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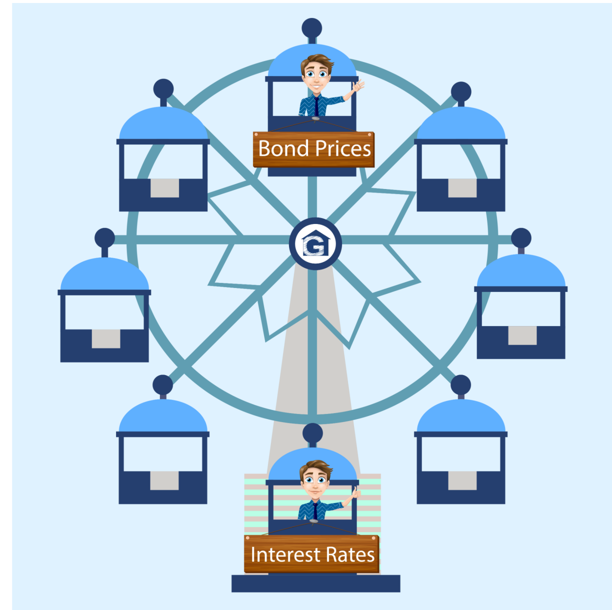
What are interest rates?



Interest rates are the amount that a lender charges someone to use their asset. An asset could be money, vehicles, houses or consumer goods. Interest Rate risk is the potential to lose some of your investment due to a change in interest rates.

Interest rates and bond prices ride the Ferris wheel on opposite sides of the ride because they are inversely proportional to each other.

But what does Inversely proportional mean?

Inversely Proportional means that if one moves up, the other must go down. If rates increase, prices must decrease and vice versa. Hence, if one Ferris wheel bucket goes to the top, the other is at the bottom.

Interest rates are usually set by a country's central bank. They set the rates to influence the cost of borrowing money, savings rates, inflation, and economic growth. A small change in interest rates can dramatically affect many different aspects of the economy.

Due to Covid, the Canadian government has lowered interest rates in order to keep money circulating in the economy and to encourage spending. This is one of the attributing factors to the inflation that you are seeing recently.

Just look at the current price of plywood. This time last year you could buy a sheet for $12, today it's $56! Or take house prices for example. In 2019 an average house in Grey Bruce, Ontario was $392,508, today the average is $613,678!

What is a bond?

A bond is a loan given by a company or a government as an agreement to borrow a certain amount of money today from someone with the promise that in the future they will repay back the initial amount plus interest.

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There are many different types of bonds:

Government Bonds: These are issued by all levels of government, municipal, provincial, and federal. They offer relatively low interest rates as they are backed by Canada. Meaning, the only way that you do not receive your money back is if the government collapses and goes bankrupt.

Corporate Bonds: These are issued by a company. They are much riskier than government bonds as the odds of the company filing for bankruptcy is much higher. Companies need to raise money in order to buy new equipment, take on new projects or build new facilities so they sell bonds to investors as a promise to make more money from you investing in them.

High Yield Bonds: These can also be called junk bonds. They are typically corporate bonds that are the most riskiest and have the highest chance of bankruptcy. Due to the high risk, they must offer a very high reward otherwise no one would want to purchase them. They do offer a chance to make it rich quick, however they can also have the opposite effect.

Pros	Cons
● Have a fixed return - you will know exactly how much you'll earn by holding the bond to maturity.	● Have a fixed return - it cannot grow beyond this amount. You lose out if another investment had a higher yield.
● Low volatility - stocks prices move every nanosecond whereas bonds are fairly stable and predictable.	● Less liquidity - Liquidity is the ability to convert your investment to cash quickly. Bonds are harder to sell and usually have to be invested for a few years.
● Bonds have a credit rating - unlike stocks, bonds are given a rating of their level of risk.	● Interest Rate Exposure - interest rates affect bonds more directly than stock prices, which can cause the value of your bond to rise or fall.
● Less risk than stocks - They offer a more stable income stream. They also get paid out before stockholders if a company files for bankruptcy.	