



MERK®

NOTES ON THE MARKET

October 14, 2008

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US Plan To Rescue Banking System

The combined weight of the US government stepped forward to provide a backstop to the domestic system of finance through the deployment of \$250bln in capital to banks. Nine major banks will receive \$125bln in capital and the remaining quantity of funds will be dispersed throughout the financial system as needed. In addition, the Federal Deposit Insurance Corporation will temporarily guarantee most new debt issued by insured banks and expand its insurance to cover all funds held in non-interest bearing accounts.

The steps taken today in conjunction with those announced over the weekend in the European Union should facilitate the restoration of sanity to the interbank markets and an orderly process of deleveraging in global markets. The decisive move away from the focus on the purchase of illiquid mortgage assets and focus on the recapitalization of the banking system is one that our Chief Investment Officer Axel Merk, proposed [see here](#) well before it became fashionable. His call for a recapitalization of the banks was one of the earliest from the financial community and we are confident that the steps taken today will bring the recent intensification of the credit crisis to a close.

We expect in the over the next few days that our preferred metrics for assessing the interbank (Libor fixings and Libor-OIS spread) will improve and the issuance of commercial paper will begin to see positive movement. Should confidence return to foreign exchange markets and risk aversion erode, the carry trade could begin to gain traction.

The rescue plan provides a five percent return for the public during the first five years and a 9% thereafter, with the companies retaining the ability to purchase back the equity at par after three years. Hopefully, this will assuage the non-insubstantial reluctance of the public to support much of what the federal government plans to do. Perhaps more importantly, the plan untied the Gordian knot at the heart of much of the recent problems in financial markets; that of shareholder equity. The injection of capital into the banking system, without wiping out current shareholders, as had been seen in the Fannie Mae and Freddie Mac debacle, will prevent the cascade of potential collapses of major financial institutions that could have occurred had the backstop not been provided.

The measures taken by the administration, while wide ranging is not comprehensive. The problems with unwinding the credit default swaps market and the issues with mark-to-market accounting have yet to be resolved. The international cooperation that brought the current crisis to an end cannot be ad-hoc. The suspension of mark-to-market rules by the EU stand in contrast with those in the US and the problems with clearing the market for credit default swaps have yet to be resolved. There is much ground still to be cultivated to create the conditions under which a meaningful recovery can begin.



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It is our preference that what comes from all of this is not simply the avoidance of a systemic global meltdown. Reformation of global accounting standards and rebuilding of the international financial architecture should be given primacy at the top of the agenda of the both the financial community. The likely onset of a global recession and what will be a long and painful period of adjustment in the United States should create the conditions under which these long sought after goals can be obtained. Hopefully, political actors during what will be an economically difficult time, will refrain from beggar thy neighbor policies and not put in place barriers to trade and other protectionist measures that will only prolong what will be a very difficult period of recovery.