CARILLON REAMS UNCONSTRAINED BOND FUND

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INSIGHT | COMMENTARY

FOURTH QUARTER | 2022

Investment Team

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Characteristics

Total Net Assets (billions): $1.16

Number of holdings: 147

Top Holdings

US TREASURY N/B T 0 7/8 09/30/26

US TREASURY N/B T 2 3/4 07/31/27

US TREASURY N/B T 2 3/4 08/15/32

US TREASURY N/B T 4 1/8 10/31/27

US TREASURY N/B T 1 3/4 01/31/29

AESOP 2022-5A A

AESOP 2020-2A A

HERTZ 2021-1A A

GOLDMAN SACHS GROUP INC GS 3.102 02/24/33

FORD MOTOR CREDIT CO LLC F 3.37 11/17/23

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Market Overview

Monthly inflation cools.

Monthly Consumer Price Index (CPI) data indicated that inflation may have peaked, at least in the short term. Year-over-year levels are still well above the U.S. Federal Reserve's (Fed) target of 2%, but the pace of increase, a key indicator, declined in the last two months that data was reported. Energy and other more volatile prices have helped temper inflation's pace; however, the Fed seems focused on services inflation, which has remained elevated.

Fed moderates, but no pivot to cuts.

The Fed increased interest rates a total of 125 basis points (bps) in the fourth quarter to 4.25%. Despite these hawkish moves, Fed Chairman Jerome Powell made clear in his comments late in November that the Federal Open Market Committee planned to moderate its pace of interest rate hikes, which it did (only a 50-bp increase in December after four consecutive increases of 75 bps each), but he also cautioned against a premature loosening of policy. Markets responded by pricing in a slightly higher terminal rate, while maintaining modest long-term inflation expectations.

Yield curve inversion intensifies.

With the Fed pushing up front-end rates, the yield curve inverted to a degree not seen for multiple decades (the U.S. 2/10 Curve was inverted approximately 55 bps at the end of the year). This sharper inversion during the fourth quarter punctuated the relevance of this commonly cited recession indicator. The market appears to be pricing in Fed cuts in the future to deal with the anticipated recession, but the timing of this change in policy continues to get pushed out.

Mid-term 'red wave' does not reach land.

During the November mid-term elections, the highly anticipated "red wave" did not materialize as the Democratic Party retained control of the U.S. Senate and losses in the House of Representatives were less than expected. House control did flip to Republicans, but with a very modest margin. The balanced outcome will likely lead to legislative gridlock for the next two years, which traditionally has been a positive environment for capital markets.

Dollar declines this quarter, only partially reversing yearlong increase.

The U.S. Dollar Index (DXY) declined more than 7.5% during the fourth quarter, a sharp reversal from earlier in the year. This reversal was partially a result of the Fed indicating a slower pace of interest rate hikes. The European Central Bank (ECB) made unexpectedly hawkish comments on the future path of rates, and Japan's central bank widened its yield curve control range, both of which supported the euro and the yen, respectively, relative to the U.S. dollar during the fourth quarter.

Spread sectors tighten, rates decline, and yield curve inverts further.

Most risk markets rallied during the quarter as hope increased that a moderating Fed will be able to address high inflation without causing a hard landing. High-yield (HY) and investment-grade (IG) credit performed well in the "risk on" environment. The mortgage-backed securities (MBS) sector outperformed following several difficult quarters earlier this year. Asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) both modestly underperformed. Treasury yields moved sharply higher and the curve inverted further, particularly between the one- and 10-year points due primarily to the Fed's continued rate increases as long-term inflation expectations remain modest.

Portfolio Review

The largest contributor for the Carillon Reams Unconstrained Bond Fund during the fourth quarter was exposure to HY corporate bonds, which experienced significant spread tightening. The allocation to IG corporate bonds was also a meaningful contributor due to moderately tighter spreads. Exposure to non-U.S. currencies contributed, as the U.S. dollar weakened during the fourth quarter against most major currencies. The allocation to agency MBS contributed, as the sector recovered following significant underperformance during the first three quarters of 2022. The U.S. Treasury sector contributed due to the modest decline in rates in the 3- to 5-year segment of the curve. Exposure to U.S. Treasury Inflation-Protected Securities (TIPS) also contributed, driven by slightly lower real yields. Allocations to ABS, CMBS, and government-related bonds all contributed a small amount.

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The Fund's weight in IG corporates increased slightly quarter over quarter, while exposure to HY corporates declined following the fourth quarter rally. HY exposure remained broad-based with no significant industry biases, while IG corporate holdings were skewed toward financials and industrials. The Fund's allocation to U.S. Treasurys increased slightly during the quarter and remained at a moderate level to bolster portfolio flexibility. Exposure to agency MBS was reduced to 0% by the end of the fourth quarter; however, the Fund initially increased exposure in October following weakness in the space before it harvested gains and exited its positions as the sector recovered toward the end of the year. The weights in CMBS and ABS both increased slightly, but remained at low absolute levels. The allocation to non-U.S. dollar currencies declined during the fourth quarter.

