



Investment Team

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Characteristics

Total Net Assets

(billions): \$1.50

Number of holdings: 178

Top Holdings

FNCL 5 11/23

TREASURY BILL B 07/11/24

US TREASURY N/B T 3 08/15/52

TSY INFL IX N/B TII 1 1/4 04/15/28

FNCL 5.5 11/23

FNCL 6 11/23

US TREASURY N/B T 2 1/4 02/15/52

US TREASURY N/B T 0 1/8 12/15/23

U.S. Bank Money Market Deposit Account

FNCL 4.5 11/23

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Market Overview

Fitch downgrades the U.S.

In a move that caught markets off-guard, Fitch Ratings downgraded the U.S. sovereign credit rating to AA+ at the end of July, leaving Moody's as the sole major rating agency still awarding the U.S. government the highest rating. This decision followed Fitch placing the U.S. government on watch during the contentious debt ceiling debates in the second quarter. Although the downgrade came unexpectedly, especially after the debt ceiling issue had been resolved, the reasons Fitch provided are hard to contest. Fitch pointed to fiscal deterioration, an escalating debt burden, and a weakening of governance standards, all factors contributing to a less optimistic long-term outlook for the U.S. economy.

Hawkish comments from Powell at Jackson Hole.

At the annual Jackson Hole Economic Symposium, Federal Reserve (Fed) Chair Jerome Powell's remarks did not signal a substantial shift, but rather affirmed the Fed's ongoing hawkish stance. After incorrectly labeling runaway inflation as "transitory" in 2021, the Fed's rapid increase in rates over the last 18 months has moderated inflation, although not yet all the way to the 2% target level. Higher rates have not slowed the economy as quickly as some expected, however, and early indicators point to robust gross domestic product (GDP) growth in the third quarter.

Ongoing job market strength stymies Fed.

Chair Powell's speech at Jackson Hole included a particularly noteworthy remark: He posited that achieving the Fed's 2% inflation target might require some softening in the job market. This expectation (or goal?) runs counter to the substantial wage increases achieved by major unions in recent contracts, as well as the ongoing negotiations by the United Auto Workers (UAW). Consequently, the Fed might find itself needing to maintain higher interest rates over an extended period to circumvent a wage-price spiral. This increases the risk of overtightening and could precipitate a hard landing for the economy.

China woes weigh on global growth.

In contrast to the United States, China's growth is faltering and underperforming expectations. Trade volumes and foreign investment have declined sharply, and China's price indexes have recently signaled deflation, not inflation. The ongoing credit crisis in its property sector continues to pose substantial challenges, and despite best efforts, the central bank hasn't managed to stimulate the economy sufficiently to maintain prior growth trajectories. Compounded by unfavorable demographics, China's path to high levels of sustained growth appears much more daunting compared to its recent history.

Spread sectors outperform, yield curve inversion moderates.

Sector excess returns were mostly positive during the third quarter, led by high-yield (HY) and investment-grade (IG) corporates. The asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) sectors also outperformed. The mortgage-backed securities (MBS) sector bucked this trend, underperforming due to elevated interest rate volatility. U.S. Treasury rates increased across the entire curve, but the move was most pronounced in 5-year and longer maturities as the market slowly abandons hopes for a quick reversal of the Fed's rate hike campaign and prices in a "higher for longer" scenario. Rates at the front end of the curve also rose, but only in line with the Fed's single 25-basis point (bp) rate hike during the quarter.

Portfolio Review

The U.S. Treasury curve experienced a significant bear steepening move during the third quarter, as concerns over increased Treasury supply and a "higher for longer" narrative took hold. The Fund's above-benchmark duration stance detracted from relative performance due to rising risk-free rates, but the negative impact was partially offset by dynamic yield curve positioning throughout the quarter.

