The Uncertainty of Uncertainty | May 2025

'There are known knowns…there are known unknowns…
But there are also unknown unknowns – the ones we don't know we don't know.'
Donald Rumsfeld

There is uncertainty, and there is uncertainty. As while the future is always unpredictable, a distinction can be made between the uncertainties we encounter.

Sometimes, we know the potential outcomes and can assign probabilities, such as flipping a coin or rolling the dice. The possible results are finite, known, and can be quantified (i.e., known unknowns).

Then there is the more ambiguous realm of 'unknown unknowns', where the possible outcomes are, well, unknown. A roll of the dice where the number of sides and quantities on each die are random. It is what economists Sir John Kay and Lord Mervyn King call 'radical uncertainty'.

The natural question for investors is, which bucket do the financial markets fall into?

Some believe we can create accurate probabilistic models of the markets and quantify risk. Others warn to 'beware of geeks bearing formulas' and subscribe to the random walk theory.

Sir Kay and Baron King of Lothbury fall into the latter group and are critical of the financial industry's assumption that markets can be modelled as distributions over known outcomes. They argue that this gives investors a false sense of precision and control.

Instead, they propose a more narrative, storytelling approach to making sense of the present and using judgment and experience to assess plausibility, not probability.

Following their logic, it would be naïve to assign precise odds for a recession. However, one could say that the possibility is lower than if 'liberation day' tariffs were implemented but higher than before the trade wars were initiated.

Similarly, it feels safe to say that there is a greater level of unpredictability and uncertainty in today's markets than pre-Trump. The disruptive nature of the current administration has increased the range of potential outcomes and the unknown unknowns.

After all, no one foresaw the magnitude of 'liberation day' tariffs nor that of the capitulation (TACO). And now we have the unpredictability of tariff negotiations, court rulings, and whatever new policies and policy shifts the administration may unveil.

Even the staunchest believers in probabilistic markets would have to concede that the current environment leans more toward radical uncertainty or even radically radical uncertainty.

The challenge for investors is navigating the sea of confusion and unpredictability. Kay and King's strategy is to emphasize robustness over optimization. Rather than positioning for a particular outcome, ensure portfolios are robust for many potentialities and be prepared to adapt. They also prescribe a healthy amount of intellectual humility, not pretending to predict the future precisely but instead navigating it wisely.

The Month of May.

Credit.

The agreement between the US and China to temporarily lower tariffs and the US/UK trade deal fuelled optimism around tariff negotiations and a de-escalation of trade wars. The optimism spilled over to credit markets, with spreads tightening to finish close to where we started the year. In the domestic market, autos and energy infrastructure outperformed on tariff relief and the rebound in oil.

May saw issuers come out of hiding after a dearth of supply through March and April. The Canadian market saw $14.9 bn of new deals, the highest monthly total this year. Notable issuers included Sleep Country, an inaugural Avenue Living bond, Manulife Bank, and Brookfield Infrastructure Partners (Hybrid). The autos also tapped the market with deals from Toyota, Hyundai, and Honda, while Metlife and Citibank issued maples. Also, with banks now out of the blackout period, we saw deals from National, BMO, and TD.

Investment grade credit spreads:

- Canadian spreads tightened -14 bps to 100 bps.
- US spreads tightened -18 bps to 88 bps.

Interest Rates.

Bond investors continued to pare back their expectations for rate cuts this year. In the aftermath of liberation day, these expectations peaked at four from the Fed and two from the BoC. By the end of May, the US market shifted to pricing two cuts, while the Canadian market was split between one and two more, with another 1.5 priced to year-end.

Longer-dated rates came under pressure, with the US 30-year yield crossing the psychological threshold of 5%. The move was driven by concerns about growing deficits ('the big beautiful bill') and an increase in global interest rates, which make Treasuries less attractive on a relative value basis.

- Canadian 2y finished at 2.59% (+11 bps) and the 10y at 3.20% (+11 bps)
- US 2y finished at 3.90% (+29 bps) and the 10y at 4.40% (+24 bps)

The Funds.

Algonquin Debt Strategies Fund.

