Market Commentary

Stocks have shed their late-October weakness and reached new highs this month. What many believed would be a significant correction -- due to the outsized gains achieved since March -- has reversed, leaving the important 50-day moving average intact for the Dow Jones Industrial Average, the strongest of the major indices. Nevertheless, the markets are overbought and susceptible to ongoing volatility.

All eyes are on the U.S. dollar, the principal scapegoat for the ongoing appreciation of most asset classes, from stocks to bonds to gold. Monday’s action illustrated this point, as even U.S. Treasury bonds gained ground while stock and commodity prices took their cues from the currency markets and some uncharacteristic comments by Federal Reserve chairman Ben Bernanke. Speaking before the Economic Club of New York, he reiterated the standard Federal Open Market Committee line, which states that growth is under way even though risks persist, and that interest rates will remain low as long as necessary.

Bernanke did diverge, however, to comment on the U.S. dollar’s slide. The value of the dollar does matter, in so much as it relates to the Fed’s dual mandate of maximum employment and price stability. The dollar index, which measures the dollar against a basket of major currencies, has dropped about 16% since mid-March. This has fanned the flames of inflation. Nowhere is this more evident than in the price of gold, which has hit all-time highs this month, even as stocks have appreciated. It is not often that gold and equities become so highly correlated, and this has led many to believe that the U.S. dollar has replaced the Japanese yen as the carry-trade currency of choice. As investors borrow dollars and invest them in higher-yielding currencies or riskier assets, the dollar weakens further and other asset classes appreciate. Gold, in turn, becomes a safe-haven asset against this demise of value.

(Continued on the next page)
Bernanke also raised eyebrows by making uncharacteristic remarks regarding prices of assets (i.e., stocks) in general, saying that he did not see any large misalignments anywhere in the financial system. Other economists have noted the absence of valuation misalignments both in global equity and credit markets, which indicates that fundamentals, and not leverage, are responsible for the strong gains in asset prices. The reductions in volume, margin trading, and derivative use are all reflected in the nominal growth of the financial sector, which would otherwise be ballooning if speculation were at the root of asset appreciation. Instead, economic recovery, cost reductions and emerging market strength are supporting this return to normalcy.

The ETF Action model portfolio has gained 1.93% since inception. That still trails the S&P 500 by more than 1%, as we continue to invest our large cash position (currently down to less than 20% of assets). In the coming weeks, we plan to add additional equity exposure, as well as currency and commodity positions, to our model portfolio.
Style Allocation

This category consists of broad funds that typically conform to the Morningstar Style Box (a tool that represents the characteristics of a security in a graphical format) definitions -- e.g., large-cap value, small-cap growth, etc.

Portfolio Positions

iShares Dow Jones Select Dividend Index (DVY)
Target Allocation: 8%

Dow Diamonds (DIA)
Target Allocation: 8%

PowerShares QQQ (QQQQ)
Target Allocation: 8%

PowerShares Dynamic Large Cap Growth (PWB)
Target Allocation: 8%

DIA: This ETF, which tracks the Dow Jones Industrial Average, has remained a clear leader since the Dow’s mid-October rally brought the index back above 10,000 for the first time since it plummeted in October 2008. Michael Kahn of Barron’s does an excellent job of slicing and dicing the Dow into different groups of stocks, all of which point to an upward trend.

First there are stocks such as American Express (AXP), which are building upon a clear upward trend, that have shown both solid momentum and volume. Next are firms such as DuPont (DD), which are breaking out to new highs after having traded in a range-bound manner while the broader market had moved higher. The upward trendlines have held, thus ensuring that stocks like DuPont continue participating in the bull market. Finally, there are stocks such as Boeing (BA), which is recovering from a pullback and breaking out, or like Johnson & Johnson (JNJ), which has turned a failed bearish technical signal into a bullish one. Both of these groups of stocks could have represented early signs of failure, but they have found support and are chasing the Dow’s leaders.

Last week we added to this position, bringing our target allocation to 16% and making it the largest position in the portfolio.

Watch List

WisdomTree Emerging Markets Small Cap Dividend (DGS)
PowerShares FTSE RAFI 1000 (PRF)
ProShares Ultra Short Russell 2000 (TWM)
iShares S&P Global 100 Index Fund (IOO)

(Continued on the next page)
TWM: The Russell 2000 Index has exhibited signs of life over past couple of days as both the S&P 500 Index and Dow Jones Industrial Average have climbed to new highs, but it has yet to advance to its own high-water marks. TWM will remain on the Watch List until the Russell has outperformed for more than a few days.
Sector Allocation

This category consists of sector funds that provide targeted exposure to one or more industries.

