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OBSERVATIONS ON THE MARKET

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Did we learn anything from the financial panic of 2008? Apparently, we did not. You want evidence, first look at CCC rated bonds, bonds that are near the bottom of the credit rating scale and considered very risky. In May of 2007, yields for CCC rated corporate bonds were at 9%, a record low. What makes these bonds a good indicator of risk is that they have a 30% probability of defaulting before they mature. Default rates are driven by the economy, and when there is growth, even slow growth, defaults decline. However, when the economy slows, CCC bonds become the canary in the coal mine. They are the first to go bad. We have now reached a new record low of 8.7%. It is obvious why. Investors are franticly searching for income to the point that they are ignoring the fact that they may not get all their money back. Want more evidence?

Another source of high income are royalty trusts. These are investments that own assets, and the stock holders receive all the income from those assets. Hugoton Royalty Trust is a royalty trust that owns natural gas interests in Oklahoma, Wyoming, and Kansas. The reserves are expected to last another 10 years and then the trust dissolves. Every year the company issues a 10k (similar to an annual report), and each year they list the value of their reserves based on current oil and natural gas prices. It is not an exact science but it is a fair value estimate. In 2013, the company stated on page 40 of their 10k that the current value of the expected payments from their reserves is $396 million. The company also gives an estimate as to what you should pay if you want a 10% return on your investment over the next 10 years, and currently that number is $189 million. So you shouldn't pay much over $189 million, and you definitely don't want to pay more than $396 million, unless you think natural gas prices are going to skyrocket in the next few years. It appears that investors will do stupid things for the perception of a big monthly check, including paying $470 million for this trust. This trust pays a 10% dividend monthly, however, remember that because the value is so high, investors who buy this trust now won't even get all their money back since the dividend comes from a declining asset; the natural gas wells eventually dry up. The greater fool theory is in full force here.

Finally, investors are experiencing short-term memory loss. Just one year ago, the southern European countries of Spain, Italy, and others where ready to fall into the Mediterranean Sea. Italy was struggling to issue new bonds. A few months evidently changes everything. Ten year bonds from Italy now pay 3.24% while Spanish debt now yields 3.04%. Compare those to US 10 year treasury bonds that are at 2.55%, what part of this doesn't make sense?

The good news is that this speculation is not as widespread as in 2007. Company balance sheets are much healthier, and the banking system does not have the leverage it had in 2007. It is like investors have been thrown into the desert and there is only one glass of water for every five people. Water (interest rates) have become very valuable. The point is not that the world is a speculative bubble ready to pop, but that some investments are no longer investments. They are speculative bubbles ready to pop. It will definitely pay to know what you own and what your mutual funds own. Sort of like drinking salt water, eventually you die.