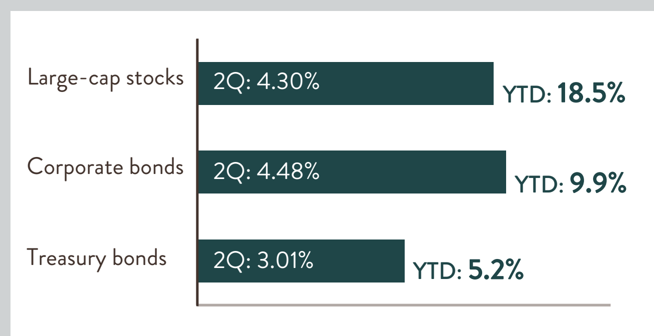
A Tale of Two Trends

In the second quarter, markets were up – all markets, that is. Stocks rallied, bringing year-to-date returns well into the double digits for most major indexes. And bonds also rallied, riding a tailwind of falling interest rates. On the surface, it appears to be good news all around.

But the discerning investor will notice something atypical about these results: that "risk-on" assets, like stocks and corporate bonds, usually have the opposite performance of "risk-off" assets, especially U.S. Treasury bonds and other conservative investments. Treasuries do best when investors are spooked by bad news and rush into safe havens, driving government bond prices higher and interest rates lower. Falling interest rates are thus a sign that investors see possible trouble ahead, maybe even the kind that leads the Federal Reserve to make interest rate cuts.

Second Quarter Rally for Risk-On and Risk-Off Assets

Year-to-date (YTD) return through 6/30/19



Source: FactSet

The second quarter was a period where risk-off and risk-on trends converged, making winners out of both the bulls and the bears.

If investors see possible trouble ahead, why did stocks deliver nice returns, too? Risk-on attitudes were clearly a driving force in the quarter as well. Not only did stocks climb upward; the risk premium for investment-grade and high-yield bonds also tightened. This measure, known as the credit spread, tends to shrink down in good times and expand when the outlook darkens.

Optimists and Pessimists, on Common Ground

So which is it — a good time for stock and risky assets, or a period where the outlook is darkening? Both, essentially. The second quarter was a period where risk-off and risk-on trends converged, making winners out of both the bulls and the bears.

There was bad news, but it sparked some good news — specifically, weaker global and U.S. activity are pushing policymakers at the Federal Reserve to consider cutting interest rates. In the absence of this possibility for Fed support, market returns could have been quite different. But a rate cut is likely, and risk-on assets have rallied at the prospect.

Risk-Off Signs Around the Globe

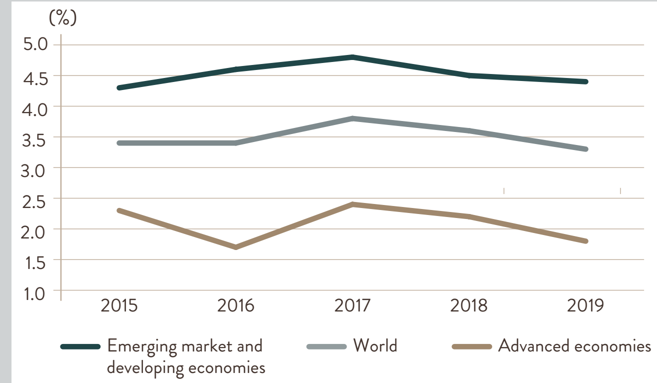
Softening global growth data is the ultimate source of the risk-off signals. Slowing manufacturing activity is one driver. The JPMorgan Global Manufacturing Purchasing Managers' Index (PMI), a measure of things like new-order volumes and inventory levels as reported in company surveys, dipped just below 50 in the June reading, reflecting slower activity in May.[1] PMI readings above 50 indicate expanding activity while readings below 50 indicate contracting trends.

Looking at the PMI data by country, about half of surveyed countries still registered growth in manufacturing measures, including the U.S. But Germany, South Korea, Taiwan and the U.K. were among contracting countries, and China's measures hovered in neutral.

Trade issues are a related source of pressure, with fallout from continued tariffs between the U.S. and China especially. The World Trade Outlook Indicator, a metric published by the World Trade Organization (WTO), posted the lowest reading since 2010 in its May report. Automobile production and sales, a component of the indicator, were down more than -10% from the prior year.[2]

The same modest pressures appear in U.S. employment reports. Nonfarm payrolls expanded over the second quarter with a particularly healthy reading in June, but the overall pace of job creation in the first half of 2019 was about 20% lower than the same period in 2018.[3]

Global GDP Growth Softens Slightly



Source: International Monetary Fund

Earnings Forecasts Continue to Adjust Lower

For investors, a key question is how all of these trends affect company earnings. Indeed, company earnings have been lower than originally forecast at the outset of 2019, with company managements and industry analysts continuing to downgrade their estimates. At the start of the second quarter, the consensus forecast for earnings growth of S&P 500 companies was -0.5%. By the end of the quarter, analysts had lowered forecasts to -2.6%. If numbers come in as currently expected, it will be the second quarter in a row with declines from year-ago earnings.[4]

The Fed's Silver Lining

Ultimately, trends in the broader economy and at companies paint a picture where activity is softening, but it's not dire. However, these dynamics do put inflation expectations in a precarious state.

