Summary

➤ Global economic measures reflected mounting stress from the U.S.-China trade war. Manufacturing activity retreated further, and oil prices were about 20% lower, on average, than the third quarter of last year. The U.S. consumer was resilient as the job market remained strong. While U.S. Gross Domestic Product growth forecasts are trending downward, especially for 2020, the U.S. continues to hold up better than many developed-market peers around the world.

➤ Stock markets were mixed, with modest gains from large-cap stocks and minor declines among small caps. Defensive assets generally fared best, with leading performance from things like utilities, real estate and consumer staples stocks. Company earnings are expected to decline from year-ago levels for the third quarter in a row.

➤ Bonds had better returns, especially long-dated U.S. government issues, as the Treasury yield curve fell and flattened further. The Federal Reserve made two rate cuts in the quarter, and investors are forecasting more to come. While investment-grade and high-yield bonds had gains, they lagged government bonds.

Feeling the Pressure

In the third quarter, markets delivered mixed results. Bonds outperformed stocks, in general, as global growth forecasts weakened further and trade conflicts continued. Defensive stocks, generally, outperformed more cyclical stocks. According to the Russell 2000, small-cap stock declined, while bellwether large caps, represented by the S&P 500, eked out modest gains.

The mixed performance reflects an increasingly mixed economic outlook. Some measures, like the U.S. job market, look roundly positive, while other areas of the economy are showing definitive cracks as trade conflicts roar on and geopolitical upheaval looms. Indeed, the Fed moved to cut its target short-term interest rate twice in the quarter, a sharp reversal from expectations of continued rate hikes at the outset of 2019.

Trade War Generates Fallout

The trade war between the U.S. and China continued through the third quarter, with additional escalation from both sides. Manufacturing and agricultural sectors have perhaps taken the most direct hit from trade tariffs, but the impact has begun to dampen the outlook for other parts of the U.S. economy as well.

The German economy is a good example. German manufacturing, a major segment of the country’s output, has contracted sharply as trading partners — China and the U.K. in particular — are buying fewer German cars and industrial machines. GDP growth in the country has been negative in recent quarters, and the German job market is beginning to feel the effects. Similar results are starting to look possible in the U.S., where economists are downgrading GDP growth forecasts for 2020 — some to rates as low as 1.7%. If U.S. growth does slow to that level, it will be a sharp retreat from the 2%-3% range that the U.S. has generally maintained in the last three years.

As the managing director of the International Monetary Fund recently noted, the global economy had been in a synchronized expansion but is now in a synchronized slowdown aggravated by trade war ripple effects.
Manufacturing and agricultural sectors have perhaps taken the most direct hit from trade tariffs, but the impact has begun to dampen the outlook for other parts of the U.S. economy as well.

Effects Spread Beyond Manufacturing

Purchasing Manager Indexes (PMIs), which forecast near-term business activity, are already reflecting contractions in manufacturing activity. The service sector is also starting to show cracks, still in growth mode but ticking downward.

Company Earnings Taking a Hit

Company earnings are another area where pressures are apparent. According to FactSet, at the end of the third quarter, analysts were forecasting total earnings for companies in the S&P 500 Index to decline by 3.7%, compared with year-ago levels.\(^1\) If financial results actually come in as expected, it will be the third consecutive quarter that earnings have declined.

Energy companies have suffered the biggest decline in third-quarter earnings. Average oil prices in the third quarter were nearly 20% lower than average oil prices for the same period in 2018, an indirect effect of trade war tensions as global demand — especially from a slowing China — ticks downward. The broader trend is even more apparent when looking at how markets handled the attack in the third quarter on a major Saudi oil production facility, an event that caused oil prices to spike upward, but only briefly. Prices finished the third quarter lower, in total.

Tech companies are also reporting earnings pressure, though one component is different according to analysts at Goldman Sachs: labor costs. Labor is a major input for tech companies, and the tight job market could be straining the bottom line for hardware makers and other industry names.

