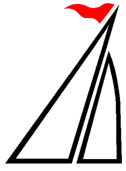

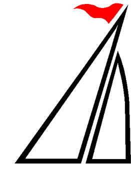

WINDWARD CAPITAL

Risk Averse Asset Management

2021 First Quarter Review

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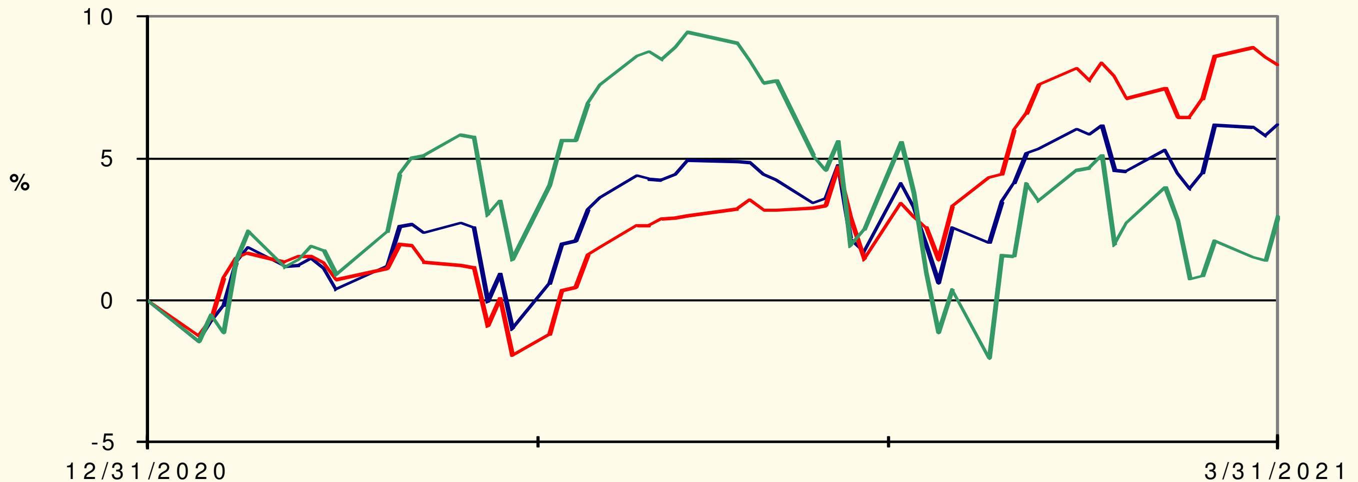

Roaring '20s

"Gatsby believed in the green light, the orgastic future that year by year recedes before us. It eluded us then, but that's no matter—tomorrow we will run faster, stretch out our arms farther. . . . And then one fine morning—"

—Nick Carraway in *The Great Gatsby* (1925)
by F. Scott Fitzgerald (1896 – 1940)

The major U.S. equity market indices reached new, historic highs during the First Quarter of 2021, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returning +6.17%, +8.29%, and +2.96%, respectively, for the period.

These ongoing positive financial market trends appear to be primarily related to optimism regarding the future outlook for the U.S. economy—especially given the accelerating rollout of several effective coronavirus vaccines and the concomitant decline in cases. In addition, the bullish sentiment among investors continues to be predicated upon strong monetary and fiscal policy support amid significant uncertainties regarding the extent and speed of the overall global macroeconomic recovery.

Although the recent overall trend in new coronavirus cases has declined and appears to have stabilized at a lower level than the late-2020/early-2021 peak, several geographic regions are continuing to experience upticks. This worrisome development suggests that some combination of either a failure to follow mitigation protocols, increased spread of more easily trans-

missible variants, or lack of adequate vaccination is to blame. Globally, there continue to be issues associated with limited vaccine supplies, logistical distribution, administration, and inoculation—as well as issues dealing with behavioral reluctance on the part of some to take the vaccine. However, we believe that these challenges will ultimately be met successfully in the coming months and that prevalence of the virus should decline sharply into the Summer. Although the depth and duration of the pandemic's impact on the world economy may differ on a country-by-country basis, we remain confident that global health authorities will eventually succeed in controlling the spread of the coronavirus—especially now that effective vaccines have been developed and are in the process of being distributed.