The Federal Reserve has a stated goal to support a steady 2% inflation level for goods and services, something that has proven stubbornly resistant despite massive quantitative easing and record-low interest rate levels. Policymakers committed to a patient wait-and-see stance at the end of 2018, reassuring those investors who worried that the Fed would continue raising interest rates in the face of weaker activity and snuff growth altogether. Over the second quarter, it became increasingly likely that the Fed would actually move to cut interest rates in the near future. Rate cuts tend to support stock markets, as cheaper financing costs flow through the economy.

[1] J.P.Morgan Global Manufacturing PMI
[2] World Trade Organization
[3] Bureau of Labor Statistics
[4] FactSet

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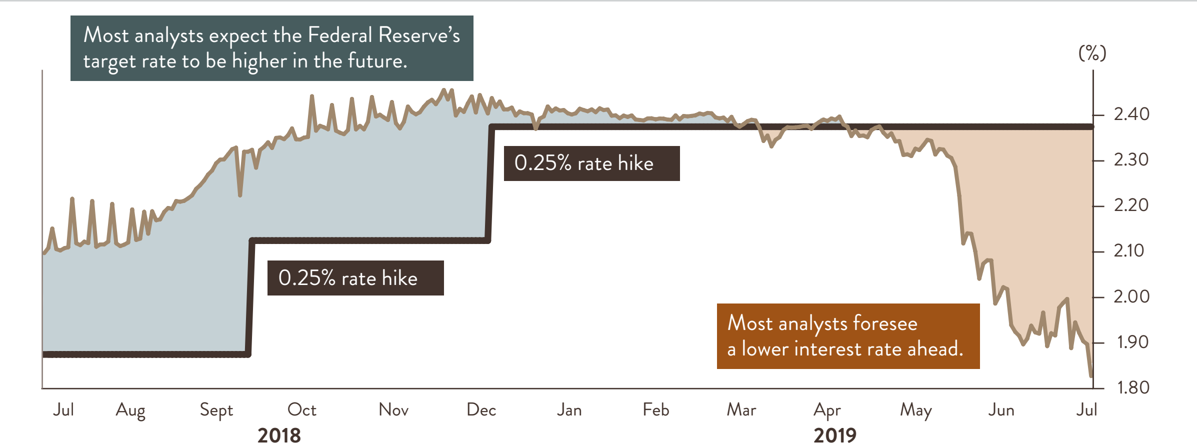
A Turn in the Forecast: Interest Rate Cuts Ahead

In the second quarter, the market consensus switched from expecting future interest rate hikes from the Federal Reserve to expecting interest rate cuts.



Source: Bloomberg

Bonds

U.S. bond indexes posted strong returns for the second quarter. The yield curve continued to fall and flattened further, with medium-term yields falling the most. Treasury and government agency issues had healthy gains. Corporate and high yield issues rallied as well, boosted by lower rates and by modestly compressing credit spreads.

Inflation data continued to come in incrementally lower over the second quarter, a key factor for the policy outlook of Federal Reserve bankers. The June reading for the Consumer Price Index (CPI), a measure that tracks the price of a basket of consumer goods, was up 1.6% compared to year-ago prices.[5] The Fed's likely switch back to an easing stance re-aligns U.S. policy with other developed market central banks, which have continued a supportive stance amid weak inflation and, in a number of cases, negative government bond yields. Markets are now forecasting one or two interest rate cuts over 2019, a complete about-face from the rate hikes forecast six months prior.

Against this backdrop, the Homestead Short-Term Bond Fund (HOSBX) rose 1.49% in the quarter, but trailed its benchmark, the ICE BofAML 1-5 Year Corporate/Government Bond Index, which returned 1.92%. The fund's shorter average duration was a detractor in the falling-rate environment. However, portfolio positions in credit sectors, including asset-backed securities, consumer loans and subprime issues, boosted relative performance. The portfolio team continued to adjust the fund's bond positioning significantly, bringing the portfolio's average duration closer to that of its benchmark.

The Homestead Short-Term Government Securities Fund (HOSGX) returned 1.37% in the second quarter. It trailed its benchmark, the ICE BofAML 1-5 Year Treasury Index, which rose 1.82%. Again, duration effects weighed on performance relative to the benchmark. Fund managers continued to adjust the portfolio's average duration to bring it closer to that of its index as the rate-outlook environment changes considerably.

Stocks

U.S. stocks continued to climb, bringing most indexes into double-digit gains for the first half. In terms of style, growth stocks outpaced value stocks for the second quarter across large-, mid- and small-cap companies.

The overall market backdrop was mixed in the second quarter. U.S. companies are poised to report second-quarter earnings that are actually down from their year-ago totals. Global GDP growth continued to soften, but only marginally. The U.S. continues to stand out as a relative stronghold, with continued expansion in manufacturing activity and continued job creation in the labor markets. The outlook for a U.S.-China deal faltered in the quarter, though many believe it will ultimately be resolved when the political incentives are in place.

