CARILLON REAMS CORE PLUS BOND FUND

CARILLON FAMILY OF FUNDS

INSIGHT | COMMENTARY

THIRD QUARTER | 2021

Investment Team

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Characteristics

Total Net Assets (billions): $1.27

Number of holdings: 151

Top Holdings

US TREASURY N/B T 0 3/4 03/31/26

US TREASURY N/B T 0 3/8 03/31/22

US TREASURY N/B T 1 1/4 10/31/21

NOTA DO TESOURO NACIONAL BNTNF 10 01/01/23

US TREASURY N/B T 1 3/4 08/15/41

US TREASURY N/B T 1 5/8 05/15/31

FORD MOTOR CREDIT F 3.37 11/17/23

FN MA4126

US TREASURY N/B T 1 1/8 02/15/31

WELLS FARGO 4.478 04/04/31

Market Overview

The Chinese government's recent emphasis on "common prosperity," a strategic shift back towards socialism from a more market-based growth initiative, accelerated during the third quarter. Increasingly, statements and actions suggest that the country's leaders view capitalism as a necessary but temporary evil that will allow the country to achieve its long-term socialist goals. Chairman Xi Jinping acknowledged this shift, almost explicitly, by lowering growth expectations and pointing to the excesses that capitalism has created within China. Cracking down on highly successful technology firms and their billionaire founders not only increases the state's control – a blunt reminder of who really calls the shots – but also siphons wealth from the richest citizens to fund social programs. A Chinese economy that will potentially grow at a slower rate has major implications for global growth and a major shift such as this cannot happen without a few unforeseen problems cropping up along the way. A significant one recently appeared when China's second largest property developer, Evergrande, missed interest payments and moved toward default late in the quarter. Although Chinese authorities are intent on reining in excessive private sector debt, an uncontrolled collapse of a firm this size, which is involved in multiple different parts of the economy, also created headaches along several dimensions and may yet metastasize into a much larger problem for global markets.

Within the U.S., the third quarter also closed with significant uncertainty surrounding four legislative initiatives. The (somewhat) bipartisan infrastructure bill, the much larger reconciliation bill favored by the progressive wing of the Democratic Party, normal government funding, and raising the debt ceiling all competed for legislators' attention as they returned from their summer recess. Thankfully, not every single piece of this legislative logjam needs to be solved immediately, as the Treasury has enough flexibility to address the debt ceiling for a few weeks. Congress was also able to pass a temporary funding bill in the final days of the quarter that will prevent a full-blown government shutdown, until December at least. The two infrastructure bills have been held up largely by disagreements within the Democratic Party, highlighting the challenges of driving a bold agenda with a narrow majority in both chambers of Congress. If these two bills falter, it could have severe consequences for President Biden's economic agenda and give the Democrats a black eye heading into the 2022 midterm elections.

The rapid spread of the COVID-19 delta variant pushed case counts back to peak levels and once again strained areas of the healthcare system during the third quarter. Certain portions of the economy were more heavily impacted, such as travel and leisure, but the lack of widespread lockdowns led to a more moderate impact on gross domestic product (GDP), and other economic indicators remained generally strong throughout the third quarter. The most recent wave of cases appeared to peak in early September, setting up a potential tailwind as activity in the hardest-hit sectors picks back up heading into the fourth quarter.

U.S. Federal Reserve (Fed) Chairman Jerome Powell tacitly admitted that inflation has not been as transitory as the Fed had initially hoped when he called it "frustrating" and noted that elevated inflation may continue into next year. Certainly COVID-related bottlenecks and other supply chain issues have placed upward pressure on prices in certain segments, and many of these will ultimately prove temporary, but rising wages and housing costs will likely keep the heat on for a longer period. Regulatory crackdowns on energy are now leading to shortages, particularly in Europe, which is causing some alarm in anticipation of a cold winter. The run up in energy costs and related commodities during the third quarter will not help the inflation picture in the short term, even though these prices are not included in "core" consumer prices indices.