As we have discussed previously, the economic effect of the coronavirus pandemic was different from that of previous financial crises: this was, at its essence, a health crisis, not a credit crisis or burst asset bubble. The recent global macroeconomic downturn was not due to an endogenous event: this was an exogenous shock that resulted in a conscious effort on the part of governmental authorities to artificially freeze parts of the economy as a medical intervention in order to slow down the spread of the coronavirus. That strategy should be viewed positively because responsive and appropriate monetary and fiscal policies alleviated the negative economic side effects of this "treatment" until health authorities were successful in their coronavirus mitigation efforts.

Predictably, some of the factors providing underlying support to the U.S. economy have also had the unintended consequence of creating speculative excesses in specific areas of the financial markets. Recent examples include trading activity in near-bankrupt companies, microcaps, penny stocks, cryptocurrencies, non-fungible tokens (NFTs), special purpose acquisition companies (SPACs), and thematic ETFs, among other financial instruments. Liquidity effects, excessive leverage, and momentum "investing" have combined with high-frequency trading, algorithms, the pervasive use of ETFs, and a variety of social media-driven commission-free retail trading platforms to exacerbate this trend. In addition, economic sectors with generally-suspect long-term business fundamentals (e.g., Energy, Materials, and Financials) have traded significantly higher based upon an unwinding (via higher yields) of the extraordinary bond market rally of mid-2020, projections of substantive and sustained inflation, and expectations regarding a renewed commodity supercycle.

The ultimate unwinding of these speculative excesses and rotational sector moves may result in increased volatility and, potentially, a near-term market correction. We do not believe, however, that these factors represent a systemic risk to the overall financial markets. In addition, we believe that the risk associated with any resultant financial market volatility is mitigated in *Windward* portfolios—especially over the long run—to a large degree by the fact that we are invested in "high quality," dominant, financially-strong, leading companies with best-in-class managements, high incremental returns on invested capital, and business models with sustainable competitive advantages.

Historically, periods of excessive ex-ante savings, combined with demand that is too weak to justify investment, cause certain areas of the financial markets to become driven by the speculative rearranging of portfolios rather than by the underlying business fundamentals (like return on capital investment). We are not "traders;" we are investors. Also, we do not subscribe to the current assumptions being made by financial market participants regarding the outlook for inflation or a commodity supercycle. As a result, our strategies may underperform relative to the market indices over the short term given the degree to which other market participants make ungrounded assumptions and/or high-frequency trading and algorithmic "investment" strategies engage in daily speculative financial market trading. We believe, however, that we will continue to be successful in making profitable long-term investments for *Windward*'s portfolio strategies.

As you know, *Windward*'s goal is to protect our clients' capital and mitigate market-related risks by investing in specific, high-quality businesses that have long-term, secular growth opportunities. Indeed, we prefer to take a proactive approach to managing risk by investing in specific companies that are taking advantage of the changes in their operating environment to create long-

run opportunities for their businesses. Our long-term performance results demonstrate the success of this disciplined investment approach.

As always, we continue to monitor domestic and international political and economic developments as they unfold. As a result, from our long-term perspective, ongoing equity market volatility continues to revolve around numerous global macroeconomic and geopolitical risks that we have elucidated upon in the past. We closely monitor these, as well as other, risks when managing *Windward*'s portfolios of investments. Since we take a long-term view, we typically do not react to short-term financial market fluctuations driven by near-sighted market participants. However, should there be a change in the global macroeconomic indicators and/or corporate fundamentals that we monitor, we are prepared to take whatever action is necessary to protect our clients' capital.

Let It Rip

After increasing at an annualized rate of +4.3% in the Fourth Quarter of 2020, U.S. Real Gross Domestic Product (GDP) is estimated by the Federal Reserve Bank of Atlanta's GDPNow forecasting model to increase +6.0% in the First Quarter of 2021. For 2021 and 2022, the consensus forecast is for annual growth of at least +5%—a level that exceeds the U.S. economy's approximate +2% secular growth rate. Given the nascent impact of the recently-passed $1.9 trillion American Rescue Plan Act—as well as the residual effects of the fiscal support enacted last year—these estimates could, in fact, prove low.

As a consequence, the near-term corporate revenue and earnings outlook remains positive. For 2021, year-over-year S&P 500 Revenues and Earnings are projected to increase +9.9% and +25.9%, respectively—to levels *higher* than the 2019 pre-pandemic peak (and after declining –0.8% and –11.2%, respectively, during 2020). For 2022, year-over-year S&P 500 Revenues and Earnings are projected to increase an additional +6.8% and +14.4%, respectively.

