

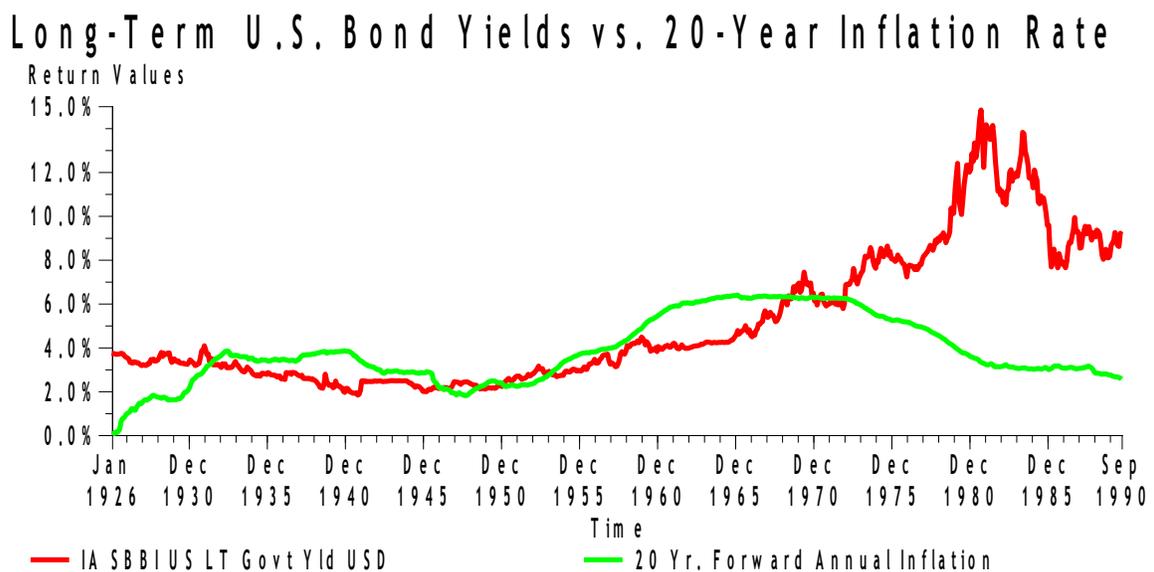


The Myopic Bond Market

It is axiomatic that investors in government bonds expect to earn a return in excess of inflation. Why invest in a bond if it does not increase the purchasing power of one's capital? Hence, the current yield to maturity of a bond includes an expected real return element and a component for expected inflationⁱ. Since 1926, long-term U.S. government bonds have had an annualized return of 5.6% comprised of a real return of 2.6% and an inflation component of 3.0%.

As yields plunge ever lower, the bond market appears to be anticipating a protracted period of low inflation. Fears of outright deflation have escalated as the economic recovery slows swelling the burgeoning legion of bond purchasers and further depressing yields. In turn, lower yields reinforce the notion that future inflation rates will themselves be lower. This self-reinforcing cycle, however, begs the question - how successful has the bond market been in forecasting future inflation rates?

The answer is "not very". As illustrated in the following graph, long-term government yields (in red) have almost consistently misestimated the subsequent long-term inflation rate (in green). During the late 1920's and the mid-1970's to 1990, the bond market chronically overestimated future inflation. This is evidenced by the fact that long-term bond yields were substantially in excess of the following 20-year inflation.