Sector allocation detracted due to an overweight to the underperforming MBS sector and an underweight to the outperforming IG corporates sector, along with non-index allocations to HY corporates, non-U.S. dollar currencies, and U.S. Treasury Inflation-Protected Securities (TIPS). Security selection detracted overall, as negative selection within IG corporates was only partially offset by positive selection within the MBS sector.



The allocation to IG corporates was essentially unchanged during the third quarter and remained underweight relative to the index. IG corporate holdings continued to favor financials. The weight in HY corporates increased modestly. The Fund's allocations to agency MBS and non-agency residential mortgage-backed securities (RMBS) both increased, and the mortgage sector continued to represent a meaningful overweight relative to the index. Exposures to CMBS and ABS both declined, but still represented modest overweights relative to the index. The allocation to U.S. Treasuries declined and remained significantly underweight relative to the index.

Portfolio duration increased during the third quarter and remained above that of the index, reflecting real rates that have reached very attractive levels. Yield curve exposure at the end of the quarter featured overweights to the 0- to 1-year, 7- to 10-year, and 25- to 30-year segments, along with underweights to the 1- to 3-year, 3- to 5-year, 5- to 7-year, and 10- to 25-year segments.

Outlook

Fears of Fed overtightening fade.

In the latter half of the third quarter, the Treasury market started to reflect a more resilient U.S. economy. Rates at the longer end rose, moderating the yield curve's steep inversion. While fears of additional rate hikes have subsided, so have expectations of imminent rate cuts. The danger of Fed overtightening still exists, however, and may be greater than many currently appreciate. If the cumulative impact of sharply higher rates has simply been delayed, rather than avoided, risk assets could quickly reprice lower as a result.

Lengthy auto workers' strike would hurt growth.

Labor unions have successfully negotiated sizable wage increases in the airline and parcel delivery industries. This has emboldened the United Auto Workers (UAW) to set high demands for wage hikes with the big three U.S. automakers. If both sides refuse to cede ground, the strikes that began in September may extend and expand, which would result in an increasing drag on GDP growth. The UAW strikes, combined with the resumption of student loan payments and higher gas prices, may cause a retrenchment in consumer spending that has remained resilient despite restrictive monetary policy measures.

U.S. dollar likely to remain firm until Fed pivot.

A resilient job market and ongoing hawkishness by the Fed drove the U.S. dollar higher against most major currencies during the second half of the quarter. Several central banks also signaled that they may be at, or very near, the end of their own rate hike cycles. U.S. dollar strength will likely remain for as long as the Fed keeps rates elevated.

China's distressed property sector a risk to global growth.

One of China's largest property developers recently filed for bankruptcy protection and its chairman has been detained by police. Another large property developer was narrowly able to avoid defaulting on its debt ... for the time being. By all indications, China's property sector is unlikely to improve anytime soon, which may weigh on China's short- and intermediate-term growth and, by extension, global GDP growth.

Risk Considerations: The return of principal in a fixed income fund is not guaranteed. Fixed income funds have the same interest rate, inflation, issuer, maturity, and credit risks that are associated with underlying fixed income securities owned by the fund. Mortgage- and Asset-Backed Securities are subject to prepayment risk and the risk of default on the underlying mortgages or other assets.

High-yield securities involve greater risk than investment grade securities and tend to be more sensitive to economic conditions and credit risk.

Foreign investments present additional risks due to currency fluctuations, economic and political factors, government regulations, differences in accounting standards, and other factors. Investments in emerging markets involve even greater risks.

Derivatives such as options, futures contracts, currency forwards, or swap agreements may involve greater risks than if the Fund invested in the referenced obligation directly. Derivatives are subject to risks such as market risk, liquidity risk, interest rate risk, credit risk, and management risk. Derivative investments could lose more than the principal amount invested. The Fund may use derivatives for hedging purposes or as part of its investment strategy. The use of leverage and derivatives investments could accelerate

losses to the fund. These losses could exceed the amount originally invested.

The Fund may, at times, experience higher-than-average portfolio turnover, which may generate significant taxable gains and increased trading expenses, which, in turn, may lower the Fund's return.