On March 11, 2021, President Joseph Biden signed the American Rescue Plan Act of 2021 (ARP). (For details regarding the American Rescue Plan Act of 2021, please see the Addendum to this *Quarterly Review*.) This $1.9 trillion COVID-19 relief package is aimed at stabilizing the economy, providing needed relief to individuals and small businesses, and improving and accelerating the administration of coronavirus vaccines and testing. The relief package, which is Biden's first major legislative initiative, is one of the largest in U.S. history and follows on the heels of the Trump Administration's $900 billion COVID-19 relief package enacted in December 2020 (the Consolidated Appropriations Act, 2021 (CAA)) and the $2.2 trillion economic stimulus bill passed by the 116th U.S. Congress and signed into law by former President Donald Trump on March 27, 2020 (the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)).

ARP serves as a complement to those previously-enacted fiscal initiatives and will provide a robust tailwind to the U.S. economy as it recovers from the pandemic. In particular, we expect that the stimulus payments to individuals and their dependents will boost net household savings to record levels and should support a consumer-led economic boom that could be one of the largest in decades. For corporations, this demand-side recovery should also precipitate a resurgence in fixed business investment in software, equipment, and research and development. As a result, we anticipate that the U.S. economy may experience one of the best periods of growth since the mid-1980s—and, quite possibly, since the World War II era began.

As we have discussed with you in previous *Quarterly Reviews*, in 2020 American households saved an extra $1.6 trillion compared to 2019 as a result of government assistance and lower consumer spending during the coronavirus pandemic. When the virus recedes, social distancing comes to an end, and the service sector springs back to life, the labor market should strengthen—perhaps significantly. As the U.S. economy recovers and employment improves, those $1.6 trillion in savings can either be spent or provide a degree of financial comfort that allows for higher spending out

of current wages. The payments from ARP could give an *additional* jump start to the post-pandemic economy and create a virtuous cycle in which consumers spend, companies hire and invest to fulfill that increased demand, and workers end up with additional funds to increase their spending even further. The dynamics of such a cycle are, of course, dependent upon the interplay between the output gap (the difference between where the economy is and where it should be) and the unemployment gap (the difference between current unemployment and the natural rate of unemployment) at any one point in time. At the moment, those gaps remain sizable.

Various measures of financial conditions for businesses are also broadly accommodative relative to historical levels and should remain so over the intermediate term, providing increased confidence and support for an economic recovery:

- ✓ *High-yield corporate bond spreads*
  High-yield credit spreads (the difference in yield between a U.S. Treasury bond and a below-investment grade corporate bond of the same maturity) have moved below trend, signaling increased confidence in an economic recovery and less risk of corporate default among the riskiest of corporate bonds. While the recent backup in interest rates has garnered the attention of investors and policymakers, rates at these levels are merely back to where they were pre-pandemic and are inherently supportive of the corporate sector and economic recovery and expansion.

- ✓ *Municipal bond spreads*
  Muni credit spreads (the difference in yield between a U.S. Treasury bond and a municipal bond of the same maturity) have moved below trend, signaling increased confidence in Federal assistance and the prospect of improved revenues as the pandemic is contained. Given the broad assistance for States and localities in ARP, conditions are favorable for a recovery in State and local finances this year.

- ✓ *Inflation expectations*
  Although significantly higher than last year's pandemic lows, both the 5-year and 10-year breakeven inflation rates (indicators of inflation expectations) are currently stable and remain broadly consistent with the U.S. Federal Reserve's (Fed's) recently-modified long-run average inflation target policy framework. As we discussed with you in detail in our *Windward Capital 2020 Fourth Quarter Review* (to which we refer you for further detail), while near-term inflation readings could exceed +2% (primarily due to year-over-year base effects), we expect these readings to be transitory and currently do not anticipate a permanent increase in the price level nor a change in inflation expectations that results in higher inflation or any significant risk to the economic outlook linked to pricing. The Fed's reaction function, as always, continues to remain data dependent, however.

