

Investment Team

Mark Egan, CFA

Lead Portfolio Manager

Todd Thompson, CFA

Portfolio Co-Manager

Clark Holland, CFA

Portfolio Co-Manager

Jason Hoyer, CFA

Portfolio Co-Manager

Dimitri Silva, CFA

Portfolio Co-Manager

Neil Aggarwal

Portfolio Co-Manager

Characteristics

Total Net Assets
(billions): \$1.57

Number of holdings: 205

Top Holdings

FNCL 4 5/24

FNCL 5 5/24

US TREASURY N/B T 4 1/2 07/15/26

TREASURY BILL B 07/11/24

US TREASURY N/B T 4 1/8 08/15/53

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

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

US TREASURY N/B T 4 02/15/34

FNCL 5.5 5/23

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

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Market Overview

Job and inflation data diminish Fed rate cut expectations.

The quarter began with strong economic data, namely robust jobs data, better than expected Institute for Supply Management reports, and solid retail sales. These all pointed to an economy that was performing a bit better than anticipated. Those positives were offset by higher than expected inflation, which could be best described as “sticky” when downward momentum stalled during the first quarter. Still, inflation is down sharply from heights experienced over the past two years. A reacceleration of growth in the first few months of this year (bringing the attendant danger of hotter inflation) caused the market to question the U.S. Federal Reserve’s (Fed’s) ability to deliver all of the expected cuts.

Fed dots or wishful thinking?

The Fed entered its March meeting seeking reasons to be confident that inflation is headed to 2%. Despite inflation data that surprised modestly higher in the earliest months of the year, Federal Open Market Committee members produced a dot plot that projected three Fed rate cuts by the end of this year. Perhaps it was some wishful thinking, because gross domestic product (GDP) expectations were increased and unemployment was projected to remain at 4% at year-end, essentially unchanged. Combining these data points, we have a Fed that surprisingly still anticipates three rate cuts while economic growth is expected to be healthy and unemployment will not increase. This sounds more like what the Fed hopes will happen than what is likely to happen.

Weaker growth in Europe points toward central bank cuts.

Contrary to the healthier than expected U.S. economy, Europe saw no GDP growth and the United Kingdom experienced a modest decline in the fourth quarter of 2023, according to the most recent data released during the first quarter. Regardless, the European Central Bank and the Bank of England expressed hesitation to cut rates too soon as inflation remains above target levels. An argument for cuts is easier to make in Europe, which experienced arguably less sticky inflation and weaker economic growth relative to the United States.

China experiences deflation.

While most of the rest of the world has spent the last year tamping down remaining excess inflation, China experienced some deflation. An ailing property sector and slumping sentiment has left China’s central bankers needing to stimulate a sluggish economy and turn the tide of sour consumer sentiment. A more modest 5% growth objective was recently proposed by party leaders, yet even that may prove difficult to achieve based on the country’s structural challenges to economic growth.

Most spread sectors outperform, and the yield curve stays inverted.

First-quarter excess returns were mostly positive across sectors. High yield (HY) led the way, and within investment grade (IG) corporate, financials outperformed industrials. Excess returns were a little more mixed in securitized products (asset-backed, mortgage-backed, and commercial mortgage-backed securities). Mortgage-backed securities (MBS) underperformed when rates moved higher during the quarter, commercial mortgage-backed securities (CMBS) shook off broad sector concerns, and asset-backed securities (ABS) also performed well. Rates rose across the U.S. Treasury curve, with two- and three-year rates rising the most. The intermediate and long parts of the curve were impacted by stickier than expected inflation modestly challenging the Fed’s plans for rate cuts. The front end of the yield curve held steady as Fed moves were delayed. The curve remains inverted out to the five-year point. It should be noted that the last vestiges of negative yields, which peaked at \$18 trillion in securities globally, finally disappeared when Japan’s rates ticked slightly positive during the first quarter.

Portfolio Review

The Fund’s above-benchmark duration stance detracted from relative performance: U.S. Treasury yields rose and the curve remained inverted after a reduction in expectations for rate cuts. Economic growth and inflation data have remained stubbornly strong. Yield curve positioning had no impact with rates moving nearly uniformly higher across the curve during the quarter.

Sector allocation contributed to performance, primarily due to non-index exposures to HY corporates, which experienced further spread compression, and an overweight to the outperforming ABS sector. The non-index allocation to U.S. Treasury Inflation-Protected Securities (TIPS) contributed due to inflation breakevens reversing course and rising steadily



beginning in February. An underweight to IG corporates detracted; spreads continued to tighten despite record first-quarter issuance. The overweight to MBS detracted slightly from performance because the rise in rates negatively impacted the sector. Security selection was positive across nearly every sector. A bias toward higher-coupon agency MBS was positive: higher-coupon outperformed lower-coupon agency MBS. The bias toward financials within IG corporates contributed as did selection within high-quality ABS. Security selection was a slight detractor within HY corporates.

