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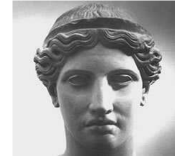

Interview: Jim Sinclair on Gold and the World Financial System

By Ron Hera
April 15, 2011
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The Hera Research Newsletter (HRN) is pleased to present an in-depth interview with Jim Sinclair, Chairman and CEO of Tanzanian Royalty Exploration and founder of Jim Sinclair's MineSet, which hosts his gold commentary as a free service to the gold investment community.

Jim Sinclair is primarily a precious metals specialist and a commodities and foreign currency trader. He founded the Sinclair Group of Companies in 1977, which offered full brokerage services in stocks, bonds, and other investment vehicles. The companies, which operated branches in New York, Kansas City, Toronto, Chicago, London and Geneva, were sold in 1983.

From 1981 to 1984, Mr. Sinclair served as a Precious Metals Advisor to Hunt Oil and the Hunt family for the liquidation of their silver position as a prerequisite for the $1 billion loan arranged by the Chairman of the Federal Reserve, Paul Volcker.

He was also a General Partner and Member of the Executive Committee of two New York Stock Exchange firms and President of Sinclair Global Clearing Corporation (a commodity clearing firm) and Global Arbitrage (a derivative dealer in metals and currencies).

In April 2002, shareholders of Tanzanian Royalty Exploration (formerly Tan Range Exploration) approved the acquisition of a Sinclair managed private company, Tanzania American International, and its exploration assets in Tanzania. Subsequently, Mr. Sinclair became Chairman of Tanzanian Royalty and now leads its efforts to become a gold royalty and development company.

He has authored three books and numerous magazine articles dealing with a variety of investment subjects, including precious metals, trading strategies and geopolitical events and their relationship to world economics and the markets. He is a frequent and popular commentator on financial and market related issues in various news publications and has been profiled in the New York Times.

In January 2003 Mr. Sinclair launched, Jim Sinclair's MineSet, which now hosts his gold commentary and is intended as a free service to the gold community.

Hera Research Newsletter (HRN): Thank you for speaking with us today. You are one of very few people who have tried to warn investors about OTC derivatives. Why are OTC derivatives a problem in your opinion?

Jim Sinclair: Over the counter (OTC) derivatives are the reason we are going through what we are going through now. An OTC derivative is a kind of wager on what something will do. Up until 2009, most of these wagers had very little, if any, money behind them and, if the direction you bet on didn't come to fruition, the amount of leverage resulted in extraordinary losses. There was a major rollover in derivatives tied to real estate in 2008, as well as in other types, such as those tied to sub-prime auto loans.

HRN: Did OTC derivatives destabilize the financial system in 2008?

Jim Sinclair: Absolutely.

HRN: Don't financial institutions use risk cancellation models to hedge risks using OTC derivatives?

Jim Sinclair: Before the failure of Lehman Brothers, OTC derivatives losses would have almost netted out to zero. You can consider derivatives like a string in a circle with various knots representing all the derivatives transactions. When Lehman went broke, the string broke. When Lehman couldn't meet its obligations on derivatives, they could no longer be netted out to zero. That's why the banks went down, and that's why you had the government bailouts and quantitative easing (QE).

HRN: OTC derivatives are the real reason for the bank bailouts?

Jim Sinclair: That is a fact which can in no way be argued away.

HRN: Hasn't the problem been cleaned up by the Dodd–Frank Wall Street Reform and Consumer Protection Act?

Jim Sinclair: The pile of OTC derivatives is over $1 quadrillion. After 2008, the International Monetary Fund (IMF) adopted a new method of valuing them called value to maturity. Value to maturity assumes all of them will function, which is a cartoon. The derivatives pile hasn't contracted. Basically, it has expanded, but value to maturity reduced the notional value from over $1 quadrillion to under $700 trillion. The amount outstanding is the same as it was in the first place.

