Quarterly Market Review

First Quarter 2019

Homestead Funds

Summary

- Stock markets rebounded from the pullback of the previous quarter, with the rally largely driven by the Federal Reserve's move to pause interest rate hikes. Policymakers assured investors they were back in wait-and-see mode. Markets had reacted badly the quarter before when the Fed raised interest rates just as weaker economic and inflation data was coming in. The move marks a significant shift from the years-long rate hike campaign as the Fed normalized interest rates after the financial crisis.
- After growing about 20% in 2018, company earnings are undergoing a shift in expectations as well. As the effects of the tax cut wear off, analysts' expectations for earnings are moderating significantly, though forecasts still project single-digit year-over-year growth for 2019.
- The Treasury yield curve flattened further, even inverting briefly as short-term rates remained anchored by Fed rate targets while medium-term rates softened. Bonds were boosted by an overall decline in interest rates.

Changing Expectations

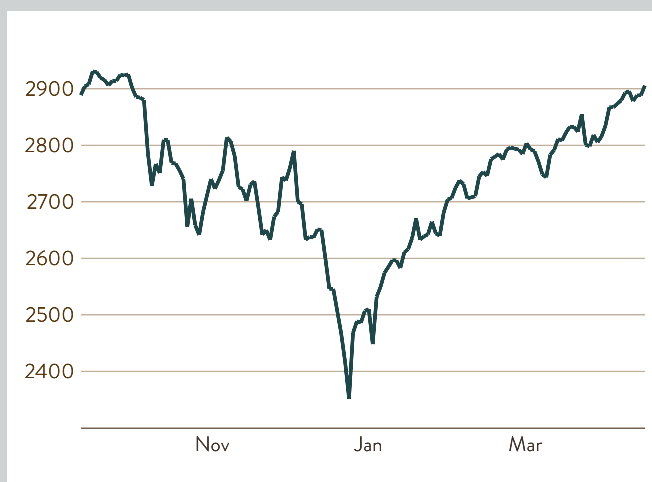
What goes down, must go up? Stock markets rebounded in the first quarter of 2019, reversing the sharp pullback of the prior quarter. In both periods, company earnings were relatively strong, unemployment and consumer confidence numbers were good, and the economy was far from recession territory – so why did markets react so differently from one quarter to the next?

In this case, it's probably a story of expectations. In the fourth quarter, U.S. inflation and global growth data softened enough that investors started to worry about the Federal Reserve's rate-hike plans, given its move to enact a fourth-quarter 0.25% rate hike just as economic data was coming in weaker. Anxieties flared at the prospect of a Fed misstep, namely that it would continue raising rates despite a slowing economic backdrop, a recipe for recession.

In the first quarter, policymakers moved to reassure investors that they would be patient – very patient – to fully assess changing conditions before making any further moves. Reassured, markets bounced back. For now, it appears that the rate-hike campaign is completed.

Stock Markets Rebound in Q1 After Tumbling in Q4

S&P 500 Index



Source: www.bloomberg.com

When it comes to monetary policy, expectations are arguably as important as actions. After all, in investing, expectations can become a reality. Markets tumble, consumers start to expect a coming recession and pull back spending, and what started as just a worry morphs into actual economic changes.

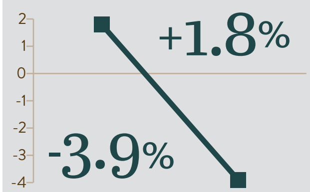
An Altered Range for Earnings Growth

Changing expectations are also a key topic for company earnings, at the moment. Analysts broadly agree that companies will report slower earnings growth in 2019 than in 2018, a year when average company earnings were up around 20% thanks to a boost from tax cuts.

In 2019, analysts are expecting company earnings to grow at a more modest single-digit rate, coming back down to earth. In fact, at the start of the 2019, the consensus forecast was for first-quarter earnings to be up 1.8% year-over-year; by the end of March, the consensus forecast for the same period was to see a decline of -3.9%.[1]

Expectations are also shifting on broader economic markers like global growth and inflation, which is reflected in longer-term interest rates. The 5-year U.S. Treasury rate, a benchmark of medium-term expectations, rallied higher through 2018 and topped 3% for the first time in years as U.S. growth and inflation came in at a quicker clip than expected. But it has been steadily easing since fall, drifting back to the same low-2% levels that it had been at a year before.