Valuations in most risk markets pulled back slightly during the third quarter from very elevated levels. Credit spreads widened, breaking from the year-to-date trend. High yield (HY) corporate option-adjusted spreads (OAS) widened +21 basis points (bps), investment grade (IG) corporates +4 bps, commercial mortgage-backed securities (CMBS) +2 bps, and asset-backed securities (ABS) +7 bps. Agency mortgage-backed security (MBS) spreads were unchanged. U.S. Treasury rates did not move much quarter over quarter, although this masked intra-quarter volatility with a large decline in rates during July followed by a reversal in August and September. For the third quarter, the 2-year, 5-year, and 10-year Treasury yields rose +3 bps, +8 bps, and +2 bps, respectively, while the 30-year rate declined -4 bps. (Source: Bloomberg)

Portfolio Review

Macro factors detracted due to yield curve positioning, primarily an underweight to the outperforming long end of the curve, while duration positioning had a minimal impact. U.S. Treasury rates rose modestly during the third quarter with the exception of the 20-30 year segment, where yields declined by a small amount. Sector allocation detracted, primarily driven by exposure to non-U.S. dollar holdings, which underperformed due to a stronger U.S. dollar during the third quarter. Security selection contributed, primarily within the IG corporates sector due to holdings that favored short-maturity and lower-beta credits, which outperformed. All other sectors had a minimal impact on performance.

The Fund's weight in IG corporates remained elevated during the third quarter and increased quarter over quarter. We viewed select IG corporate bonds as offering moderately attractive spreads relative to U.S. Treasurys on a risk-adjusted basis, but exposure was focused on short-maturity and lower-beta credits in order to lower the Fund's overall sensitivity to credit spreads. The Fund's exposure to HY corporates was unchanged and remained at a low absolute level, as we viewed the sector as broadly unattractive at current spread levels. Non-U.S. dollar exposure increased during the third quarter, but remained modest on an absolute basis.

The Fund's allocation to U.S. Treasurys increased during the third quarter but remained underweight relative to the index. The Fund's agency MBS exposure decreased by a small amount quarter over quarter and remained at a low absolute level, as we viewed agency MBS spreads as offering little relative value. CMBS exposure was also down by a small amount, but still represented an overweight versus the index at quarter's end. CMBS holdings remained concentrated in well-structured senior securities due to their stable cash flow characteristics. The Fund's ABS weight was unchanged and remained moderate on an absolute basis, with holdings focused on high-quality auto loan collateral.

The Funds' duration declined during the third quarter and was significantly below that of the index at quarter end. This below-index duration stance reflected a view that real interest rates were unattractive and long-term rate risk was skewed to the upside. The Fund remained underweight the 10+ year maturity segment of the yield curve, along with the 1-3 year and 5-7 year segments, balanced by overweights to the 0-1 year, 3-5 year, and 7-10 year segments.

Outlook

Chairman Powell indicated that the criteria for beginning to taper asset purchases have been "all but met." He even offered, for the first time, a timeline that would see tapering begin by year end and finish by mid-2022. The Fed has consistently communicated that the decision and timing of tapering is distinct from increases in the Fed funds policy rate. Recent Treasury rate moves indicate that the market did not necessarily believe this subtle delineation and focused instead on changes in the Fed's "dot plot," which continues to pull forward the expected timing of the first rate increase.

Democratic leaders are in a difficult spot as they try to hold together their thin Congressional majority while factions within the party press somewhat opposing views on how to shape infrastructure legislation. A significant amount of "horse trading" will be necessary, and the final reconciliation bill will likely shrink from its initial $3.5 trillion estimate. Permanent government funding and raising the debt ceiling will likely pass without lengthy government shutdowns, if any, but these issues further complicate the agenda for Democratic leadership in Congress and the Biden administration.

Shortages in lumber moderated and prices have declined sharply, but supply issues remained in semiconductors, aluminum, and various other commodities. Localized bottlenecks should slowly be resolved in these commodity markets and lead to price moderation over time. Wage pressures, however, are less likely to abate, even when factoring in the expiration of enhanced unemployment benefits. There are currently more job openings than unemployed people in the labor force, and this labor shortage sets the stage for sustained wage increases.

Valuations remain elevated, supported by a still-accommodative Fed, but cracks may be forming as tapering and interest rate increases are not as far in the distance as they once were. The Fed has also recently ceded some ground on the issue of inflation being "transitory" as upward price pressures have persisted longer than initially expected. Nominal Treasury yields increased late in the third quarter, but with inflation persistently high this still leaves real interest rates significantly negative, which stands in stark contrast with economic conditions that remain robust. The tailwinds for above-trend growth continue to be strong, but valuations in all spread sectors fully reflect this optimism.

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.

Basis points (bps) are units of measure for interest rates, equity indices, and yields of fixed-income securities. One basis point equals 1/100th of 1%.

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. The higher the duration, the more risk and price volatility the bond carries.

Benchmark Index

The Bloomberg U.S. Aggregate Bond 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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