\(^1\) FactSet Earnings Insight, September 27, 2019
The Bright(er) Side

Still, it’s not all bad news. Despite current headwinds and uncertainties, the U.S. consumer is in fairly good shape, enjoying a strong job market and feeling confident. The University of Michigan U.S. Index of Consumer Sentiment, an index that measures consumer confidence levels, remained in solidly optimistic territory throughout the third quarter, with all three monthly readings coming in above the long-term average.

A confident consumer is no small thing in the U.S. economy. Indeed, consumer spending activity accounts for nearly two-thirds of GDP in the U.S., a key reason why our domestic economy has proven so much more resilient to global pressures than other developed-market countries.

Bonds

U.S. bond indexes posted solid returns in the third quarter. The yield curve continued to fall and flattened further, with long-term yields falling more than short-term yields. Treasury and government agency issues, especially long-dated debt securities, posted the biggest gains. While investment-grade and high-yield corporate bonds also delivered positive returns, they trailed government bonds.

The Federal Reserve cut its target rate by 0.25% in July and again in September, aiming to offset slowing economic activity with lower interest rates. Inflation measures appear contained across goods and services, hovering in the range of 1% to 2% (on an annual basis) depending on the inflation gauge. Notably, wage inflation also remains constrained, despite cyclical lows in unemployment. At the end of the third quarter, markets were forecasting another rate cut for October; however, yields on U.S. Treasuries remain positive. Globally, a number of major countries now have negative yields on 10-year government bonds, including Japan, Germany and France.

Against this backdrop, the Homestead Short-Term Government Securities Fund (HOSGX) returned 0.74% in the third quarter, in line with its benchmark, the ICE BofA ML 1-5 Year Treasury Index, which rose 0.75%. Portfolio managers continued to adjust the portfolio’s average duration to bring it closer to that of its index to navigate the falling-rate environment.

The Homestead Short-Term Bond Fund (HOSBX) rose 0.82% in the quarter, but slightly trailed its benchmark, the ICE BofAML 1-5 Year Corporate/Government Bond Index, which returned 0.90%. The fund’s shorter average duration was a detractor as interest rates continued to decline. 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 average duration closer to that of its benchmark.

The Homestead Intermediate Bond Fund (HOIBX) returned 2.00% in the third quarter, modestly trailing its benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index, which rose 2.27%. Underweight positions in bonds from utilities and industrials companies weighed on fund performance, though positioning in asset-backed securities, commercial paper and cash aided returns. The fund began operations on May 1, 2019.

 Stocks

U.S. stocks had mixed performance in the quarter, with large-cap benchmarks posting minor gains and small-cap benchmarks declining modestly. Style performance was also mixed, with growth outperforming value among large caps but value outperforming in the small- and mid-cap spaces.

Market sentiment wavered over the period as investors assessed the mixed signals from economic data and geopolitical developments. U.S. companies are likely to report a decline in company earnings from year-ago levels, but relative strength in household spending continued to reassure investors. Political uncertainty only increased, with continued conflict between the U.S. and China over trade negotiations, ongoing instability in the Brexit outlook and looming impeachment proceedings in the U.S. As equity markets finished the period roughly flat but earnings declined, relative stock valuations edged upward.

The Homestead Value Fund (HOVLX) declined 0.30% in the third quarter, trailing its benchmark, the S&P 500 Value Index, which rose 2.83%. The fund’s positioning in the information technology sector detracted from returns, driven by stock selection. An overweight position and stock choices in the healthcare sector also weighed on relative performance. Conversely, stock choices in the financials and communication services sector boosted the fund’s performance.

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 has very limited exposure, and financials stocks. Since the start of the year, the portfolio managers have been actively adding new stocks to the portfolio and aiming to broaden the fund’s exposure to different sectors.