Portfolio Positions

iShares Dow Jones U.S Consumer Goods Sector Index Fund (IYK)
Target Allocation: 6%

First Trust Dow Jones Internet Index Fund (FDN)
Target Allocation: 5%

Market Vectors Junior Gold Miners (GDXJ)
Target Allocation: 2%

GDXJ: The gold miners -- in similar fashion to the situation of silver relative to gold (see chart below) -- have yet to achieve their March 2008 peak.

Market Vectors Gold Miners (GDX) is 10.7% below its all-time high, and if the ratio between iShares COMEX Gold Trust (IAU) and GDX returns back to approximately 1.75, it would require that GDX trade at more than $63 per share, for a gain of 24%. If that happened, I suspect that GDXJ would appreciate even more.

(Continued on the next page)
The main question is whether gold and stock prices can stay high. If they do, the argument for the rise of gold-mining shares is compelling. The biggest risk may be with stocks, because gold miners have followed the broader market lower during each decline. The sharp upward moves in the above chart came in autumn 2008, late February 2009, July 2009 and October 2009 -- all periods during which IAU outperformed GDX.

Watch List

**Market Vectors Coal** (KOL)
**Market Vectors Steel** (SLX)
**iShares Dow Jones U.S Oil Equipment & Services Index** (IEZ)
**iShares Dow Jones U.S. Industrial Sector Index Fund** (IYJ)

**KOL:** This ETF remains a top fund on our Watch List due to its momentum. The fund seeks to provide investors with exposure to some of the most prominent companies involved in the production, transportation and storage of the world’s coal supplies. Year to date through Nov. 13, the fund has seen strong gains, with a rise of 129%.

KOL has appreciated this year as consumers across the globe have increased their demand for electricity, which uses coal to generate energy. Based on the Energy Information Administration’s 2009 International Energy Outlook, the world’s coal consumption is expected to increase by 49% from 2006 to 2030 as energy demand rises.

KOL tracks the performance of 40 firms that represent the Stowe Coal Index (COAL). Top-held firms in the fund include China Coal Energy, Peabody Energy (BTU), China Shenhua Energy, and Consol Energy (CNX). This diversified ETF provides investors with exposure to some of the globe’s largest energy markets. Firms from the U.S. and China respectively account for 47% and 22.3% of the fund’s index. Other nations represented in the index include Indonesia, Australia and South Africa.

Recent events -- including Warren Buffett’s investment in Burlington Northern Santa Fe (BNI) and a record snowfall in China -- make it apparent that coal will continue to be an essential commodity in powering the globe for years to come. Also bolstering this potential, in our belief, is the prospect of long-term global economic healing. KOL is currently the only pure-play ETF available to bank on this industry’s future gains.
International Allocation

This category consists of individual country or regional funds.

Portfolio Positions

iShares MSCI Turkey Investable Market Index Fund (TUR)
Target Allocation: 3%

iShares MSCI Brazil Index Fund (EWZ)
Target Allocation: 3%

TUR: This ETF suffered last week from a broad selloff in emerging-market funds. Recent country-specific data points include a drop in industrial production in the third quarter. As is the case for many emerging nations, the dip was less acute than usual, and it represents a fading of recent weakness. The country has seen improvements in manufacturing, utilities and mining output. The worst of the production slide may have passed, and Turkey’s economy continues to benefit from the global recovery and from improving diplomatic ties with its neighbors. We will continue to hold TUR in the short term, or until another fund within our rankings surpasses it. TUR rebounded Monday along with other emerging-markets ETFs.

Watch List

Market Vectors Russia (RSX)
iShares Austria Investable Market Index Fund (EWO)
iShares MSCI Taiwan Index Fund (EWT)
iShares MSCI Chile Investable Market Fund (ECH)
SPDR S&P Emerging Europe ETF (GUR)

GUR: This week, we added GUR to our International Watch List. The fund seeks to replicate the performance of the S&P European Emerging BMI Capped Index, which tracks some of the largest firms from five of the most promising emerging nations in Europe. The nations represented in GUR include Russia, Turkey, Poland, Hungary and the Czech Republic.

Looking at the sector distribution of GUR, it becomes apparent that this fund’s performance is heavily reliant on the energy industry. Firms representing this sector account for nearly 45% of the fund’s total assets. Other fund concentrations include allocations to the financial sector (at 23%) and to materials (at 11.5%).