The flavor of the present moment is credit default swaps against the solvency, or lack thereof, of sovereign nations. New derivatives have some margin behind them, but they only work if they are not called upon. If a nation's debt was in fact to default, it would happen very quickly without a great deal of run up before. Most people would expect a rescue to be coming. Let's say a rescue didn't come, those credit default swaps would simply not be able to function and down again would come the banking system.

HRN: Are you saying that the financial system is less stable today than it was in 2008?

Jim Sinclair: It appears more stable but that's only an appearance. The entire equity rally took place almost to the day from when the Financial Accounting Standards Board (FASB) relaxed the

mark to market rule. It allowed financial institutions to make up whatever value they wanted for their worthless pieces of paper. If they used the real values, the banks would have come down.

HRN: Wasn't the FASB change a temporary measure to halt the decline in mortgage-backed securities?

Jim Sinclair: It wasn't just mortgage-backed securities. It was all the paper on bank balance sheets. The balance sheets of banks appear to be in good shape but they're not. In fact, they will need a lot more funds.

HRN: Then the financial system is still vulnerable?

Jim Sinclair: They've kicked the can down the road. The purpose of QE, in other words the printing of money, is to maintain some degree of integrity in the financial system. Bear in mind that the grease for the wheels of equity markets is liquidity, meaning that if you create a lot of money, it goes into the hands of banking institutions and international investment houses. So, the equity out of thin air market has been sustained by QE.

HRN: What can the government do to prevent another crisis?

Jim Sinclair: You can assume that what's been done already will be done again. There are no other tools in a practical sense. The idea that there won't be a continuation of QE is nonsense.

HRN: Can the government bail out the banks again?

Jim Sinclair: The central banks will buy the government debt. That's called quantitative easing.

HRN: Doesn't QE undermine the dollar?

Jim Sinclair: The dollar is an exercise in psychology. It's a piece of paper with a promise to pay but there's nothing in which it can be paid. It's legal settlement for debt but there's nothing that it's convertible into. To maintain confidence, it's necessary to maintain the stature of a currency. In an arithmetic sense, if you go into a market to sell a supply of apples, and if you're the only seller, you can get a nice price. If more sellers, meaning more apples, come into the market, there goes the price of apples. QE creates more dollars, which increases the supply.

HRN: If the dollar is loosing value because of QE, what about the Euro?

Jim Sinclair: If you look at the dollar or the Euro or the Yen, or even the Swiss franc, it's a race to the bottom amongst all currencies. All countries everywhere are creating more paper every day. It's a relative valuation, rather than a valuation based on an objective reference. What happens in the European Union immediately affects the dollar.

HRN: You mean the sovereign debt crisis?

Jim Sinclair: There's too much focus on the Euro countries. There's no difference between the economic union of Europe and the union of the states in the United States. The states of Europe have been revealed to be insolvent. How about the states of the United States? Out of New York, Illinois, California, etc., how many are solvent? The focus of the media has been on the Euro. The U.S. should stand in front of a mirror. The states of the economic union of America are in no better shape.

HRN: The news media is ignoring the U.S. sovereign debt crisis?

Jim Sinclair: In George Orwell's Nineteen Eighty-Four, there were loud speakers constantly teaching the people what Big Brother wanted. The loudspeakers today are financial television. How much attention has financial TV put on the insolvency of U.S. states? It's been mentioned, but not like the solvency problems of Portugal, Greece, Spain and Ireland, which have gotten hours, days, weeks and months of constant coverage. The solvency of New York, Illinois and California has been brought up but fleetingly at best.

HRN: So, the solvency problems of U.S. states are like an elephant in the room that no one is talking about?

Jim Sinclair: How can you say that the Euro is a disaster based on the financial condition of the states of the economic union of Europe, when the states of the economic union of the United States are in equally bad shape and in some cases worse? There's no difference. If you want to analyze the Euro based on the weakness of its member states, how can the dollar be strong when the states of the United States are as weak or weaker?

HRN: So, the Euro could rise against the U.S. dollar, despite the European sovereign debt crisis?

Jim Sinclair: Sure it can. The question is, can the dollar go lower? The Euro could go to $1.50 or higher.

HRN: But the U.S. dollar is the world reserve currency. Doesn't that guarantee its value?

