The Science of Not Knowing | June 2025

‘If you want a guarantee, buy a toaster.’
Clint Eastwood

Last month, we noted that while the future is always unpredictable, Trump’s erratic policies and policy shifts have increased the level of uncertainty. The President encapsulated the situation a day before bombing Iran by telling reporters, ‘nobody knows what I’m going to do.’ And as for clarity on trade deals, the nonchalant response has been ‘different amounts of money, different amounts of tariffs.’

Some argue that the US administration is strategically weaponizing uncertainty as a negotiating and foreign policy tactic. Whether intentional or not, radical uncertainty is the reality we face. And as investors, it is helpful to understand how this impacts our investment decisions.

Physiologically, uncertainty triggers our stress response, with our bodies producing greater amounts of cortisol, glucose, and free fatty acids. Essentially, the body prepares itself for action and prioritizes short-term functions over long-term ones, such as digestion and reproduction.

The trader-turned-neuroscientist John Coates and his team studied these stress responses in bond traders. They discovered that short bouts of volatility increased levels of dopamine and testosterone, encouraging risk-taking to capitalize on the potential opportunities from market swings.

But if the volatility persisted for several days, the excitement morphed into anxiety and stress. They found that the cortisol levels of the traders tracked market volatility almost tick for tick, regardless of whether they were making or losing money.

In a follow-up study, they observed that risk preferences changed dramatically after just eight days of increased cortisol levels. The participants become significantly more risk-averse, requiring a 44% greater risk premium to act.

Intuitively, this makes sense. If you do not know what is around the corner, you will be more anxious and fearful of taking risks.

But on the other side of the spectrum from fear is another, rarer response to uncertainty: hope. After all, if the outcomes are unknown, there is the potential for them to be positive.

With stocks hitting all-time highs and credit spreads flirting with historical tights, it seems the market’s response to uncertainty is one of hope. Hope that trade negotiations go well, that geopolitical risks remain contained, that deficits do not become a problem, and that rate cuts will stimulate the economy.

These are all plausible outcomes, and betting against the US economy can be perilous. But we believe the combination of high uncertainty and low risk premiums warrants a degree of caution.

What remains to be seen is how consumers and businesses respond to the uncertainty. Anecdotal evidence and sentiment surveys suggest a decreased willingness to spend, invest, and expand. Whether or not this materially impacts behaviour (i.e., if saying becomes doing), only time and hard data will tell. Thus, for now, in addition to caution, our other response to not knowing is a healthy dose of patience.

The Month of June.

Credit.

Even the whopping $20.3 bn of new domestic supply in June (and the US bombing Iran) could not stop the rally in credit markets. Following the 'liberation day' sell-off, which saw investment grade spreads generically 20-30 bps wider, credit has ridden the one-way train of the broader market rally with spreads grinding tighter. In addition to the positive momentum in risk assets, credit has benefited from robust investor demand.

Investment grade credit spreads:

- Canadian spreads tightened -3 bps to 97 bps.
- US spreads tightened -5 bps to 83 bps.

Interest Rates.

The volatility in rate markets is subsiding as investors generally agree on future central bank moves.

Canadian bond traders are content to keep the bond market pricing one or two cuts this year, before the Bank of Canada moves to the sidelines. This means the only excitement left is speculating on which meeting the cut will occur.

With rates still in restrictive territory, the Federal Reserve could easily deliver 75bps-125bps of cuts over the next 18 months. As such, yields south of the border are a little more volatile. However, the market seems to revert to around 100 bps of cuts after a move to one of the extremes.

- Canadian 2y finished at 2.59% (unchanged) and the 10y at 3.27% (+7 bps)
- US 2y finished at 3.72% (-18 bps) and the 10y at 4.23% (-17 bps)

The Funds.

Algonquin Debt Strategies Fund.

With credit spreads trading at the tighter end of the range, we continue to maintain a conservative risk posture. Our focus is on generating yield through high-quality, liquid securities and seeking performance through tactical positioning and idiosyncratic opportunities. In June, with Canadian credit tightening by only 3 bps, the majority of the return came from the yield earned, active trading, and credit positioning.

Portfolio Metrics:

- 4-6% yield
- Average credit rating: BBB+
- Average maturity: 2.7y
- IR Duration: 0.8y

	1M	3M	6M	YTD	1Y	3Y	5Y	10y	SI
X Class	0.53%	1.42%	1.69%	1.69%	7.79%	9.44%	7.23%	7.65%	8.23%
F Class	0.46%	1.21%	1.35%	1.35%	6.77%	8.45%	6.35%	NA	NA

* As of June 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 exposure remained at the lower end of our range, while the interest rate duration was actively managed between 3 and 4y. With modest moves in Canadian rates and credit, the bulk of the return came from carry, idiosyncratic credits, and trading.

Portfolio Metrics:

- 4-5% yield
- Average credit rating: A-
- Average maturity: 3.1y
- IR Duration: 3.4y

	1M	3M	6M	YTD	1Y	2y	3y	5y	SI
F Class	0.62%	1.29%	2.49%	2.49%	9.27%	9.25%	8.32%	5.30%	5.04%

* As of June 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.

The summer months are generally favourable for credit spreads, as issuance wanes and investors are left to sift through dealer inventories when putting cash to work. Given the experience of the last three months, it will take a significant shock to push spreads wider, so we lean to spreads narrowing slightly before supply picks up in September. In the coming weeks, our focus will be on individual credit stories that offer some reasonable upside.

Interest rates have been range-bound for several months. We generally agree with the consensus view on rate cuts, although we think that the probability of two cuts from the Bank of Canada is higher than most people expect. That said, we have adopted an unemotional strategy of reducing duration when yields approach the bottom end of the range, and increasing exposure when yields rise.

While uncertainty appears to be the White House's strategy, it does not seem to be having a significant impact on the US economy, as inflation is grinding lower while growth remains stable. There is a possibility that this changes over time. Accordingly, we have decided to be patient and allow some time to pass to assess the impact of the various initiatives on the US economy. As such, we continue to maintain a defensive posture and focus on generating excess returns through tactical trading and unique opportunities at the issuer and security levels.

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