Q. Evidence of Ms. McShane Page 6

(a) For the decline in long Canada bond yields please provide evidentiary support for the notion that equities are not "locked in" similar to long bonds. In particular is it Ms. McShane's view that equities performed well during the 1970s when inflation reached into double figures in Canada? If so please provide evidentiary support.

(b) In terms of the supply impact on Long Canada yields, please define what she understands by the break-even inflation rate (BEIR) and confirm that the yield on the nominal bond is depressed for whatever reason the BEIR is a biased low estimate of future inflation? If she can not so confirm please explain why not?

(c) If in b) above Ms. McShane feels that the yield on the real return bond is similarly depressed, please provide all evidentiary basis for the conclusion that the supply impact is equally felt in these two areas of the bond market.

(d) Please provide all evidentiary support that the current BEIR is a biased low estimate of future inflation.

A. (a) The conceptual basis for the conclusion that equities are not locked in similar to bonds recognizes that equities have a greater ability than bonds to maintain purchasing power during a period of inflation. With higher expected inflation, investors would expect both higher input and output prices of the underlying companies' products and services, so that the present value of the expected cash flows are unaffected by the rate of inflation. That is not to say that equities have been a good hedge against inflation over the short-term in inflationary periods, particularly when there are inflationary shocks to the system as there were in the 1970s with the rise in oil prices and the compounding effect of monetary policy, when companies were not able to raise prices to offset rising input costs. In his book, *Stocks for the Long Run*, 4th Edition, 2007, page 205, Dr. Jeremy Siegel concluded that "The message of this chapter is that stocks are not good hedges against increased inflation in the short run. However, no financial asset is. In the long run, stocks are extremely good hedges against inflation, while bonds are not. Stocks are also the best financial asset if you fear rapid inflation since many countries with high inflation can still have quite viable, if not booming, stock markets. Fixed-income assets, on the other hand, cannot protect investors from excessive government issuance of money."

Looking specifically at Canadian market returns, for the post-World War II years in which inflation was in excess of 7%, stocks on average had a positive real return of approximately 1.5%, but the real return on long-term Canada bonds for those same years averaged close to -4.5%.

(b) Ms. McShane understands the break even rate of inflation to be the differential between the yield on conventional or nominal government securities and the yield on similar term inflation-indexed government securities.

(c) Not necessarily. The yield may reasonably reflect long-term inflation expectations, while the real return component is lower than its long-term equilibrium value. Currently, the difference between the yield on nominal long-term Government of Canada bonds and real return bonds (3.85% versus 1.85%) is approximately equal to the most recent (April 2009) consensus forecast of inflation from 2009 to 2019 of approximately 2.0%.

(d) While the supply impacts on the yields of conventional and inflation-indexed bonds may not be identical, the supply of long-term inflation indexed bonds is relatively small compared to the total supply of long-term Government of Canada bonds. Inflation-indexed bonds are an important component of pension funds' asset mix; the long-term target for the Ontario Municipal Employees Retirement System is 5%. The Ontario Teachers' Pension Plan has reduced its exposure to equities and increased its exposure to inflation-sensitive assets including real return bonds. Over the long-term it is reasonable to expect the yield on inflation-indexed bonds to approximately equate to the long-term real growth in the economy. The current yield on the long-term inflation-indexed bond of 1.85% is relatively low compared to the long-term forecast real GDP growth rate of 2.5%, suggesting that the inflation-indexed bond yield is abnormally low.