

**CIOVACCO**  
CAPITAL MANAGEMENT  
**2008 Asset Class Outlook**

**Perspective**

- **Technical analysis:** the strength of trends from a long, intermediate, and short-term perspective.
- **Economic environment:** considers the slowing U.S. economy, Fed cycle, long-term global macro trends, such as U.S. debt levels and the long-term shift of economic power from developed economies to emerging economies.
- **Historical perspective:** considers past Fed cycles, bear markets, economic cycles.

**The A Team – Energy, Precious Metals, Agricultural Commodities**

In an environment where the money supply is increasing or is expected to increase based on current and anticipated future policies, commodities are used as a hedge against depreciating paper currencies. Both recent and current trends are holding to historical form. The risk is that continued economic weakness, especially a sharper than expected recession in the U.S., could be the catalyst for sharp corrections. The safest bets are physical gold and silver and physical commodities over owning stocks in these asset classes. On the more aggressive side, agricultural commodities are getting much attention and owning stocks vs. physical commodities historically has more upside.

**The B Team – Emerging Market Stocks, Timber, TIPS, and Foreign Bonds**

Similar to the comments on the pros and cons of commodity stocks above, emerging market stocks have many attractive qualities in the current environment. The possible downside to emerging market stocks is global economic weakness could spark nasty corrections. Timber is known as an alternative asset class or a place where people look to do something different when risks abound. Until recently, timber charts looked strong. The recent weakness, however, has not yet disrupted a strong up trend. While timber may seem an odd choice in the face of a housing recession, the industry can choose to let the trees grow and increase in value as paper currencies continue to depreciate. This risk is this benefit may be outweighed by the negative perception of anything related to residential housing. Foreign bonds are attractive from a weakening U.S. dollar and weakening U.S. economy perspective. If a foreign bond pays 5% in the coming year and the U.S. dollar depreciates vs. the bond's native currency by 10%, the foreign bond returns 5.5% after the currency adjustments. Another attraction is many foreign countries may fare better in a global economic downturn. Therefore the risk of default on bonds from the stronger economies would be less than a U.S.-based bond. The safe play is to stay with short maturities. The aggressive play is to buy longer maturities. Treasury Inflation Protected Securities (TIPS) are government securities designed by the U.S. Treasury to help protect investors from inflation. The benefits are

obvious in the current environment. However, in the long run you must rely on the government's published inflation data. I like TIPS in an allocation, just not too many of them.

### **The C Team – U.S. Treasuries, U.S. Bonds, Hedged U.S. Stocks, U.S. Stocks, G-7 Foreign Stocks**

U.S. bonds may turn out to be the best performers of all for the next six to twelve months. However, their long term attractiveness is limited. The depreciating U.S. dollar and high debt levels in the U.S. add a level of risk which many investors may be missing in U.S. bonds. If the U.S. dollar were to crash in the future, the U.S. bond market would not be the place to be. Obviously hedging strategies are highly dependent on the skill of the person(s) doing the hedging. Concerns here are the possibility of the U.S. stock market getting stuck in a long-term trading range, which requires great hedging skills in order to produce superior results. The trading range concern applies to all U.S. stocks. The worse things get economically, the more attractive hedging strategies become. If things get bad economically, but not too bad, U.S. bonds will provide a safe haven and a good relative return. Foreign stocks from many developed countries have had a lengthy run. Many developed countries face similar problems to the U.S., such as real estate bubbles, high levels of debt, and long-term entitlement problems. It is not yet time to throw in the towel on stocks of developed foreign nations, but they merit a close watch.

### **The D Team – Global Commercial Real Estate and U.S. Small Cap Stocks**

Both of these asset classes have had long and outstanding runs. The credit markets and sentiment have turned against all real estate. Even foreign real estate has been unable to buck the negative trends. The risk-reward in real estate is simply unattractive. If things get better quickly, the trends could reverse, but continued weakness seems much more probable. Smaller capitalization stocks have outperformed their bigger brothers for quite some time. Consequently, there is more risk in the charts when compared to an asset class which has gone through more recent and prolonged corrections and consolidation. The perception is smaller companies are more risky during economic downturns which is another strike. Finally, smaller cap stocks do not have an attractive track record during many Fed rate-cutting cycles.

