

1 **Q. Evidence of Ms. McShane, Equity risk premium tests, Pages 44-56: Please confirm**  
2 **that an increase in inflationary expectations causes bond yields to increase and all**  
3 **else constant equity prices as well as bond prices to fall? If not please explain why**  
4 **not?**

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6 A. Confirmed that, all else constant, if the cost of equity rises when inflation rises, equity  
7 prices will fall, and a negative relationship will be observed. Similarly, as bond yields  
8 increase, bond prices fall. "All else constant" is consistent with the documented negative  
9 effect on real economic activity and corporate profitability of high rates of inflation. For  
10 example, Fama, Eugene F., "Stock Returns, Real Activity, Inflation, and Money", The  
11 American Economic Review, September, vol. 71(4), 1981 documents the negative  
12 relationship between high rates of inflation and future real economic growth rates.  
13 Sharpe, Steven A., "Stock Prices, Expected Returns, and Inflation", Finance and  
14 Economics Discussion Series 1999-02, 1999, argued that expectations of real earnings  
15 growth are negatively related to expected inflation due to declines in productivity which,  
16 in turn, impact corporate profitability. A recent study on U.S. markets also showed that  
17 historically, inflation has not been good for real equity returns. The study found that,  
18 over a 200 year period, equities performed best during periods of deflation, returned an  
19 average real return of 8% when inflation was in the range of 0-5% over the entire period  
20 and 10% since 1971, and that while equities have more than kept pace with inflation over  
21 the long-term, "the asset class generally does not do well in high inflation years." (Mullin,  
22 John J. and Leila Heckman, *Outlook for U.S. Inflation: Lessons from Two Centuries of*  
23 *Financial History*, Mesirow Financial International Equity, September 2009.) These  
24 studies which document a negative relationship between real equity returns and inflation,  
25 are supportive of Ms. McShane's analysis at lines 1282 to 1318 of her testimony, where  
26 she documented the negative relationship between inflation and real returns in Canada.