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MARKETS | HEARD ON THE STREET

The Market Gets Caught in a Squeeze Play

Rising interest rates overseas and new money-market regulations could put bond investors in difficult straits

The U.S. Treasury building in Washington *PHOTO: ASSOCIATED PRESS*

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Eight years after the demise of Lehman Brothers, a long-delayed crisis-era regulation could roil markets at a time when volatility is already rising.

Recent market action has been centered on a selloff in long-term government-bonds in the world's major economies. The selling, which began in Europe and Japan, hit the U.S. bond market, sending yields on Treasurys higher.

The major force behind that selling is worries that both the Bank of Japan and European Central Bank will shift their asset purchases away from long-term bonds. But a rise in the cost of hedging currencies for overseas investors looking to pick up extra yield in the U.S. also has been a factor. And it looks likely to grow more pronounced in the weeks ahead.

The higher costs of the hedges comes not from decisions by central banks but from long-delayed rules stemming from the financial crisis. After Lehman collapsed, one of the biggest shocks to the system was the collapse of a money-market mutual fund that had invested in Lehman debt. So to prevent that from happening again, starting Oct. 14 so-called prime money-market funds, which invest in corporate paper and other short-term debt, will be able to impose redemption fees, or halt redemptions altogether, during times of stress.

But that makes money in prime funds seem less safe for investors who previously treated them like bank accounts. So investors have been pulling out, and prime funds have been shifting more of their holdings into highly liquid assets like cash and short-term Treasurys. As result, demand for other types of short-term debt has fallen, pushing rates higher. The London interbank offered rate, for example, has risen sharply. And the borrowing costs associated with currency hedges have risen.

Some industry observers think the squeeze could get more intense as the rule change approaches. So foreigners, facing high hedging costs, could be less enamored with U.S. Treasurys. That could push yields higher, and roil the stock market.

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With both the Federal Reserve and the Bank of Japan meeting this week, the timing couldn't be worse.

The Fed isn't likely to move on rates, but if it sends a strong signal that it expects to raise rates later this year, it could add pressure to markets. The main event will be Japan, where the BOJ has said the meeting will entail a "comprehensive assessment" of its stimulus measures.

One move the BOJ might make is to redirect more of its purchases toward shorter-term government bonds while reducing longer-term bond purchases. The idea is that the stimulative effects of lower short-term rates are more pronounced, and that higher bond yields at the long end would help out struggling pension funds and other income-driven investors. That would also diminish their appetite for higher-yielding long-term Treasurys.

Looking ahead, the ECB, which helped kick off the Treasury selloff earlier this month when it didn't give the stimulus signal investors were looking for, may also adopt measures that would allow it to refocus its purchases on shorter-term bonds.

The collision of the new money market rules with the rising risks to long-term rates from overseas could make for a classic case of unintended consequences and bad timing for regulations. If markets get wrongfooted by a rise in long-term Treasury yields that has little to do with what's going on with the U.S. economy, you can imagine all kinds of adverse feedback loops.

At the least, investors should be ready for what could be a rocky few weeks.