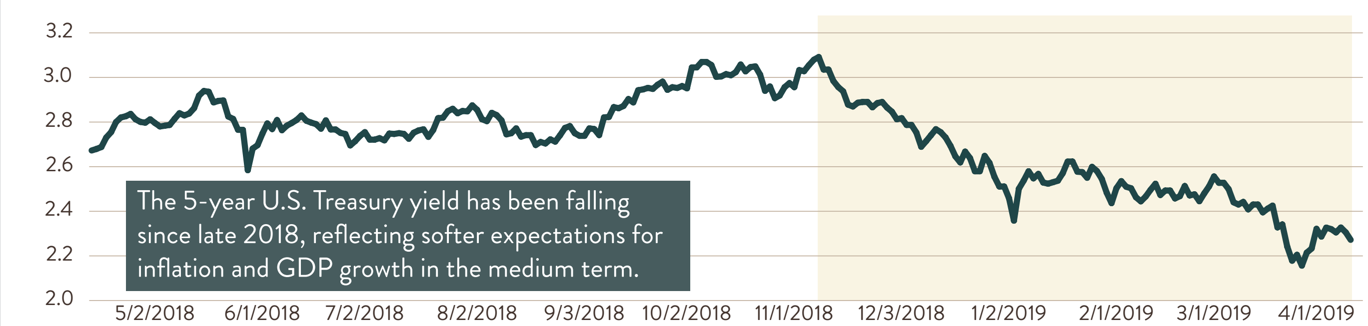
Earnings Expectations Drift Downward



Q1 earnings **growth forecasts fell** from +1.8% at the start of the year to -3.9% by March

In investing, expectations can become a reality. Markets tumble, consumers start to expect a coming recession and pull back spending, and what started as just a worry morphs into actual economic changes.

Five-Year U.S. Treasury Rates Drifting Back Down



Source: www.treasury.gov

[1]https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_011119.pdf
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Climbing the Wall of Worry

All in all, the markets are facing an unusual mix of trends. Employment and consumer confidence are still quite strong in the U.S. and continue to outpace developed-market peers in much of the globe. China has been a source of modestly better momentum in recent months, and manufacturing data is good.

On the other hand, global growth in aggregate has downshifted, with particular weakness from the EU. Italy faces real challenges, and even Germany has posted weaker activity in recent data. Brexit continues to loom unresolved. Interest rates here in the U.S. are signaling weaker growth ahead, and company earnings trends seem to confirm the shift.

Still, bull markets don't die of old age, and we believe the current expansion seems poised to carry on. Lower growth is still growth.

As we assess changing expectations, we certainly have to account for the key driver of U.S. economic activity – the consumer. According to the University of Michigan Index of Consumer Sentiment, consumers are still feeling good, and notably, it's the population in the lower 2/3 bracket of income who are especially upbeat. According to Surveys of Consumers chief economist Richard Curtin: "Overall, the data do not indicate an emerging recession but point toward slightly lower unit sales of vehicles and homes during the year ahead."[3]

Bonds

U.S. bond indexes posted gains for the first quarter. The yield curve generally fell and flattened further, with longer-dated yields falling a bit more than the short end of the curve. Treasury and government agency issues had healthy gains. Corporate and high yield issues rallied as well, boosted by lower rates and by compressing credit spreads. Credit sectors, like stock markets, recovered from the shock of the previous quarter and returned to trend.

After a poorly received rate hike in the fourth quarter, which was enacted just as weaker economic and inflation data were changing the outlook, Fed policymakers changed direction and announced a pause in rate hikes. Inflation data did come in incrementally weaker over the first quarter as well, further reinforcing the need to ease off rate increases. Investors' rate forecasts changed significantly, from expecting two additional rate hikes in 2019 to new forecasts of zero rate hikes or even possible rate cuts before the year is over.

Against this backdrop, the Homestead Short-Term Government Securities Fund (HOSGX) returned 1.02% in the first quarter. It trailed its benchmark, the ICE BofAML 1-5 Year Treasury Index, which rose 1.22%. The fund's shorter average duration was a detractor in the falling-rate environment. As the rate outlook shifted, the portfolio managers adjusted the fund's bond positioning significantly, bringing the fund's average duration closer to that of its benchmark. The fund had maintained a significantly shorter-than-benchmark duration for several years to mitigate the impacts of the Fed's rate-hike campaign.