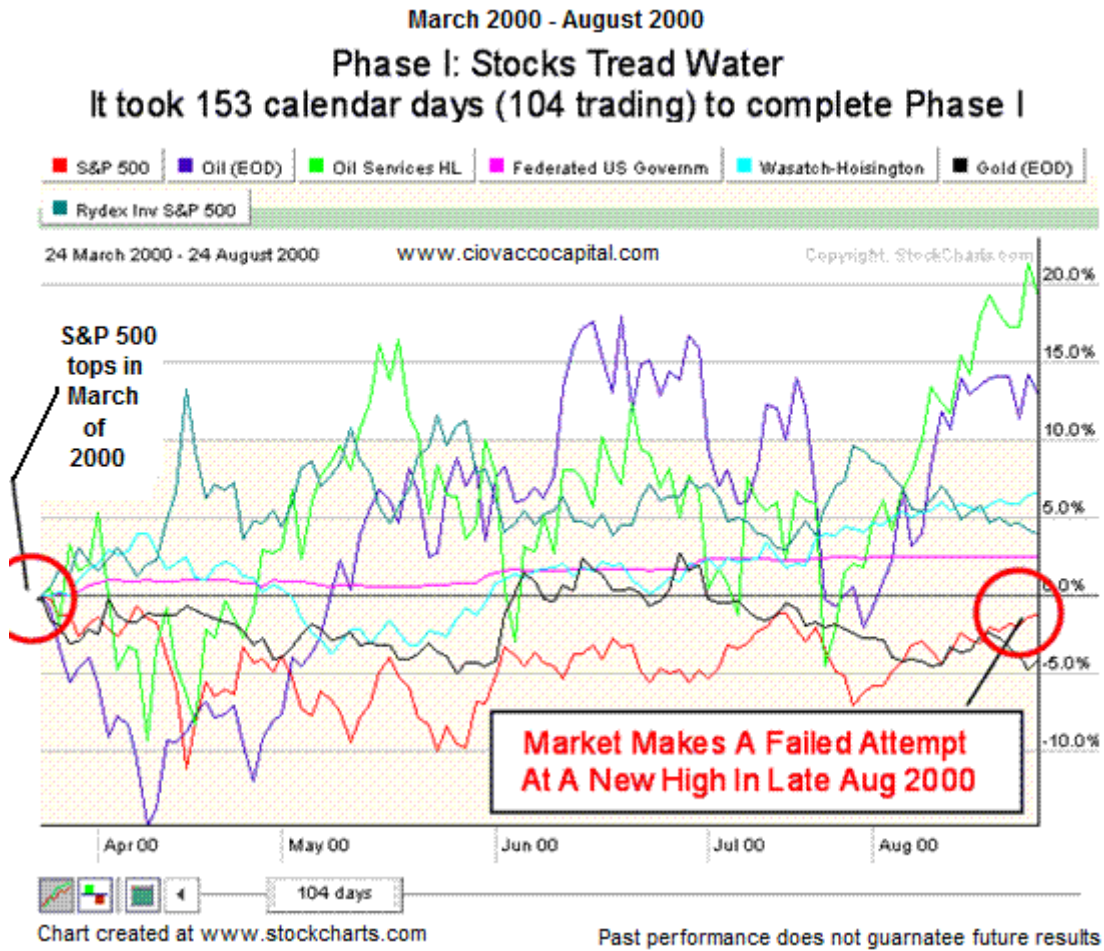
### **Risks – 2000 Shows It May Be a Volatile Ride**

As stated previously, if global economic weakness significantly exceeds current forecasts, the list of attractive asset classes would shrink. The uncertainty in the housing, credit, and SIV (structured investment vehicle) markets underscores the need for diversification and flexibility. If you pay close attention to what is happening, you do not need to rely on accurate forecasting to navigate through these uncertain times. The relative performance of asset classes will point you in the right direction.