Jim Sinclair: Only by default. It remains so because central banks own dollars. If central banks could exchange them for gold or other currencies without a major dislocation, they would.

HRN: Then, as a practical matter, central banks can't get out of the dollar?

Jim Sinclair: The only one that's gotten out of it is China. They've made deals all around the world for metals, materials, energy and manufacturing. If you add it all up, China is no more stuck in the dollar than the man in the moon.

HRN: Doesn't the U.S. maintain a strong dollar policy?

Jim Sinclair: The strong dollar policy has only been a moderate, long-term downtrend that continues lower.

HRN: Don't central banks manage currency exchange rates to prevent disruptive changes, like the recent Japanese Yen intervention?

Jim Sinclair: In the Japanese yen intervention, the central banks intervened but how long can they intervene? They have to create money to intervene, which comes back to QE.

HRN: Do you mean the overall affect of currency interventions is to create new money?

Jim Sinclair: Anything that happens around the world, for instance, the Bank of Japan's response to the horrible disaster in Japan, was to go straight to QE. Money is being created everywhere

without any discipline but the problems of financial institutions remain because they have make-believe balance sheets with improper values for their OTC derivatives.

HRN: Doesn't the suspension of the FASB mark to market rule buy time for banks to repair their balance sheets?

Jim Sinclair: There are five million homes for sale in the United States if you include the off-market shadow inventory, which is a real inventory. There's no repair coming in the real estate market, therefore, there's no repair coming in the OTC derivatives based on that. That means there's no repair coming in the underlying paper that the banks now value at much higher levels than they could possibly sell them for, if they could sell them at all.

HRN: Will bank balance sheets eventually get better?

Jim Sinclair: As long as confidence remains in place, which depends on the equity market and that comes back to QE.

HRN: Are you saying that the U.S. stock market rally is driven by QE?

Jim Sinclair: There's an inability to stop QE without the whole house of cards coming down on itself. There's no other choice. It's the only tool left. The Federal Reserve can't take a hawkish position on monetary policy and interest rates without this whole thing rolling over. They can talk about it constantly and might have more back door QE than front door QE.

HRN: If QE doesn't stop soon, what will happen?

Jim Sinclair: The end game is a virtual reserve currency linked to gold. It will be based on an average of major currencies, which will slow down the movement in the index. The International Monetary Fund (IMF) is moving in that direction with Special Drawing Rights (SDRs). The dollar will be just another currency. The dollar's not going to zero. It could loose a significant part of its buying power, which it already has and could again.

HRN: How would a virtual currency work?

Jim Sinclair: There would have to be a broad measure of the money supply, such as M3 used to be for the U.S. dollar, but on an international basis. The price of gold would be related to that measure. Central banks would have to value their gold according to their contribution to or extraction of international liquidity, so the price of gold would rise or fall on its own.

HRN: Wouldn't that be a gold standard?

Jim Sinclair: There'll never be a return to a gold standard in my opinion. The end of all hyperinflations has been a commodity currency. That's exactly what happened in Germany, for example. Gold has the capacity to give confidence to people if there's some relationship between the currency and gold. The virtual currency will be linked to gold but not convertible into gold.

HRN: So, a gold component will restore confidence?

Jim Sinclair: The answer is a commodity currency. That's what happened every time there was this type of situation in monetary history. The rentenmark, which ended the German hyperinflation in 1923, was supposedly backed by all the real estate in Germany, but the

government didn't own that real estate. The point is that it wasn't true. There was no great commodity backing for the rentenmark, but it was enough. It was a period when people were searching for anything to restore confidence in the currency.

HRN: Do you expect high inflation in U.S. dollar terms?

Jim Sinclair: The deed is done. Inflation is a pregnancy. The conception has already taken place. There's a delayed effect but if you do the crime, you do the time. The Federal Reserve could stop QE tomorrow and it wouldn't stop what's going to happen because of what they've already done.

HRN: Won't inflation reduce the real value of debt and help to repair bank balance sheets?