With market technicals supportive of credit, we modestly increased our exposures. However, we continued to manage the Fund within a defensive risk posture. We were selective in our participation in the new issue market, with a preference for deals priced with concessions and bonds from smaller, less frequent issuers, which may be insulated from widening relative to the bellwether issuers (i.e., Big Six banks). Overall, the rally in credit and profits from tactical trading led to a strong monthly return of 0.99%.

Portfolio Metrics:

- 4-6% yield
- Average credit rating: BBB+
- Average maturity: 2.4y
- IR Duration: 0.9y

	1M	3M	6M	YTD	1Y	3Y	5Y	10y	SI
X Class	1.08%	0.81%	1.77%	1.15%	7.75%	9.29%	8.05%	7.62%	8.24%
F Class	0.99%	0.64%	1.42%	0.88%	6.73%	8.31%	7.17%	NA	NA

* As of May 30th, 2025

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Returns are shown on 'Series 1 X Founder's Class' since inception and for 'Series 1 F Class' since May 1st, 2016, and are based on NAVs in Canadian dollars as calculated by SGGG Fund Services Inc. net of all fees and expenses. For periods greater than one year, returns are annualized.

Algonquin Fixed Income 2.0

The Fund's credit and interest rate exposures were actively managed at the lower end of our typical range. As credit spreads tightened, we further reduced our credit exposure with an emphasis on quality. We are also opportunistically adding rate exposure (on sell-offs) as a hedge if the data starts to paint a picture of underlying economic weakness. Regarding performance, the reduced duration exposure meant that losses from the rise in rates were more than offset by profits from credit and the yield earned, with the Fund generating a return of 0.55%.

Portfolio Metrics:

- 4-5% yield
- Average credit rating: BBB+
- Average maturity: 2.9y
- IR Duration: 3.3y

	1M	3M	6M	YTD	1Y	2y	3y	5y	SI
F Class	0.55%	0.72%	2.49%	1.86%	9.64%	8.91%	7.60%	5.90%	5.00%

* As of May 30th, 2025

Algonquin Fixed Income 2.0 Fund is an Alternative Mutual Fund and was launched on December 9, 2019. Returns are shown for Class F since inception and are based on NAVs in Canadian dollars as calculated by SGGG Fund Services Inc., net of all fees and expenses. Investors should read the Simplified Prospectus, Annual Information Form, and Fund Facts Documents and consult their registered investment dealer before making an investment decision. Commissions, trailing commissions, management fees, and operating expenses all may be associated with mutual fund investments. An Alternative Mutual Fund is not guaranteed, its value changes frequently and its past performance is not indicative of future performance and may not be repeated. Payment of quarterly distributions is not guaranteed and paid at the discretion of the manager; therefore, it may vary from period to period and does not infer fund performance or rate of return.

Looking Ahead.

It seems the market's response to the uncertainty is to assume the best (and prepare for the best). In the game of trade negotiation chicken, investors are betting that Trump continues to 'chicken out'. Stocks are at all-time highs, and credit spreads are trading at the tighter end of their historical ranges.

Our response to the uncertainty is to ensure our portfolios are robust and flexible. In practice, this means the funds are concentrated in higher-quality, liquid issuers. The high degree of liquidity in the portfolios enables us to either reduce or increase risk based on how the macroeconomic story unfolds.

As for valuations, we find it difficult to share the market's level of optimism and continue to manage the portfolios from a more defensive risk posture. For context, our credit exposures are 50% lower than last year. This positions us to deploy capital into weakness and capitalize on market dislocations while also leaving sufficient room for short-term, tactical opportunities.

On the rates front, now that markets have dialled back their expectations for rate cuts, we see some hedge value from shorter date yields (i.e. 2-5y). If the economic data show signs of a slowdown, bond traders could start pricing in a more aggressive cutting cycle from the Fed and BoC.

With inflation still firm and deficits set to grow, we remain cautious around long-end yields (10y+). Too many factors are at play to determine the premium investors will require to extend duration. Accordingly, our preference has been to stay out of the way.

Contact

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