Using the early stages of the 2000-2002 bear market in U.S. stocks as a guide, there were not many places to hide from March 2000-March 2001. If you break the 2000-2002 bear market into phases, the first two phases are depicted in the charts below. We are in a different part of the commodities cycle and there are numerous differences between now and 2000. However, the point is while the A Team above is well positioned for the next 12 to 24 months, sharp corrections could occur along the way.

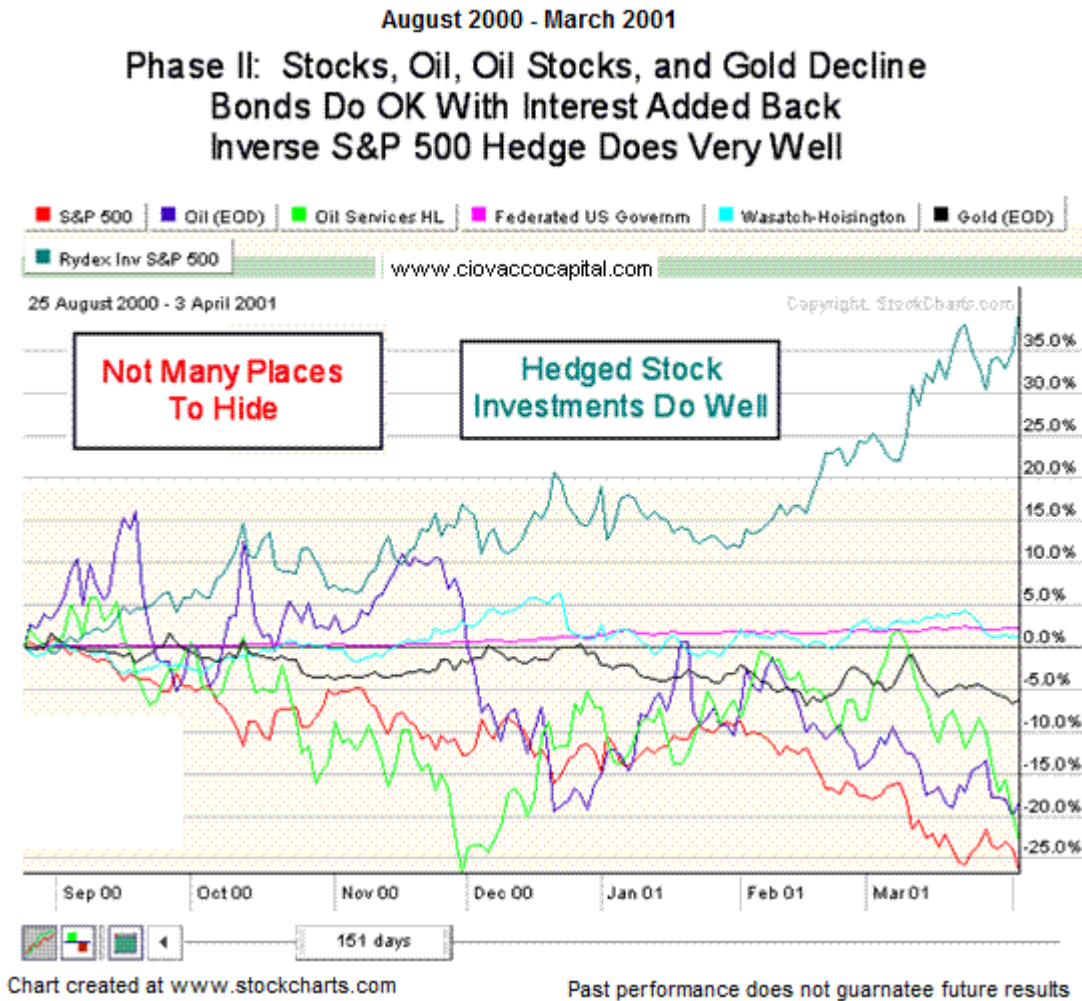
We'll see how things play out and adjust accordingly.

Graph 1



Graph 2 is on the following page

Graph 2



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