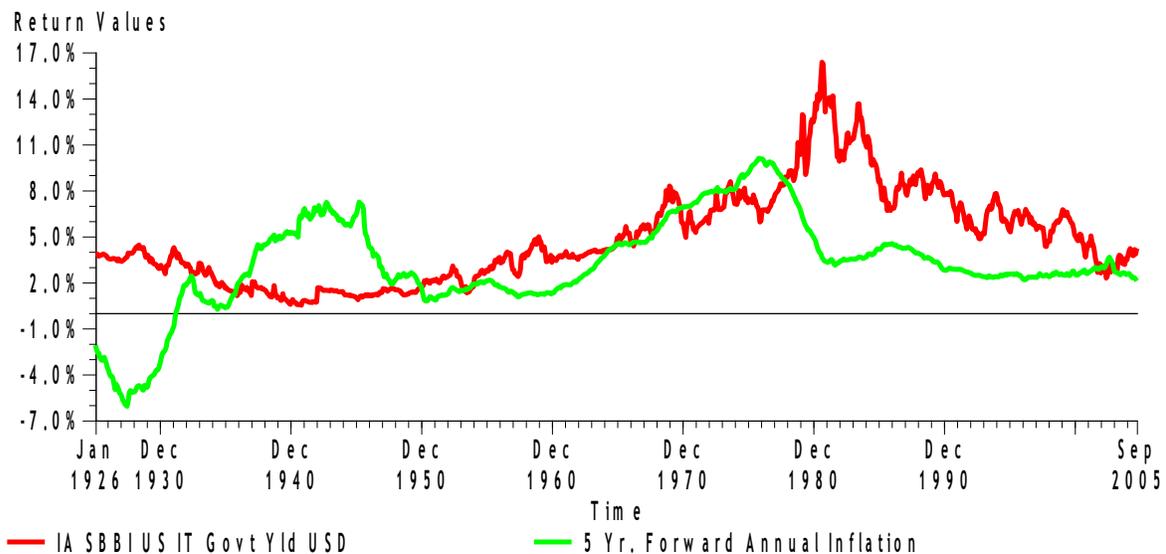




Conversely, from the early 1930's until the early 1970's, the bond market nearly always under-estimated subsequent inflation. In general, long-term bond yields were below the subsequent long-term inflation rate. Overall, the correlation between long-term bond yields and the subsequent long-term inflation was a negligible 0.20.

Mid-term bond yields also did a poor job of anticipating future inflation. The following graph illustrates how intermediate-term government yields (in red) failed to anticipate the subsequent five-year inflation rate (in green). As can be seen, intermediate-term bond yields tended to be either too high relative to the subsequent realized inflation rates (as occurred in the late 1920's and the late 1970's through to mid-2000's) or too low (as occurred in the late 1930's and 1940's and the 1970's).

Intermediate-Term U.S. Bond Yields vs. 5-Yr. Inflation Rate



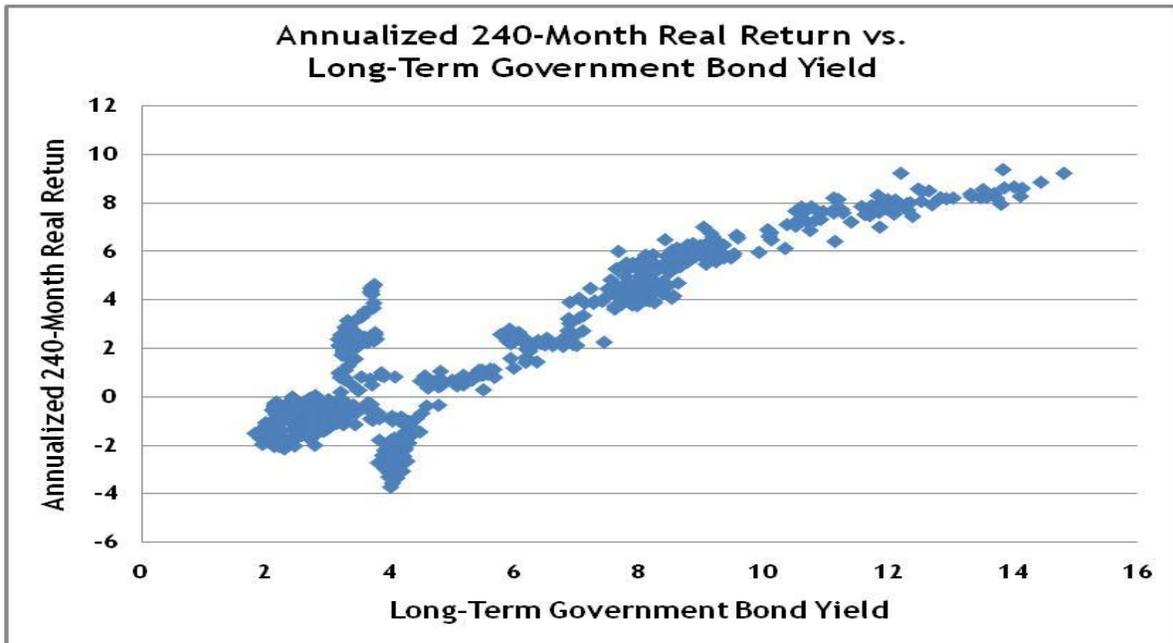
The correlation between intermediate-term bond yields and the subsequent five-year inflation rate was a weak 0.27.

The bond market does a poor job of estimating future inflation rates over the mid to long-term. Hence, investors should have little comfort that today's low yields properly anticipate future inflation over longer time frames or properly compensate them for the risk of potentially higher inflation further down the road.

In fact, historically, low bond yields have not provided investors with sufficient reward for the risk of unexpected higher inflation. This is illustrated in the following graph which compares the monthly long-term bond yields from January 1926 to



September 1990 to the annualized real (i.e. inflation adjusted) return actually earned in long-term bonds over the subsequent twenty years.



Low long-term government bond yields such as the 3.4% yield today have typically resulted in either low or negative real returns for long-term bondholders. The only exception was the mid-1920's when bond investors benefited from falling prices in the late 1920's and early 1930's as well as wartime price controls. Very low intermediate-term bond yields such as the 1.3% yield today have also resulted in either low or negative real returns over the subsequent five years (see Appendix I).