The Homestead Value Fund (HOLVX) returned 3.71% in the second quarter, trailing its benchmark, the S&P 500 Value Index, which rose 4.02%. The fund's positioning in the information technology sector contributed to returns, boosted by stock choices. Fund

[5]Bureau of Labor Statistics

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holdings in the health care sector also outperformed. Conversely, stock picks in the communication services sector weighed on fund performance, as did stock choices in the consumer discretionary sector.

In terms of positioning, the Value Fund continued to be overweight relative to its benchmark in health care, materials and information technology sectors. The fund is most underweight in consumer staples, a sector where it does not have any holdings, and financials stocks. These over- and underweights are relative to the global industry classification standard (GICS) sectors. In recent months, the portfolio managers have been actively adding new stocks to the portfolio and aiming to broaden the fund's sector exposure.

The Small-Company Stock Fund (HSCSX) rose 6.51% in the quarter, outpacing its benchmark, the Russell 2000 Index, which gained 2.10%. Stock choices in the financials sector boosted relative returns, as did holdings in the health care sector. Conversely, positions in the consumer discretionary sector detracted from performance.

Relative to its benchmark, the Small-Company Stock Fund continues to be notably underweight in the real estate sector and in the health care sector. The portfolio's key overweights are in industrials, materials and financials stocks. As in the Value Fund, the Small-Company Stock Fund's portfolio managers assemble the portfolio with a bottom-up approach.

Total Returns as of 6/30/2019

		Average Annual				
	Q2	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* **(HOSGX)**	1.37%	3.59%	1.13%	1.13%	1.33%	3.09%
ICE BofA ML 1-5 Year U.S. Treasury Index	1.82%	4.89%	1.31%	1.54%	1.73%	3.94%
Expense ratio 0.82% (gross) 0.75% (net) (12/31/18)*						
> *Short-Term Bond Fund* **(HOSBX)**	1.49%	3.97%	2.07%	1.73%	3.01%	4.24%
ICE BofA ML 1-5 Year Corp./Gov. Index	1.92%	5.37%	1.75%	1.85%	2.31%	4.47%
Expense ratio 0.77% (12/31/18)						
Equity Funds						
> *Value Fund* **(HOVLX)**	3.71%	11.19%	12.78%	9.10%	13.90%	10.20%
S&P 500 Value Index	4.02%	8.67%	10.64%	7.92%	13.10%	NA
Expense ratio 0.60% (12/31/18)						
> *Small-Company Stock Fund* **(HSCSX)**	6.51%	-9.82%	4.53%	3.32%	13.15%	8.36%
Russell 2000 Index	2.10%	-3.31%	12.30%	7.06%	13.45%	7.31%
Expense ratio 0.90% (12/31/18)						

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.

*RE Advisers has contractually agreed, through at least May 1, 2019, to limit the Fund's operating expenses to an amount not to exceed 0.75%. This waiver agreement will terminate immediately upon termination of the Fund's Management Agreement and may be terminated by the Fund or RE Advisers with one year's notice.

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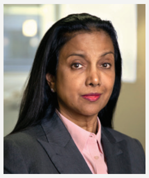
Equity Fund Management



Prabha Carpenter, CFA®

Senior Equity Portfolio Manager

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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Senior Equity Portfolio Manager

Jim co-manages RE Advisers' large- and small-cap value strategies. He received a BA in English from Colby College and an MBA from the Olin Graduate School of Business at Babson College. Jim holds the Chartered Financial Analyst designation.

Bond Fund Management

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Senior Fixed-Income Portfolio Manager

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Debt securities are subject to interest rate risk, credit risk, extension risk, income risk, issuer risk and market risk. The value of U.S. Government securities can decrease due to changes in interest rates or changes to the financial condition or credit rating of the U.S. Government. Investments in asset-backed and mortgage-backed securities are also subject to prepayment risk as well as increased susceptibility to adverse economic developments. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Equity securities generally have greater price volatility than fixed-income securities and are subject to issuer risk and market risk. Value stocks are subject to the risk that returns on stocks within the style category will trail returns of stocks representing other styles or the market overall. Securities of small and medium-sized companies tend to be riskier than those of larger companies.

Index Definitions: The **ICE BofA Merrill Lynch 1 – 5 Year U.S. Treasury Index** measures the performance of short-term U.S. Treasury securities. The **ICE 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. Index returns do not include reinvested dividends.

On September 28, 2018, the telecommunication services sector was expanded and renamed communication services. Some securities previously assigned to information technology or consumer discretionary were reclassified as communication services. Additionally, some securities previously assigned to information technology were reclassified as consumer discretionary.

Investing in mutual funds involves risk, including the possible loss of principal. Past performance does not guarantee future results.

Investors should carefully consider fund objectives risks, charges and expenses before investing. The prospectus contains this and other information about the funds and should be read carefully before investing. To obtain a prospectus, call 800-258-3030 or download a PDF at homesteadfunds.com.

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