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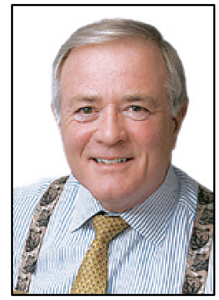

William Rutherford

Just when we thought it was safe to go out in the woods...

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Recent indicators show the world economy is strong. The U.S. Institute for Supply Management index just hit a seven-year high. Aided by U.S. workers dropping out of the workforce, according to government numbers, U.S. unemployment dropped to below 9 percent as about 225,000 jobs were added in the private, nonfarm sector. German unemployment reached a new post-reunification low. Swedish gross domestic product growth hit 7.3 percent in the fourth quarter, and China is working to throttle back its growth.

Companies are sitting on huge amounts of cash. Merger and acquisition activity has picked up, as have initial public offerings. Growth seemingly has returned.

But just when the outlook is starting to look brighter, storm clouds gather on the horizon. Uprisings in the Middle East have added uncertainty to the strength of the recovery. Certainly tyrants in power for decades felt the sting, but so did oil markets. And what about U.S. foreign policy? Is the U.S. a net winner or loser? What are the economic effects?

Politically, we should be concerned about our feeble response to the various crises. Our policy seems to be to take a passive position and let events unfold. President Obama may occasionally comment that some person should go, but it is hard to see that we had much impact on events.

In spite of our passivity, Egyptians seemed to be very angry with the U.S. Bahrain, meanwhile, seems to be angry with the U.S. because of its passivity. And is the House of Saud immune from the kind of unrest that is spreading in the Middle East? And what about our strong men in Iraq and Afghanistan? Don't the uprisings raise the stakes as to whether we back these fellows?

It is not at all clear that we have a point of view on Libya, even though Obama has called for Moammar Gaddafi to leave. A call to leave seems a bit callow when the person has armed himself with artillery and planes he is willing to use against his own population. True, the Libyan people have asked us to stay out; but that might change with Gaddafi leveling artillery on largely defenseless civilians.

Yes, we have promised humanitarian aid, but could we not find bases where Libyan pilots who want to defect can fly their planes with impunity? Perhaps we wouldn't need a no-fly zone if the Libyan air force flew away. No doubt there are other initiatives that we could take, but it appears that we are just waiting to let events unfold as though we don't really mean that Gaddafi must go.

These political events have strongly affected the price of oil, which has surpassed $100 per barrel. Since the first Arab embargo of oil in 1973, there have been five oil shocks; each was followed by a global recession. A further rise in the price of oil may lead to another financial crisis, and governments are much more vulnerable today than in the past. With all the turmoil in the Middle East, oil prices seem unlikely to decline.

With the prices of commodities, from metals to food, hitting new highs, we see further inflationary pressure. That has given rise to fear that the Federal Reserve is too lax in its money supply and interest rates, and cannot respond to higher prices. Several entities, notably the U.K. and the

European Central Bank, either have given notice that they will raise interest rates or have raised them already, but the Federal Reserve has taken a steadfast, low-interest rate approach.

With record government spending and deficits, and a persistently weak economy, the Fed path is pretty much set for it. Furthermore, a weaker U.S. dollar has had the benefit of stimulating the U.S. manufacturing sector, and making our massive debt easier to repay. Nevertheless, we are in troubled waters, and a steady hand at the tiller will be needed to see us through.

For the moment at least, equities are apparently better than bonds. Indeed, large amounts of cash are leaving bond funds for equity funds, buoying the price of equities. The talk of municipal bond defaults appears overblown. Mark Zandi, chief economist for Moody's analytics, said recently that the risk of a round of municipal bond defaults is "close to zero."

Zandi went on to predict that the U.S. will add about 1.25 million private industry jobs in the next year, and that unemployment would fall to about 8 percent by the end of 2012. He further said that state and local governments will fire approximately 250,000 employees in the next year.

So, in summary, the growth story is still intact for the moment. The world economy is growing, but faces huge challenges. Careful asset allocation and stock selection are paramount. Inflation is a risk, so one needs to be wary of a downturn in the economy still trying to grow. It is a challenging time.

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