When interest rates go up, bond prices go down… until they mature!

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Let's look at what happens to bond prices when interest rates go up. Imagine if a company issued a seven-year bond paying 4%. The bond would be issued at par, its original value, or $100, and the interest it pays is 4%, or $4 per year on a $100 investment.

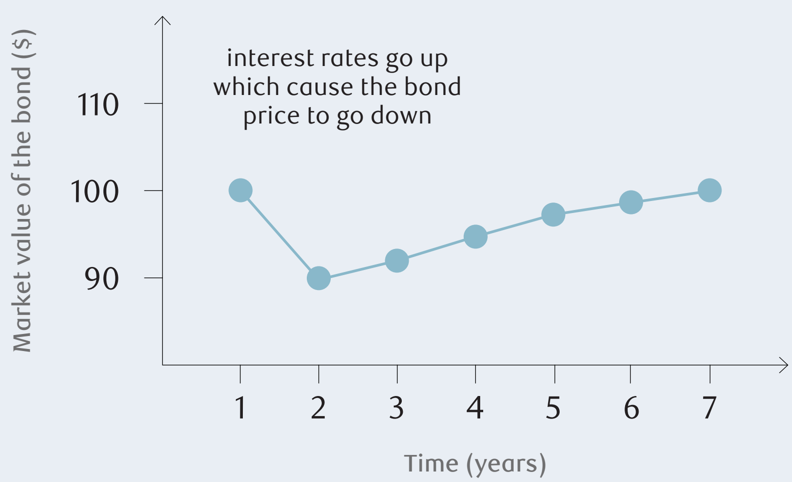
Assuming simple interest, the bondholder would receive $4 per year for the seven-year holding period, for a total of $28 on the $100 investment. When the bond matures in seven years, the principal, or $100, would be returned to the bondholder.

Here's what can happen to the bond in between the date the bond is issued and the date it matures.

If interest rates go up, the value or price of the bond goes down. Let's assume that in the second year of owning the bond, interest rates go up so much that the price of our bond went from $100 to $90.

On our statement, we would see that the market value of our fixed income investment has dropped 10% from $100 to $90. We would still be collecting our $4 per year, which is a small consolation to us. The key here is to remember that our bond will mature at par or $100. In other words, as long as the issuer is still in existence when the term of the bond is up, we will get back our initial $100.

Chart 1: **Market value of our bond example over the course of the seven-year holding period**



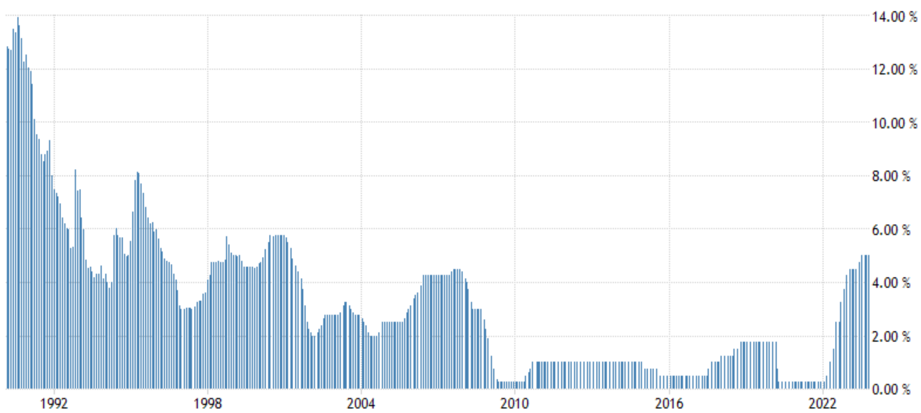
The end result of this example is that we collected our $4 per year or $28 over the seven-year time frame, and we got back our original $100 investment. We can see that focusing on the interest coming in, and knowing that the bond will mature at our original investment is important. The current market value of the bond is not very meaningful since we had no intention of selling it. Our plan was to hold it until maturity.

In 2023, the Bank of Canada raised interest rates to 5%, which is the highest interest rate we have seen in Canada in 22 years. All that to say, interest rates have gone up very fast since 2021 and, as a result, the market value of fixed income assets has gone down.

Now that we know how bonds work, we appreciate that, over time, the market value of fixed-income assets will recover as bonds inch closer and closer to their maturity dates. All the while, interest will continue to be collected by the holder of the fixed income assets.

As mentioned earlier, if the plan was to hold the fixed income asset until maturity, the current market value is not very meaningful, and one's focus should be on the interest coming in and the original investment, which will be collected on the date of maturity.

Chart 2: **Bank of Canada overnight interest rate since 1989**



Source: tradingeconomics.com | Bank of Canada

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