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Sərbəst işin adı: How rising Interest Rates and Inflation affect Bonds?

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**How rising Interest Rates and Inflation affect Bonds?**

*Interest Rates And Bond Values*

As interest rates rise, the value of existing bonds go down. That's counterintuitive for some. A simple example will clarify the situation.

Imagine you invest $10,000 in a 10-year bond that pays 2%. Now imagine rates on 10-year bonds jump to 3%, and you want to sell your investment. Could you sell your bond at its $10,000 face value? Absolutely not. Why would an investor pay face value for your bond when he could invest $10,000 in a new 10-year bond and earn 3%? Instead, the bond's value will go down to offset its lower interest rate.

One could of course choose not to sell the bond, but the loss is just as real. If an investor holds on to the bond, he earns interest at a below market rate of 2% in our example. It may not feel like a loss, but it's a loss.

In these circumstances, an investor wants the return of her money as quickly as possible so that it can be reinvested at the higher 3% rate. At first glance it may appear she needs to wait ten years when the bond matures. In reality, however, she'll start to see the return of a small portion of the money with the first interest payment.

These interest payments can be reinvested immediately. And that brings us to a concept called duration.

*What Are the Effects of Inflation on the Bonds?*

The bond market builds expectations on inflation into their pricing models, and in general, bonds are priced to offer at least some real return on top of the projected inflation rate. Therefore, when inflation levels rise in a sustained manner, bond investors will demand a higher interest rate from the bonds they purchase in order to maintain a margin that will allow them to see their assets rise in purchasing power over time.

This has a couple of impacts. First, for existing bonds, higher prevailing interest rates in the bond market reduce the value of existing bonds that carry lower rates. Secondly, when issuers come to market to offer new bonds, they have to pay more in interest in order to find investors willing to lend to them. This combination is generally unattractive, and it explains why central banks are typically reluctant to let inflation send prices higher unchecked.

*Second-order impacts*

In addition to the immediate impact on interest rates, inflation also tends to lead to reduced bond issuance, restricting the amount of capital available to businesses and putting a drag on economic growth. For instance, in recent years, interest rates have been at rock-bottom levels, and hundreds of companies have taken advantage by locking in low financing costs through issuing longer-term bonds than they might otherwise have typically done. Conversely, higher interest rates from inflation make it more expensive for businesses to borrow.

Finally, high inflation levels spur interest in inflation-indexed bonds. These specialty bonds base their payments not on a fixed face value but rather on a maturity value that rises or falls depending on a particular inflation gauge. The size of the inflation-indexed bond market is tiny compared to that of traditional bonds, but when nominal rates are high, indexing bonds to inflation looks more attractive to borrowers.

Bond investors typically don't like inflation, because the disruptions inflation causes are harmful to the value of the stream of payments that traditional bonds make. Nevertheless, inflation is a constant threat, so knowing how to handle it is crucial in order to be successful with your bond investing.