Unlike other emerging-markets Europe ETFs, such as iShares MSCI Turkey Investable Market Index Fund (TUR) and RSX, GUR has the added benefit of geographic diversification. This quality provides investors with added protection against economic downturns or political strains occurring in any single nation. Adding to our GUR model portfolio position could either supplement or replace our existing TUR position.

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In 2009, GUR has maintained strong upward momentum. The fund was up 78.5% as of Nov. 13, year to date. By investing in Europe’s emerging markets, GUR investors will likely continue to see strong performance as the whole of the continent experiences economic growth.

**ECH**: This fund had another spurt of short-term momentum over the past month as other emerging markets sold off. Chile is a major copper exporter, but shares of ECH didn’t capture much of the metal’s gain this week. **iPath Copper ETN** (JJC) rose 5% over the past week, with almost all of those gains occurring yesterday, and many other emerging-markets ETFs had gains of 2% or more. ECH, however, gained only 0.9% yesterday, closing behind even the broader U.S. indices. ECH will remain on the Watch List for now, but its attractiveness could deteriorate quickly if it returns to underperformance in the near term.
Commodity Allocation

This category consists of funds that seek to replicate movements in the commodities markets.

Portfolio Positions

iShares COMEX Gold Trust (IAU)
Target Allocation: 2.5%

Watch List

PowerShares DB Base Metals Fund (DBB)
iShares Silver Trust (SLV)

DBB: It’s a good thing this fund lacks exposure to nickel. With a three-way split in its components among aluminum, copper and zinc, DBB has seen a nice rise thanks to copper’s strength. Nickel, on the other hand, has performed abysmally. In the past month iPath Nickel (JJN) declined about 10%, although it gained more than 4% on Monday. While everyone is focused on the precious metals (mainly gold) due to their monetary properties, industrial metals tend to experience more upside in an economic recovery. A much stronger economy would probably see gold decline as fear of inflation and/or deflation subsides, while demand for industrial commodities would increase.

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SLV: This ETF had been flat in terms of performance for the past month, while IAU had advanced 6%. Yesterday changed that, with iShares Silver having gained 5% on the day. SLV’s move brought the fund to a new high for 2009 and its highest price since July 2008. While gold trades at a new high on every up day, silver is still below its 2008 peak. SLV reached $20.73 in March 2008, which is still 15.1% higher than Monday’s closing price.

As this chart of the ratio between IAU and SLV shows, SLV tumbled between July and October along with other commodities while gold held its value. Since then, silver has been slowly closing the gap with gold, but there’s still room for gains. A return to the ratio of 5 to 1, with IAU at $111.72, would put SLV trading at $22.34 -- a gain of 24% from the current level.
Currency Allocation

This category consists of funds that seek to provide exposure to specific foreign currencies or baskets of currencies.

Portfolio Positions

**PowerShares DB U.S. Dollar Bearish Fund** (UDN)
Target Allocation: 2%

Watch List

**PowerShares DB U.S. Dollar Bullish Fund** (UUP)
**WisdomTree Dreyfus Brazil Real Fund** (BZF)
**WisdomTree Dreyfus New Zealand Dollar Fund** (BNZ)

**UUP:** Last week we discussed the surprising developments involving this fund. The ETF had seen tremendous demand in recent weeks, causing it to cease creating new shares until the **Securities and Exchange Commission** (SEC) approved its application for an additional 100,000,000 shares. By the end of the week, approval for new-share creation had been granted and the fund, once again, was trading normally. Its premium vanished as a result.

Had the problem persisted and the U.S. dollar strengthened, however, the fund would have continued to trade higher on both counts. UUP will remain on our Watch List while we look for a potential turning point, whether short-term or long-term, in the dollar's overall direction.
Fixed Income Allocation

This category consists of funds that provide current income or high-yield opportunities.

Portfolio Positions

iShares Barclays TIPS Bond (TIP)
Target Allocation: 6%

iShares iBoxx $ High Yield Corporate Bond Fund (HYG)
Target Allocation: 5%

iShares JPMorgan USD Emerging Markets Bond Fund (EMB)
Target Allocation: 5%

Watch List

iShares Barclays 20+ Year Treasury Bond Fund (TLT)
iShares Barclays 3-7 Year Treasury Bond Fund (IEI)
Real Estate

This category consists of funds exposed to domestic and global real estate sectors.

Portfolio Positions

None taken to date.

Watch List

iShares S&P Developed Ex-U.S. Property Index Fund (WPS)
iShares Cohen & Steers Realty Majors Index Fund (ICF)
iShares NAREIT Residential Plus Capped Index Fund (REZ)
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