Relationship between price of a bond and the prevailing interest rate
The price of a bond is inversely proportional to the rate of interest in the economy.

Making an investment in bonds can be quite a daunting process that not many investors opt for. That is so because it requires some amount of knowledge on how the economy works, so that one can decipher the effect of various factors on bond prices.

For instance, the prevailing rate of interest has a deep impact on the price movements of bonds. Usually, an inverse relationship can be traced between the two. This means that the value of a bond goes up when the interest rate goes down and vice versa.

How does it work?
It is important to note that if you hold the bond until maturity, you are entitled to receive the face value of the bond, irrespective of the prevailing interest rate. The change in interest rate affects the price of your bond only if you decide to sell it in the secondary market before maturity.

Let us understand this with the help of an example. Say you buy a bond with face value of Rs 10,000 with a coupon rate of 10 percent and maturity of eight years. This means you should get Rs 1,000 as interest every year, and Rs 10,000 on maturity.

However, if the prevailing interest rate increases after four years of investment, then new bonds issued by same company would offer a higher rate of return, say for instance 12 percent. If you decide to sell your bond (that offers 10 percent interest) in the secondary market at this point of time, not many investors would be interested in buying it, since they would prefer newly-issued bonds at 12 percent.

If you still want to sell your holdings, you would have to sell them at a price below the face value in order to attract buyers, effectively reducing their price.

The value of a bond hence decreases if the interest rate increases and vice versa.