- ✓ *Fed policy*
  The Fed has consistently lowered its short-term policy rate when a crisis has pushed the economy into recession, and then raised interest rates when sustainable economic growth can support whatever rate of interest is normal for each particular era (the "equilibrium rate of interest"). Currently, we do not anticipate that the Fed will begin to taper its current $120 billion in monthly asset purchases until next year, and the tapering could take the better part of 24 months to complete given the size and scale of Fed monetary accommodation. This supports the Fed's forecast of no increase in the short-term policy rate, which currently stands at 0.00-0.25%, until late 2023 or early 2024. The Fed's ability to guide market sentiment has reduced the volatility of the business cycle in other eras—though, as recent experience has shown, investors will, from time to time, challenge the Fed's intent to follow through on current policy given the rapid improvement in the economic outlook.

- ✓ *Cost of capital*
  Negative (or near-zero) real interest rates create the opportunity to finance support for damaged income streams and to invest in the continued growth of the economy and generate attractive returns. At the current rate of inflation, real U.S. interest rates have now become barely positive after years of being negative. In other words, even with the recent rise in the 10-year Treasury bond yield, on a real basis rates still remain historically low and provide attractive financing for investment in a growing economy. Although the secular global macroeconomic "dearth of demand/surfeit of supply" dynamics that we have discussed with you in the past still apply, the current low cost of capital is not an impediment to business investment decision-making.

Based upon the latest Congressional Budget Office (CBO) estimate, ARP will result in a cumulative increase of $1.92 trillion in Federal debt over a 10-year period. The assumed implications associated with an increase in debt of this magnitude has recently prompted an algorithmic trade to push long-term interest rates and certain economic sectors higher than is warranted by the underlying fundamentals, in our view. As we have discussed with you over the past year, the risk of providing too little fiscal and monetary support during the coronavirus pandemic far outweighs the risk of oversupplying such aid given the potentially severe negative ramifications of this demand shock to the global macroeconomy—especially in an environment in which there was already a pre-existing secular dearth of demand and surfeit of supply dynamic that harbored significant deflationary risks. Although the absolute magnitude of sovereign debt is appreciably higher than before the pandemic, it is important to maintain some perspective regarding the recent rise in interest rates: only now have the increases in long-term (10- and 30-year) U.S. government bond yields approached the lower end of what has been a narrow range in rates that has remained in place for the last 10 years, pre-pandemic. Intermediate (2- and 5-year) U.S. government bond yields, on the other hand, are still at the lowest levels seen since 2011-2013.

Financial markets will tolerate an increase in interest rates if it is moderately-paced, comes early in the economic cycle when there is still slack, accompanies accelerating growth, and is supported by accommodative monetary policy.

While the U.S. economy continues to rebound from the deep contraction of the first half of 2020, a variety of factors will determine its future progress, including: (1) the timing of the full deployment of COVID-19 vaccines and their ongoing effectiveness, (2) the rate of decline in coronavirus cases and the ultimate achievement of herd immunity, (3) the potential waning impact of fiscal and monetary support measures, (4) the status of the labor market recovery and household consumption, and (5) the pace of social mobility and travel, among other issues. We continue to monitor these factors and remain optimistic regarding the outlook.

Infrastructure Weak

The $20 trillion U.S. economy relies on a vast network of infrastructure, from roads and bridges to freight rail and ports, to electrical grids and internet provision. But the systems currently in place were built decades ago, and economists say that low efficiencies and rising maintenance costs are restraining economic potential that upgrades would provide. Civil engineers raise safety concerns as well, warning that many bridges are structurally deficient and that antiquated drinking water and wastewater systems pose risks to public health. Meanwhile, America's international peers enjoy more efficient and reliable services, and the U.S. lags behind other developed countries in infrastructure spending.

The Biden Administration has introduced an 8-year, $2 trillion plan to overhaul and upgrade the nation's infrastructure, calling it "a transformational effort" that could create the "most resilient, innovative economy in the world." Among the initiatives included are $621 billion for roads, bridges, and highways; $480 billion to

facilitate manufacturing growth and research; and $213 billion for housing infrastructure. The remainder would go to projects including productivity-enhancing investment in technological infrastructure and resilient environmental infrastructure, as well as expanding access to home care. The costs of the plan would be offset by increased corporate tax revenues raised over 15 years, particularly from multinationals that earn and book profits overseas. (Specific details regarding proposals in the "American Jobs Plan" can be found on The White House website.)

