Usually, when it?s a good time to own high quality intermediate term bonds ? those that serve as workhorses of most investors? portfolios, it?s a bad time to own *"high yield" (*a nice marketing term for *?junk?)* bonds, and *vice versa*. That?s because lower interest rates provide a good climate for relatively safe bonds that don?t deliver much yield, and because the economic weakness that low rates signal is often a danger to shaky borrowers. Conversely, the rising rates that can inflict duration-related damage to safer, lower yielding bonds usually coincide with a robust economy that?s good for junk bonds. So it?s not often that the climate is good or bad for both high-quality intermediate term bonds and high yielding junk bonds. But, in a note to its investors, the Los Angeles-based value investment firm FPA Funds has just argued that the current environment is bad for both the typical portfolio bond workhorses and more exotic high yielding fare. First, there is a disagreement between the yield curve and the implied inflation that the 10-Year TIPS bond is signaling. The yield curve is flat, implying that investors anticipate deflation. After all, the only reason an investor in longer term bonds would accept a marginally higher yield over a shorter term bond is if the investor anticipates deflation and lower rates in the future. However, that seems unlikely to FPA New Income Fund (FPNIX) portfolio managers Thomas Atteberry and Abhijeet Patwardhan and FPA product specialist Ryan Leggio, since the difference in yield between the 10-year TIPS bond and the 10-Year Treasury is around 2 percentage points now, indicating an anticipation of 2% inflation. But if inflation ? or at least some tepid alternative to deflation ? is on the horizon, doesn?t that mean that it?s a good environment for junk bonds? Not so fast say Atteberry, Patwardhan, and Leggio. The high yield "spread" ? the difference in yield between high yielding corporate bonds and Treasuries ? is very low. That means investors aren?t getting paid much to take the credit risk of owning high yield bonds. That?s especially true since leverage is high among corporate borrowers and covenant quality levels are low. A covenant is a legally binding agreement between borrowers and lenders designed to protect the interests of both parties. Low covenant quality means borrowers don?t have to meet specific requirements. The authors note that *?this is only the third time in the past twenty years when the yield curve has been this flat while at the same time high yield spreads have been this tight.?* The upshot of their analysis is that it?s a good time for bond investors to reduce both credit and duration risks. The FPA New Income fund, accordingly, has a short duration, and is reducing credit risk. The fund is avoiding unsecured corporate bonds, and favors secured bonds, for example. It has around 8% of its portfolio in corporate bonds overall compared to 31% and 39%, respectively for funds in the Morningstar Intermediate-Term •Bond and Short-Term Bond Fund categories. As an alternative the fund prefers highly rated asset-backed securities which absorb 57% of its assets. Altogether, 71% of the fund's assets are in AAA-rated securities. FPA New Income has always been a *"belt-and-suspenders"* bond fund from the time legendary investor Bob Rodriguez ran it. It's managers dislike posting negative return numbers. This has caused them to miss some rallies in bonds. For example, the fund has posted a 2.04% annualized return for the past decade ending in February 2018, while the Bloomberg Barclays US Aggregate Index has delivered a 3.60% annualized return over that time. But the fund's willingness to "shoot only in a target rich environment" also means it has kept investors safe since 1984, including a 4.31% return during the financial crisis year of 2008 when so many bond funds missed the credit problems of their holdings and faltered as a result. Also, besides never posting a negative return in a calendar year since inception, over the 30 year period ending in February 2018, the fund achieved a 5.85% annualized return versus the 6.13% annualized return of the index. Ten years is a long time, but it's worth considering whether the fund's underperformance over the last decade indicates more alarming things about the prevailing credit and interest rate conditions than about its approach.