At today's low yields, government bond investors are banking on a future of protracted low inflation or even outright deflation. They need to understand that, like Mr. Magoo, the bond market really doesn't see clearly at a distance. Hence, although low inflation is the likely scenario over the several years, beyond that, the bond market has limited insight into mid to long-term inflation.

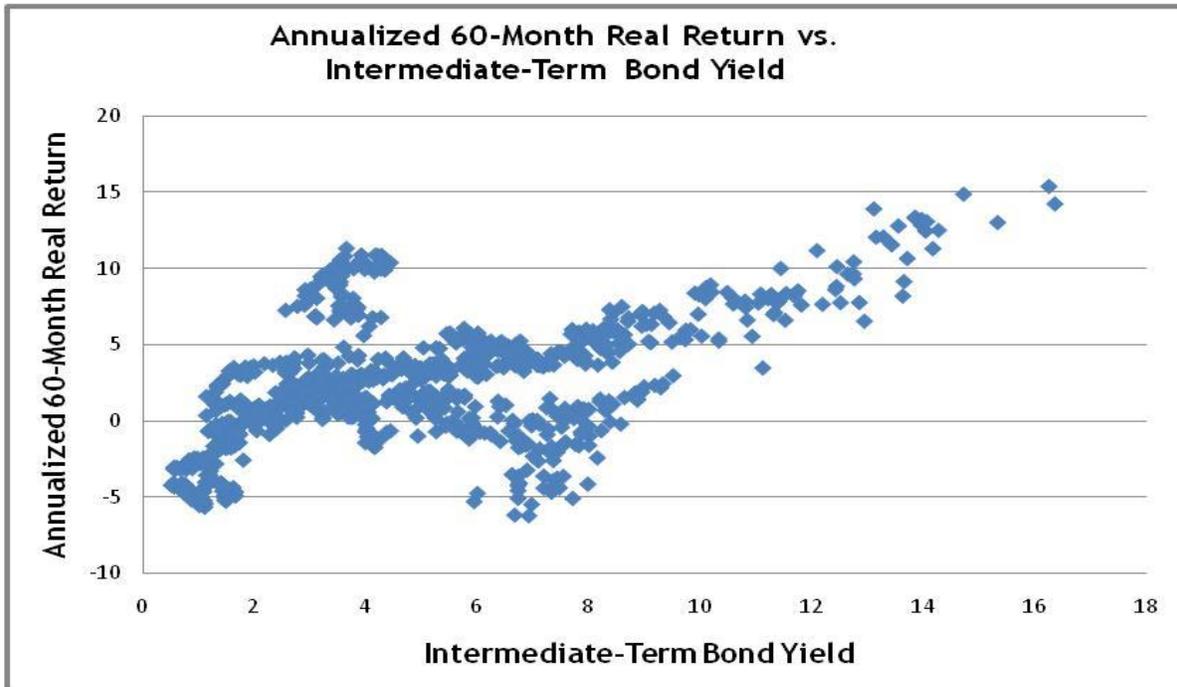
And the market is akin to Mr. Magoo in another respect. With yields so low today, it will also be prone to some nasty accidents in the future.

September 30, 2010

www.tacitacapital.com



Appendix I



Source: Data from Morningstar Ibbotson covering the period January 1926 to September 2005; calculations by Tacita Capital. 60-month real return is the actual annualized inflation-adjusted return on intermediate-term bonds compared to the bond yield in month one.



Tacita Capital Inc. (“Tacita”) is a private, independent family office and investment counselling firm that specializes in providing integrated wealth advisory and portfolio management services to families of affluence. We understand the challenges of affluence and apply the leading research and best practices of top financial academics and industry practitioners in assisting our clients to reach their goals.

Tacita research has been prepared without regard to the individual financial circumstances and objectives of persons who receive it and is not intended to replace individually tailored investment advice. The asset classes/securities/instruments/strategies discussed may not be suitable for all investors and certain investors may not be eligible to purchase or participate in some or all of them. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives. Tacita recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial advisor.

Tacita research is prepared for informational purposes. Neither the information nor any opinion expressed constitutes a solicitation by Tacita for the purchase or sale of any securities or financial products. This research is not intended to provide tax, legal, or accounting advice and readers are advised to seek out qualified professionals that provide advice on these issues for their individual circumstances.

Tacita research is based on public information. Tacita makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to inform any parties when opinions, estimates or information in Tacita research changes.

All investments involve risk including loss of principal. The value of and income from investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in securities transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. Management fees and expenses are associated with investing.

ⁱ The yield of bond actually incorporates four elements: 1) a real return component for deferring consumption and assuming the risk of investment; b) an expected inflation premium; 3) an inflation uncertainty premium for the risk of changing inflation rates; and 4) a term premium for the risk of extending the investment horizon. For simplicity sake, I have combined the real return and term premia into a single real return element and the expected inflation and inflation uncertainty premium into an expected inflation component.