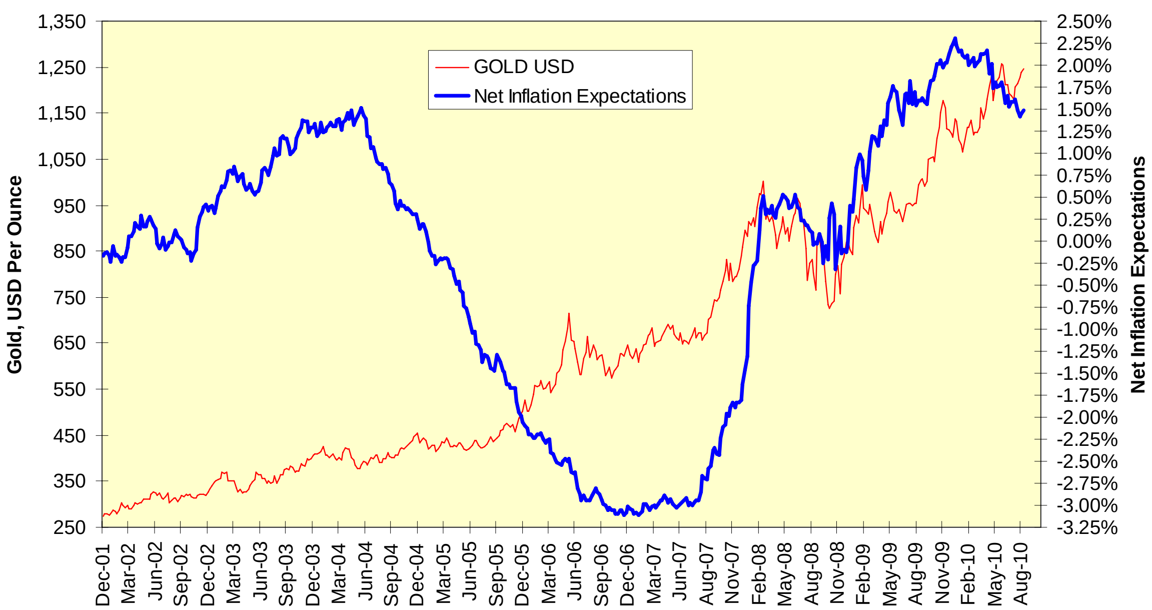
Gold's Passage To India

When I entitled a March column, "Gold Needs More Irresponsibility," I never had any doubt my call would be answered. Challenging the world's governments to stand and be counted in the profligacy department was a proverbial fastball down the middle.

But while the printing presses have been in high gear here and elsewhere, inflation expectations have been declining; the world's central banks proved in the 1970s they could not stop inflation on a dare and now they are proving they cannot start it on a dare. If the excess of these inflation expectations over the short-term interest rate, what I call net inflation expectations, is declining, then gold and all other inert assets are facing a headwind. And yet the price of gold continues to rise today just as it did between May 2004 and October 2006 when the net inflation expectations measure declined significantly.

Gold And Net Inflation Expectations

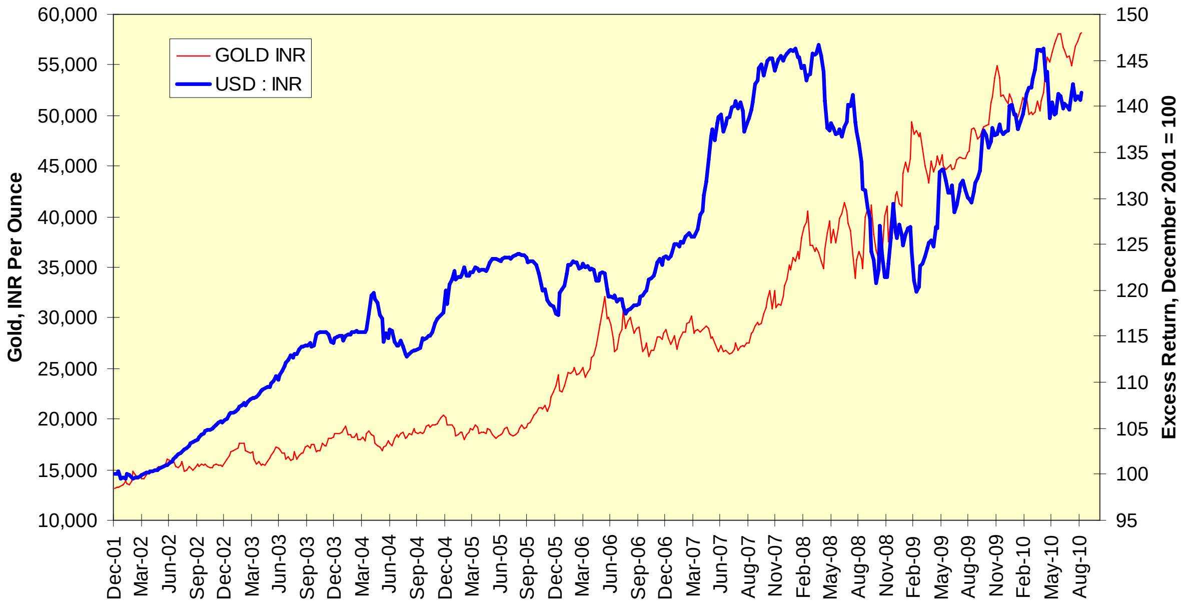


One answer to this paradox of an inflation hedge declining in the face of declining inflation expectations is an income effect. Newly wealthy countries such as India are amongst the largest buyers of gold. If you are in a culture with little cultural history of investing in paper representations of wealth, then you are more than happy to take your stash of rupees (INR) and convert them into gold.

Pretty, shiny gold. The second-to-last person on earth will be able to get something of value for it. Only the last person on earth will be left holding the bag.

However, the holding costs of gold in India are higher than they are here; three-month Mumbai interbank rates are 6.91% as I write. A ready solution to this problem exists, though: Borrow three-month U.S. dollars and lend in three-month INR. The excess return on that trade has been chugging right along as our good friends in India have been pushing their short-term rates higher while we have been keeping them near 0%. The trade will remain open as long as the U.S. signals there is no risk in borrowing all of the USD you want for as little as possible. The price of gold in INR has been moving higher along with this carry trade return, regardless of net inflation expectations in the U.S.

Gold And The Dollar Carry Into The Rupee



The implications of this carry trade are extremely bullish for gold as they imply an open and indeed expanding arbitrage for as long as India and others raise rates while Benevolent Ben keeps our rates low. Quantitative ease has done little for employment in the U.S., but it has done wonders for gold in India.