The allocation to IG corporates increased marginally during the first quarter while maintaining a slight underweight relative to the index. Within IG corporate holdings, the overweight to financials was reduced and the overweight to utilities was increased. Exposure to HY corporates was reduced to zero, since valuations became less attractive following recent outperformance. The allocation to agency MBS declined moderately, with exposure to agency residential mortgage-backed securities (RMBS) contracting more than non-agency RMBS. The mortgage sector continued to represent a meaningful overweight versus the index. ABS exposure was meaningfully increased during the quarter; it now represents the second largest overweight in the portfolio. The weight in CMBS maintained its slight overweight. Exposure to non-U.S. dollar currencies remained the same, at a low absolute level. The allocation to U.S. Treasuries declined and remained significantly underweight relative to the index.

Portfolio duration increased as rates across the yield curve moved higher. Duration remained moderately above that of the index, reflecting real rates that are attractive on a long-term basis. Yield curve exposure at the end of the quarter featured overweights to the 5- to 7-year and 20- to 30-year duration segments. This was offset by underweights to the 7- to 10-year and 10- to 20-year duration segments.

Outlook

Risk markets appear vulnerable.

Risk markets continued to rally in the first quarter with strong gains in commodities and equities and the tightening of corporate spreads. While economic growth has been quite resilient in the face of tighter financial conditions, the expectations placed on the Fed to begin cutting rates have been at least as persistent. Although the Fed

has communicated that it is increasingly comfortable with the idea of reducing rates, sticky inflation reports indicate that this optimism may be misplaced. If the Fed fails to deliver cuts, the market rally may quickly run out of steam, and it could reverse.

Domestic political risk is likely to build.

A sharply divided Congress found a way to avoid a threatened government shutdown, at least until Oct. 1. The timing of this agreement's expiration adds political risk to what is shaping up to be a volatile presidential election. As the 2024 election season comes into sharper focus, market unease over the possibility of an especially uncertain political outcome could put upward pressure on volatility.

Europe may lead in rate-cutting cycle.

Inflation in developed markets has continued to slow, but it is not yet at a level that would allow central bankers to let down their guard. Economic weakness is more acute in Europe, which barely avoided recession by posting 0.0% growth in the fourth quarter of 2023, versus 3.4% growth in the United States over the same period. The Fed seems willing to cut rates, but its peers across the pond may have an easier time justifying such actions. A weak euro relative to the dollar may be indicating that markets recognize that Europe may need more rate cuts than the United States.

Geopolitical climate is unlikely to improve.

Despite scant prospects for a military breakthrough in Ukraine, neither side appears motivated to negotiate a settlement. Ukraine is unwilling to cede territory to an aggressor nation, and Russia has spent significant resources making a costly investment with little strategic return. In the Middle East, Israel has resisted calls for a cease-fire, instead pressing further into Gaza in hopes of eliminating Hamas. Spillover impacts, such as attacks on shipping in the Red Sea, are likely to continue until the conflict in Gaza abates.

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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Definitions

An agency bond is a security issued by a government-sponsored enterprise or by a federal government department other than the U.S. Treasury. Some agency bonds are not fully guaranteed in the same way that U.S. Treasury and municipal bonds are.

Breakeven inflation rates reflect what market participants expect inflation to be over a specified period of time, on average. For example, the 10-year breakeven inflation rate reflects what market participants expect inflation to be in the next 10 years, on average. It is calculated using 10-Year U.S. Treasury Constant Maturity Securities and 10-Year Treasury Inflation-Indexed Constant Maturity Securities. The five-year breakeven inflation rate is derived from 5-Year Treasury Constant Maturity Securities and 5-Year Treasury Inflation-Indexed Constant Maturity Securities.

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.

The dot plot of the U.S. Federal Reserve is a chart summarizing the Federal Open Market Committee's (FOMC) outlook for the federal funds rate. Each dot represents the interest rate forecasted by one of the 12 members of the committee.

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.

The Federal Open Market Committee (FOMC) consists of 12 members: the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. The FOMC holds eight regularly scheduled meetings per year at which it reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.

The Group of 10, also known as the G10, consists of 11 industrialized nations that meet at least annually to work together on matters of international finance. The member nations are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States, with Switzerland playing a minor role.

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

The Institute for Supply Management produces several surveys assessing business conditions and outlooks across a variety of industries. They include the ISM Purchasing Managers' Index (PMI), which measures the prevailing direction of economic trends in the manufacturing sector, and the Services ISM® Report on Business®, which is based on data compiled from purchasing and supply executives and reflects the change, if any, in the current month compared to the previous month in supplier deliveries along with seasonally adjusted business activity, new orders, and employment.

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

A neutral range is one in which a financial metric for a security or portfolio stays within a tight range of that metric's values for a reference security or benchmark.

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.

Relative performance (RP) is a measure of a security's performance compared to a specified benchmark such as a stock index, sector or other group of similar securities.

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

Sticky is a term used to describe measured data that is slow to change, in contrast to faster-changing or more variable data.

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.

Tailwind is a term used to describe events or market forces that exert a positive influence on an investment's performance.

Total return, when measuring performance, is the actual rate of return of an investment or a pool of investments over a given period of time. Total return includes interest, capital gains, dividends, and distributions realized over the specified period. Total return accounts for two categories of return: income including interest paid by fixed-income investments, distributions, or dividends and capital appreciation, representing the change in the market price of an asset.

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.

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.

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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