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The View

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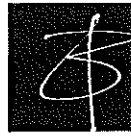
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Brace for More Volatility

August 2nd U.S. debt ceiling deadline looms ominously over markets

Volatility has picked up significantly since May, as investors digest fluctuating news about economic growth, China, and European debt issues. However, the issue that is now front and center, and which will likely remain there until a deal is struck, is whether or not the U.S. will raise its debt ceiling. The current ceiling of \$14.3 trillion was reached in May. The government ostensibly has until August 2nd (a self imposed deadline, but one that markets are heeding as well) to raise the current debt ceiling from \$14.3 trillion to something likely over \$16 trillion to accommodate anticipated borrowing needs to cover the projected fiscal 2012 deficit. As Republicans and Democrats negotiate, posture, and threaten one another, the calendar moves inexorably forward, and markets seem increasingly nervous.

That a deal gets done and the U.S. raises its debt ceiling, pays its bills on time, and remains a AAA-rated sovereign entity is all but certain, in our view. However, just as certain, is that our elected politicians will likely push this issue to the wire and may need extra incentive in the form of a nasty market drop or other financial distress to get them to compromise. Unfortunately, our sharply divided government will probably be loathe to forge a compromise until forced to by markets, so investors should brace for more volatility at a minimum, and perhaps some scary days as well.



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To be sure, the timing and impact of the ups and downs of this issue are impossible to predict. Trying to trade around this volatility is likely folly. Still, many investors simply add this matter to the growing pile of issues to be concerned about and prefer to pull back the reins on risk. This is understandable, and if one is not able to withstand the volatility and potential for loss that accompany such market stress it may be wise to put protection measures in place and/or reduce risk. Nevertheless, any substantial downdrafts are likely to be temporary, and markets will inevitably turn their attention back to economic fundamentals and corporate earnings. Greed will set in and investors will seek bargains, thus ensuring assets do not get too undervalued or overvalued. Except for the very nimble investor, often the best course of action in times like these is to do nothing, and this can often be the most difficult thing to do as well.

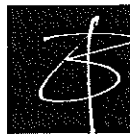
The Current View

PIIGS rear their ugly heads

The PIIGS (Portugal, Italy, Ireland, Greece, and Spain) are back filling up the financial news headlines, just as they did last summer, and the news is not good. By all accounts, Europe's various rescue packages to the PIIGS are merely delaying the inevitable defaults of many banks and perhaps some countries. The good news is that unlike the damage that can be done from unforeseen or underestimated financial meltdowns, this slow moving train wreck should catch no one by surprise. Rescue packages and loans to strapped countries, although likely wasted money from a long-term perspective, buy time for banks and investors to address their exposures and, hopefully, shore up their capital bases. Still, at some point, the insolvency of certain institutions and sovereigns will come to a head. Our read on various indicators is that markets are comforted by the illumination of these problems and, for the time being, investors do not expect contagion to spread. Let's hope they are right.

The austerity vs. additional stimulus debate

Central to the debate over the debt ceiling is the differing views on the health and growth potential of the U.S. economy. One side points to terrible unemployment and record food stamp participants as signs that the economy is far from healthy and therefore unable to grow on its own at a pace required to create jobs. Therefore, they say, more stimulus is needed and the removal of existing stimulus would be destructive. The other side sees escalating spending and debt as the biggest threat to our country and therefore demands austerity. Congress, and indeed the country, is roughly split down the middle. A major move to one side or the other in this debate is unlikely. This is good news for investors, as markets do not like extremes. The most likely outcome, it seems, is one where both sides get some of what they want and thus a clear resolution of our short and long-term issues will remain elusive.



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Contradictory data continue to give both bulls and bears reason for confidence. While recently the mix of news has been somewhat more favorable for the bears, most indicators remain in the middle of a fairly defined range. Indeed, the S&P 500 has traded in a 100 point range from roughly 1260 to 1360 all year, and it's hard to see a major breakout or breakdown on the horizon. Bulls point to record corporate earnings, strong retail sales, a drop in the price of oil, and historically low interest rates as reasons to expect strong performance from stocks in the coming months. Bears, on the other hand, note that we have had 14 consecutive weeks of jobless claims above the critical 400,000 level, housing continues to be very weak, corporate insiders are selling shares at a rapid clip and far outpace corporate insider buyers, and economic growth has slowed sharply. Factually, both camps are right, and the market reflects this trendless, back and forth tug-of-war between bulls and bears. This seems logical given the mixed data, and we will likely need a definitive move in employment in one direction or another to break out of this range. Add politicians to the mix, however, and markets can quickly become irrational (as noted above). One can only hope that their involvement will be short lived.

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What's Your View?

Please contact us with comments, questions, concerns and any general feedback.

Asheville, NC office:

828-274-1542

John Kuhns
Garst Reese, CFA
John Rhodin, CFA, CFP®, CIC
Jon Vannice, CTFA, CFP®
David Whilden

Hilton Head Island, SC office:

843-342-8800

Tommy Arnold, CFA, CIC
Martha Anne McDonald, CPA
Jason Allen, CFA
Heidi Yoshida, CFP®