Jim Sinclair: Inflation is the way debt will be taken care of. The value of the currency will be so reduced as to reduce the debt load. It will also change the political scene. Whoever has power going into this will not have power coming out of it.

HRN: In other words, inflation is politically destabilizing?

Jim Sinclair: People really haven't seen the big picture. Currency induced cost push inflation is already here. Look at what's going on right now in the Middle East. We are moving from order to lack of order.

HRN: Would you say that inflation in food prices is indirectly driving oil prices higher?

Jim Sinclair: Oil goes right through from fertilizers to farm equipment to transportation and to food prices. The price of food is going to go even higher than we are seeing this year. The price of oil is headed decidedly higher. Peak Oil was a concept of the future. Now it's a concept of now. A car getting 25 miles per gallon will probably be too expensive for the average person to drive.

HRN: How will high oil prices affect the prices of other things?

Jim Sinclair: There will be dislocation in the means of delivery of products. There may be shortages of goods, not because there are no available goods but because the means of distribution breaks down. It's not that there won't be corn or wheat, but the fuel needed to deliver it will be too expensive and people who work in transportation will demand higher pay so they can live. That's where hyperinflation comes in.

HRN: And money to maintain the distribution of goods will be printed out of thin air?

Jim Sinclair: Every nation that has ever done this has turned into a banana republic. People can live in banana republics but there will be few wealthy people. There will be a few super wealthy people and an enormous amount of poverty. You can see it across the border in Nogales, Mexico, where people continue to live in extreme poverty.

HRN: America is becoming like Mexico?

Jim Sinclair: The standard of living is going much lower. People have to realize that the damage is already done. It's not a question of whether the U.S. can be pushed over the edge. We are over the edge. We are watching the consequences play out now.

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HRN: What can people do to protect their wealth from inflation?

Jim Sinclair: People have to try to maintain their buying power. Each person can become their own central bank and, to the best of their abilities, focus on the assets that benefit from the disorder that's taking place and that will continue to take place.

HRN: Do you mean buying precious metals or commodities?

Jim Sinclair: I've spoken to people who, over the last ten years, have had this perspective. They have done very well. Even doing it now could protect your wealth.

HRN: What about gold? Do you see gold as a currency that can't be debased?

Jim Sinclair: What is real money? Gold is a currency that has no liability attached to it. It's a measure of value and a store of wealth that's universally acceptable.

HRN: So, gold is an alternative to dollars or Euros?

Jim Sinclair: Physical gold is the answer. An individual who holds gold will have more time and ability to function.

HRN: How much higher do you think the price of gold could go?

Jim Sinclair: What's the exchange rate of a currency with no liability attached to it? Gold is going much higher. We could see shocking gold prices, maybe Alf Fields' target of $10,000 per ounce or Martin Armstrong's target of $12,000 per ounce. I think that my price target of $1,650 per ounce gold is going to be so low it will be considered silly.

HRN: Thank you for your time today.

Jim Sinclair: It was my pleasure.

After Words

Nicknamed "Mr. Gold" for his incredible timing of the gold market in the 1970's, when he called the top of the market in 1980 to the day, Jim Sinclair, is a legendary precious metals, commodities and currency trader. Mr. Sinclair was influenced by his father, Bert Seligman, who was the business partner of Jesse Livermore, "The Great Bear of Wall Street" famous for short selling in the stock market crashes of 1907 and 1929. Currently Chairman, President and CEO of Tanzanian Royalty Exploration Corporation, part of Mr. Sinclair's strategy to protect his interests from the effects of currency debasement, is to acquire as much gold in the ground as possible without rushing to production because, he believes, the price of gold will go much higher. Mr. Sinclair's famous 2001 gold price target of $1,650 per ounce in 2011—a prediction ten years into the future—fell within 22% of the gold price in January 2011 after a phenomenal 511% increase over a ten year period, from an average price of $265.49 in January 2001 to an average price of $1,356.40 in January 2011 (London p.m. Fix)—one of the most astonishing calls in the history of precious metals trading. As a commentator on precious metals, commodities and currencies, investors ignore Jim Sinclair at their peril.

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