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The Short View

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It looks as if the equity markets have designed a better liquidity trap - and US mortgage agencies are trapped.

In a traditional liquidity trap, associated with Keynes, low interest rates cause the problem. Once rates have fallen too far, it is impossible to stimulate activity by cutting further. There is no incentive to invest in assets that might grow, so investors pile into cash, even though this pays low rates.

Arguably, the world fell into this trap during the Depression, while Japan did so in the 1990s.

Now try the same trick with equity markets. Financial services groups need to raise capital to repair the damage they sustained in the credit crisis. Rather than borrowing, they need to raise equity.

Everyone knows this. That causes share prices to go down. These price falls make it harder for financials to raise the money from the stock market.

The logical response of equity investors is to sell financials' stock (or sell it short). That exacerbates the problem. Financials are very cheap - many banks, including the mortgage agency Freddie Mac, are trading at dividend yields of more than 10 per cent - but no one wants to buy them.

Such valuations imply certainty that dividends will be cut, and also some real risk that the institutions could go under.

But even Freddie and Fannie Mae, the other US mortgage agency, are trading at less than half their book value. They have an implicit governmental guarantee, and could not be allowed to go bust.

But equity holders cannot expect a bail-out. Hence the negative spiral that saw Freddie's shares, down more than 75 per cent for the year, fall 30 per cent early yesterday.

What would rescue them? Some capital, from somewhere, for the banks, or some new reason for confidence. Otherwise, financials seem trapped by the stock market.

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