

A lull in the current severe markets storm or the beginning of the storm's end?

- **Some confidence returns in authorities' ability to stabilise the financial system**
- **Capital injections are likely to support the stability of the UK banks for depositors says Newton**
- **The rules of banking in the UK have changed dramatically: in the future it will be a lower return, tightly regulated business**
- **Newton remains cautious on UK bank stocks**

Marking what could be either be a lull in the current severe markets storm or the beginning of the storm's end, UK, European and US markets reacted positively to this morning's announcement of the details of the UK government's re-capitalisation of the banking system. The UK Treasury announced that it would be making equity (including preference share) investments totalling £37 billion in Royal Bank of Scotland and, once they have merged, in HBOS and Lloyds TSB. By market close, the FTSE 100 was up by 8.3 %.

Peter Hensman, Chief Strategist at Newton Investment Management comments that "the Royal Bank of Scotland, HBOS and Lloyds TSB have agreed to accept £37 billion of taxpayer funding to boost their capital positions. Barclays hopes to be able to raise funds in public markets in order to improve its capital base. While the UK government plan to recapitalise the banks, ease access to funding and guarantee interbank lending is radical and follows the prescription laid down by the Swedish model following the intervention by the authorities there in 1992, last week showed that actions taken by the authorities in any one country to stem what is clearly a system wide financial crisis are likely to prove insufficient to ease market conditions. Despite the rally in equity markets this morning, LIBOR spreads narrowed only marginally at the official pricing, the dollar remains relatively robust and real yields on government bonds are rising sharply. All of this suggests that the shortage of cash remains.

While it can be argued that the capital injections are likely to support the stability of the UK banks for depositors and should go at least some way to improving the availability of money to the economy, they do little to improve the attractions of an equity investment in the UK bank sector – not that the banks managed to do a very good job of risk management in the past decade. The outlook for a subdued growth backdrop is not changed by the recapitalisation of the UK banks, and investment opportunities are likely to be best in stable growth companies that have strong, internally generated cashflows and little reliance on debt market financing."

Markets across Europe were also strongly up, led by the region's leading banks with UBS, Credit Suisse, Commerzbank and Deutsche Bank all rallying by between 10% and 20%; the FTSE Eurofirst 300 Index was 8.7% higher. European governments and central banks had also announced on Monday morning detailed plans to mount a rescue of the eurozone's financial system and its main central banks promised unlimited dollar funding in co-ordination with the US Federal Reserve. The New York market followed the European mood and the Dow Jones Industrial Average rose. The US market was also cheered by Treasury Secretary Henry Paulson's declaration that that Washington was also developing plans to buy equity in financial institutions, following the UK and European bail-out plans.

Simon Pryke, Director of Investment Management – Global Research at Newton, comments that "after the G7 and EU leaders meetings at the weekend a more co-ordinated approach to stabilising the banking system is emerging. Governments around the world are moving to guarantee bank funding (including deposits), and accepting the

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need for the state to inject capital into major banks, so adopting an approach similar to that of the UK government. We are reasonably optimistic that these moves should improve confidence, encouraging banks to start lending to each other, and to their customers. It is not particularly good news for bank share prices, however. Governments are demanding a hefty price for their support. In the UK, HBOS, Royal Bank of Scotland and Lloyds TSB are having huge equity share issues underwritten by the government: it is likely to become the major shareholder in all three. Dividends are being scrapped and board remuneration curbed, while the government will influence lending policy. The rules of banking in the UK have changed dramatically: in the future it will be a lower return, tightly regulated business. We remain cautious on UK bank stocks."

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