The Fund's duration was unchanged quarter over quarter and remained above the neutral range for the strategy, as real rates continued to be attractive. The Fund maintained a modest bullet structure that favored the 3- to 5-year segment of the yield curve. Relative to the prior quarter, maturity exposure shifted modestly into the 10- to 15-year and 0- to 1-year segments, with reduced exposure to the 5- to 7-year and 7- to 10-year segments.

Outlook

The Fed moderates, but indicates no pivot.

The Fed has begun moderating its interest rate increases but has needed to continually disabuse the market of the belief that a pivot to interest rate cuts is near. Despite this, markets seem to still believe that the Fed's actions will lead to a recession, thereby necessitating rate cuts, but this has not yet come to fruition. A narrowing of these divergent views is likely at some point, but significant uncertainty remains regarding timing.

Will tighter financial conditions lead to recession?

As higher interest rates impact consumers and businesses, we believe the chances that the United States avoids a recession are low but still greater than zero. The sharp increase in mortgage rates for consumers and a loss of access to the capital markets for lower quality borrowers will likely negatively impact the economy in the near term. This is classic "removing the punchbowl" behavior that Chairman Powell has made clear he does not intend to pivot away from.

No 'red wave' most likely means less fiscal flexibility.

With Republicans controlling the House following the mid-term elections, legislative gridlock is likely for the next two years. A divided government is less likely to respond quickly if the Fed is unable to avoid an economic hard landing. This implies a slower recovery from any recession that might materialize and additional pressure on the Fed to reverse course or pivot if a painful recession cannot be avoided.

China abandoning zero-COVID should boost global growth.

In December, China suddenly moved away from its multi-year, stringent restrictions put in place to combat COVID-19. While much of the world had already reopened, China's authoritarian government refused to budge – that is, until it executed an abrupt reversal aimed at reviving slumping economic growth. This change in policy brightens a somewhat dim global growth picture for 2023.

Risk Considerations: The Fund employs an unconstrained investment approach which creates considerable exposure to certain types of securities that present significant volatility in the Fund's performance, particularly over short periods of time. 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.

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.

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.

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, derivatives, and short sales 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.

Short-sale risk includes the potential loss of more money than the actual cost of the investment, and the risk that the third party to the short sale may fail to honor its contract terms, causing a loss to the fund.

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Definitions

The U.S. Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The U.S. Bureau of Labor Statistics bases the index on prices of food, clothing, shelter, fuels, transportation, doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living. Prices are collected each month in 75 urban areas across the country from about 6,000 households and 22,000 retailers.

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%.

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.

The terminal rate is the rate at which the U.S. Federal Reserve stops raising the federal funds rate in an attempt to bring down inflation. The federal funds rate, known as the fed funds rate, is the target interest rate set by the Federal Open Market Committee of the Federal Reserve. The target is the Fed's suggested rate for commercial banks to borrow and lend their excess

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reserves to each other overnight.

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.

The U.S. 2/10 Curve, known as the 2s/10s, is a bellwether indicator that measures the difference between the rates of the 10-year U.S. Treasury bond and the 2-year Treasury note. Measured in basis points, it is watched as an indicator of where the U.S. economy is in the business cycle, as the spread typically narrows as the economy moves through the cycle, reaches a low point and may go negative near the onset of a recession, then widens again during and after a recession.

The U.S. Dollar Index is a measure of the value of the U.S. dollar relative to the value of a basket of currencies from most of the U.S.'s most significant trading partners.

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

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

Yield curve control occurs when a central bank targets a longer-term interest rate and then buys or sells as many bonds as necessary to hit that targeted rate.

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.

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.

A bulleted yield exposure entails having the majority of a portfolio's bonds centered around a certain segment of the yield curve.

Benchmark Indices

The ICE BofA US 3-Month Treasury Index measures the performance of a single issue of outstanding treasury bill which matures closest to, but not beyond, three months from the rebalancing date. The issue is purchased at the beginning of the month and held for a full month; at the end of the month that issue is sold and rolled into a newly selected issue.

The ICE BofA US Dollar 3-Month Deposit Offered Rate Constant Maturity Index (formerly called the BofA Merrill Lynch 3-Month LIBOR Constant Maturity Index) is based on the assumed purchase of a synthetic instrument having 3 months to maturity and with a coupon equal to the closing quote for 3-Month LIBOR. That issue is sold the following day (priced at a yield equal to the current day closing 3-Month LIBOR rate) and is rolled into a new 3-Month instrument. The index, therefore, will always have a constant maturity equal to exactly 3 months. It is not possible to invest in an index.

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