# MARKET WARNING

## Citigroup's William Rhodes predicts a material correction in the next year



**FINANCIAL TIMES** THURSDAY MARCH 29 2007

**WILLIAM RHODES**

# A market correction is coming, this time for real

The recent market turmoil should not have been unexpected. We are living in an increasingly interdependent world. Times have been good, even with the volatility of the past few weeks sparked by the Shanghai market and then fuelled by the subprime sector in the US. We have been living in extraordinary times in a global "Goldilocks" economy – not too hot, not too cold. The macro-economy still looks pretty good but the shaking of the trees over the past few weeks has, it is to be hoped, awakened investors and lenders to the risks in the marketplace.

High growth in emerging markets continues, as exemplified by the tremendous growth in China and India. Western and eastern Europe are growing. The Russian economy, driven by energy, has been strengthened well beyond what was expected a few years ago. The Middle Eastern oil-exporting countries are going through a boom fuelled by oil and gas: it is different from earlier periods of high oil prices because this time a substantial amount of the money is staying in the region, rather than being invested elsewhere as in the 1970s.

Africa is in many ways going through something of an economic renaissance. The Japanese economy also has improved and the US locomotive has continued, maintaining good growth of more than 3 per cent in 2006 notwithstanding the downward revision of fourth-quarter growth from 3.5 to 2.2 per cent.

However, much of the good news has come as a result of extraordinary levels of liquidity pouring into opportunities around the globe. To a large extent this is due to the Federal Reserve's expansionary monetary policies early in the decade and the US administration's fiscal stimulus. The yen carry trade has also facilitated the buoyant expansion of investments and leverage evident everywhere today. The low spreads, the tremendous build-up of liquidity, the reach for yield and the lack of differentiation among borrowers have stimulated both dynamic growth and some real concerns.

Periods of economic expansion tend to last between five and seven years. We are entering the sixth year of expansion in the US

Pockets of excess are becoming harder to ignore. Problems in the housing and mortgage area such as the subprime sector in the US are one such example of excess that should come as no surprise. As lenders and investors inevitably become more discriminating, liquidity will recede and a number of problems will surface. Too many countries and companies with vastly different risk profiles are still commanding similar pricing.

It has been my experience that periods of economic expansion tend to last between five and seven years. We are entering the sixth year of expansion in the US. Against that background, I believe that over the next 12 months a market correction will occur and this time it will be a real correction. I said as much last spring during the Inter-American Development Bank meetings in Belo Horizonte, Brazil. Soon afterwards, in May 2006, the markets did experience a correction but it was so mild and short-lived that it was in a way less effective than no correction at all. I say that because it left the inexperienced with the impression that it would be smooth sailing from there on.

Market developments in the past few weeks should be seen as a warning. What has been evident for a number of months is that, in the US, we are seeing lagging inflation and slower growth. Whether this means that we are going to have to fend off recessionary tendencies is not yet clear. However, what is clear to me is that in the next year a material correction in the markets will occur.

During the last big adjustment that started in July 1997 in Thailand and spread to a number of Asian economies including South Korea, followed by Russia in 1998 – and led ultimately to the bail-out of Long Term Capital Management, the US hedge fund – a number of today's large market operators were not yet in the mix.

Today, hedge funds, private equity and those involved in credit derivatives play important, and as yet largely untested, roles. The primary worry of many who make or regulate the market is not inflation or growth or interest rates, but instead the coming adjustment and the possible destabilising effect these new players could have on the functioning of international markets as liquidity recedes. It is also possible that they could provide relief for markets that face shortages of liquidity.

Either way, this clearly is the time to exercise greater prudence in lending and in investing and to resist any temptation to relax standards.

*The writer is senior vice-chairman of Citigroup, and chairman, president and chief executive of Citibank*