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Bond Ratings: Ratings are by Moody's, S&P, and/or Fitch. Ratings provided by nationally recognized statistical rating organizations, also called ratings agencies, are appraisals of a particular issuer's creditworthiness, including the possibility that the issuer will not be able to pay interest or repay principal. Ratings are not recommendations to buy, sell or hold a security, nor do ratings remove market risk. Securities with the same rating can actually trade at significantly different prices. In addition, ratings are subject to review, revision, suspension, reduction or withdrawal at any time, and a rating agency may place an issuer under review or credit watch. Additionally, Fitch reports are available for municipal bonds. More about ratings is available at moody's.com, standardandpoors.com, and fitchratings.com.

Definitions

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Bear steepening refers to a move when interest rates rise, but are led by longer-term rates that shift the entire yield curve higher.

A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as "bond spreads" or "default spreads," credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

Duration incorporates a bond's yield, coupon, final maturity and call features into one number, expressed in years, that indicates how price-sensitive a bond or portfolio is to changes in interest rates. Bonds with



higher durations carry more risk and have higher price volatility than bonds with lower durations.

Hawkish, dovish, and centrist are terms used to describe the monetary policy preferences of central bankers and others. Hawks prioritize controlling inflation and may favor raising interest rates to reduce it or keep it in check. Doves tend to support maintaining lower interest rates, often in support of stimulating job growth and the economy more generally. Centrists tend to occupy the middle of the continuum between tight (hawkish) and loose (dovish) monetary policy.

High-yield bonds have credit ratings below BBB- from Standard & Poor's or below Baa3 from Moody's.

Investment-grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

The Jackson Hole Economic Symposium, hosted annually by the Federal Reserve Bank of Kansas City in Jackson Hole, Wyo., brings together dozens of central bankers, policymakers, scholars, and economists to discuss economic issues, implications, and policy options.

Overweight describes a portfolio position in an industry sector or some other category that is greater than the corresponding weight level in a benchmark portfolio.

A real interest rate is an interest rate that has been adjusted to remove the effects of inflation. Once adjusted, it reflects the real cost of funds to a borrower and the real yield to a lender or to an investor. A real interest rate reflects the rate of time preference for current goods over future goods. For an investment, a real interest rate is calculated as the difference between the nominal interest rate, which is not adjusted for inflation, and the inflation rate.

A risk-free interest rate, also known as a risk-free rate of return, is a theoretical interest rate of an investment that carries no risk. Real risk-free rates are calculated by subtracting the rate of inflation from the yield of the Treasury bond matching the duration of the investment in question.

Spread sector is a term used in fixed income investing to describe nongovernmental fixed-income securities, such as corporate bonds or mortgage bonds, whether investment grade or high yield, that provide an additional yield, or "spread," over the yield of a risk-free government bond.

U.S. Treasury Inflation-Protected Securities (TIPS) provide protection against inflation. The principal of a TIPS instrument increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, investors are paid the adjusted principal or original principal, whichever is greater.

Underweight describes a portfolio position in an industry sector or some other category that is less than the corresponding weight level in a benchmark portfolio.

The wage-price spiral is a macroeconomic theory that posits a cause-and-effect relationship between rising wages and rising prices, or inflation. According to the theory, rising wages increase disposable income, stimulating spending and fueling increases in prices. Rising prices, in turn, increase the demand for higher wages, which leads to higher production costs and further upward pressure on prices.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. Investors and market analysts watch certain yield curves for signs of inversion, when yields for longer-term debt instruments fall below yields on short-term

debt with the same credit quality. Inversions are watched as potential signs of a weakening economy and in certain cases, a harbinger of recessions.

Benchmark Index

The Bloomberg U.S. Aggregate Bond Index, the Fund's benchmark index, is composed of the total U.S. investment-grade bond market. The market-weighted index includes Treasuries, agencies, CMBS, ABS, and investment-grade corporates. It is not possible to invest in an index.

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