The Homestead Short-Term Bond Fund (HOSBX) rose 1.34% in the quarter, but trailed its benchmark, the ICE BofAML 1-5 Year Corporate/Government Bond Index, which returned 1.64%. Fund managers adjusted the average duration of issues in the fund to bring it closer to the duration of its benchmark.

Stocks

U.S. stocks rebounded in the first quarter. Non-U.S. markets also rallied. In terms of style, growth stocks outpaced value stocks across large-, mid- and small-cap companies.

The overall market backdrop was mixed in the first quarter. A change in the Fed's position was a key driver of the rebound, but other data on economic activity was mixed. Earnings softened, perhaps even a bit more than expected, and GDP growth turned slightly weaker. Labor markets, however, continued to be strong, and manufacturing activity showed a healthy pace. The outlook for a U.S.-China trade deal improved, and China reported incrementally stronger economic activity as well. Europe, on the other hand, faces considerable challenges, including a poor outlook in Italy and the continued stress of an unresolved Brexit.

The Homestead Value Fund (HOLVX) returned 12.01% in the first quarter, in-line with its benchmark, the S&P 500 Value Index, which rose 12.19%. The fund's positioning in the financials sector contributed to returns, boosted by stock choices and by a sector underweight relative to the benchmark. Fund holdings in the materials sector also outperformed. Conversely, an overweight in health care weighed on fund performance, as did stock choices in the energy 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

[3]http:https://www.marketwatch.com/story/consumer-sentiment-improves-for-second-straight-month-in-march-2019-03-29

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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 diversification by sector.

The Small-Company Stock Fund (HSCSX) rose 12.71% in the quarter, trailing its benchmark, the Russell 2000 Index, which gained 14.58%. Stock choices in the information technology sector detracted from relative performance, as did selection in the newly formed communication services sector. On the other hand, stock picks in the consumer discretionary sector outperformed. The fund also benefited from avoidance of the utilities sector, which lagged the overall benchmark in returns for the quarter.

Relative to its benchmark, the Small-Company Stock Fund continues to be notably underweight in the real estate sector, where it does not have any exposure, and in the health care sector. The portfolio is especially overweight in industrials, materials and financials stocks.

Total Returns as of 3/31/2019

		Average Annual				
	Q1	1-yr	3-yr	5-yr	10-yr	Since inception
Bond Funds						
> *Short-Term Government Securities Fund* **(HOSGX)**	1.02%	2.14%	0.79%	0.99%	1.25%	3.06%
ICE BofA ML 1-5 Year U.S. Treasury Index	1.22%	3.14%	0.97%	1.29%	1.46%	3.90%
Expense ratio 0.82% (gross) 0.75% (net) (12/31/18)*						
> *Short-Term Bond Fund* **(HOSBX)**	1.34%	2.99%	1.89%	1.53%	3.51%	4.22%
ICE BofA ML 1-5 Year Corp./Gov. Index	1.64%	3.57%	1.44%	1.61%	2.29%	4.44%
Expense ratio 0.77% (12/31/18)						
Equity Funds						
> *Value Fund* **(HOVLX)**	12.01%	7.39%	12.67%	9.59%	15.28%	10.15%
S&P 500 Value Index	12.19%	5.93%	10.62%	8.05%	14.49%	NA
Expense ratio 0.60% (12/31/18)						
> *Small-Company Stock Fund* **(HSCSX)**	12.71%	-14.80%	3.32%	2.31%	14.85%	8.14%
Russell 2000 Index	14.58%	2.05%	12.92%	7.05%	15.36%	7.29%
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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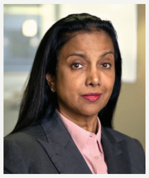
Equity Fund Management



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.

Jim Polk, CFA®
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

Mauricio Agudelo, CFA®
Senior Fixed-Income Portfolio Manager

Mauricio 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.

Ivan Naranjo, CFA®, FRM®
Fixed-Income Portfolio Manager

Ivan co-manages RE Advisers' fixed-income strategies. He joined RE Advisers in 2018. Ivan received a BS in finance from the University of Maryland, Robert H. Smith School of Business. He holds the Chartered Financial Analyst and Financial Risk Manager designations.

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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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