At the end of the third quarter, markets were forecasting another rate cut for October.
The Small-Company Stock Fund (HSCSX) fell 4.14% in the quarter, lagging its benchmark, the Russell 2000 Index, which retreated 2.40%. Stock choices in the consumer discretionary and health care sectors weighed on relative returns. Conversely, stock picks in the information technology and materials sectors were additive. The fund’s underweight in the energy sector also boosted performance.

Relative to its benchmark, the Small-Company Stock Fund continues to be notably underweight in the real estate sector and in utilities, a sector where it does not hold any stocks. The portfolio’s key overweights continue to be in the information technology, materials and financials sectors. As in the Value Fund, the Small-Company Stock Fund’s portfolio managers assemble the portfolio with a bottom-up approach, applying a company-specific approach to diversification.

### Total Returns as of 9/30/2019

<table>
<thead>
<tr>
<th>Bond Funds</th>
<th>Average Annual</th>
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<tbody>
<tr>
<td><strong>&gt; Short-Term Government Securities Fund (HOSGX)</strong></td>
<td></td>
</tr>
<tr>
<td>ICE BofA ML 1-5 Year U.S. Treasury Index</td>
<td>0.74% 0.75%</td>
</tr>
<tr>
<td>Expense ratio 0.82% (gross) 0.75% (net) (12/31/18)*</td>
<td>3.96% 1.38% 1.31% 1.30% 3.09%</td>
</tr>
<tr>
<td><strong>&gt; Short-Term Bond Fund (HOSBX)</strong></td>
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<tr>
<td>ICE BofA ML 1-5 Year Corp./Gov. Index</td>
<td>0.82% 0.90%</td>
</tr>
<tr>
<td>Expense ratio 0.77% (12/31/18)</td>
<td>4.26% 2.22% 1.87% 2.66% 4.23%</td>
</tr>
<tr>
<td><strong>&gt; Intermediate Bond Fund (HOIBX)</strong></td>
<td></td>
</tr>
<tr>
<td>Bloomberg Barclays U.S. Agg Index</td>
<td>2.00% 2.27%</td>
</tr>
<tr>
<td>Expense ratio 2.08% (gross) 0.80% (net) (5/1/19)*</td>
<td>NA 10.30% 2.92% 3.38% 3.75% 5.36%</td>
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<table>
<thead>
<tr>
<th>Equity Funds</th>
<th>Average Annual</th>
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</thead>
<tbody>
<tr>
<td><strong>&gt; Value Fund (HOVLX)</strong></td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500 Value Index</td>
<td>–0.30% 2.83%</td>
</tr>
<tr>
<td>Expense ratio 0.60% (12/31/18)</td>
<td>1.28% 5.56% 10.61% 8.47% 12.00% 10.09% NA</td>
</tr>
<tr>
<td><strong>&gt; Small-Company Stock Fund (HSCSX)</strong></td>
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</tr>
<tr>
<td>Russell 2000 Index</td>
<td>–4.14% –2.40%</td>
</tr>
<tr>
<td>Expense ratio 0.90% (12/31/18)</td>
<td>–13.09% 8.89% 8.28% 3.45% 10.54% 8.05% 7.10%</td>
</tr>
</tbody>
</table>

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, 2020 (Short-Term Government Securities Fund) or May 1, 2021 (Intermediate Bond Fund) to limit the Funds’ operating expenses to an amount not to exceed 0.75% (Short-Term Government Securities Fund) or 0.80% (Intermediate Bond Fund). 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.

**The inception date of this fund is May 1, 2019.
The views expressed in this market commentary are those of the individual as of the date noted and may have changed since that date. The opinions stated may contain forward-looking statements and may discuss the impact of domestic and foreign markets, industry and economic trends, and governmental regulations of the funds and their holdings. Such statements are subject to uncertainty, and the impact on the funds might be materially different from what is described here.

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 Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The Dow Jones Industrial Average measures the stock price performance of 30 actively traded, blue chip companies. The MSCI Emerging Markets Index represents the performance of large and middle-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. The MSCI EAFE Index represents the performance of large- and middle-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.

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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