As investors, we remain politically agnostic in evaluating the economic and corporate impacts of public policy. That is the reason why we would prefer to analyze the actual legislative mandates and policies that are enacted and determine their corporate beneficiaries before considering major changes to the current investments in *Windward*'s portfolio strategies. In our opinion, there currently remains too much uncertainty associated with the legislative success of the American Jobs Plan to be able to confidently make any definitive assertions regarding its long-term impact—either positive or negative—on the geopolitical and global macroeconomic outlook, much less the financial markets. Historically, however, public and private technological innovation has, in concert with free enterprise and market-based economics, driven progress in the U.S. economy.

If ultimately approved, the spending in the Biden plan would end decades of stagnation in U.S. public investment in research and infrastructure—and would return government outlays in those areas, as a share of the economy, to its highest levels since the 1960s. The economics of such a plan are straightforward: a well-designed project that modernizes the national infrastructure results in increased jobs, productivity, and growth—all of which should create a meaningful increase in the U.S. standard of living. From our vantage point, a modern-day effort to improve America's infrastructure—if done correctly—also has the potential to maintain and/or improve upon the country's global strategic competitive advantages while serving to accelerate and transform the U.S. economy to participate more effectively in an increasingly digital future.

In our view, a properly-designed infrastructure initiative would include the following major components:

The first part would focus on the repair, rehabilitation, or construction of traditional infrastructure projects like roads, bridges, ports, waterways, water delivery systems, sewers, rail, public transit, public aviation, and public school ventilation systems. These are the big, time-consuming, and expensive projects that support every-day life. The Federal government has done these types of projects before: financing and building the national highway system, the transcontinental railroad, Hoover Dam, and the Erie Canal, for example. These are the public projects that the private sector has no financial incentive to build on its own.

The second part would focus on the critical infrastructure of the digital economy. This includes wireless and landline broadband, electric transportation charging stations, and other infrastructure to support the use of data analytics, the internet of things, artificial intelligence, and machine learning to push the outer boundaries of productivity that can lift living standards. This would require innovative public-private partnerships.

Finally, the third component of any infrastructure program would revolve around making critical public and private infrastructure more resilient. For example, electrical grids, software networks, and military installations need to be brought up to code, reinforced, and/or adapted to withstand current and future shocks associated with more frequent demand surges and climate changes and to ensure that geostrategic competition or geopolitical conflict do not result in widespread disruptions or security breaches.

Funding for such an ambitious infrastructure initiative would require substantial resources.

Biden would fund his infrastructure plan, in part, by eliminating tax preferences for fossil fuel producers, but the bulk of his funding would come from a corporate-wide tax increase, among other measures. He would raise the corporate tax rate to 28% from the current 21% rate, reversing a portion of the tax cut signed into law by former President Donald Trump (who lowered corporate taxes from a previous 35% rate). Biden would

also take a variety of steps to raise taxes on multinational corporations—many of which would be consistent with the overhaul of the taxation of profits earned overseas that was included in the Trump Administration's 2017 Tax Cuts and Jobs Act. Those measures include raising the rate of a minimum tax on global profits and eliminating several provisions that allow companies to reduce their American tax liability on profits they earn and book abroad. Biden would also add a new minimum tax on the global income of the largest multinationals, and he would ramp up enforcement efforts by the Internal Revenue Service against large companies that evade taxes.

We believe that a more optimal funding approach would include comprehensive and effective structural tax *reform* (an issue which we have advocated for years), combined with seed money for a national "infrastructure bank" that leverages the broad and deep American capital markets to provide financing via a free enterprise system that incentivizes profit motives.

Regardless of the specifics, the overall outcome of the Biden Administration's infrastructure plan faces uncertain legislative prospects in a U.S. Senate that is currently controlled by Democrats under only a 50-50 split. Without any significant GOP support, Democrats would need to use a special process called "reconciliation" that is typically employed to quickly advance high-priority fiscal legislation. Created by the Congressional Budget Act of 1974, reconciliation allows for expedited consideration of certain tax, spending, and debt limit legislation. In the Senate, reconciliation bills are not subject to filibuster, and the scope of amendments is limited, giving this approach several advantages for enacting controversial budget and tax measures. However, the actual process of employing this technique successfully is much more complicated.

Although the probability of enacting this particular legislation remains uncertain, the United States' infrastructure needs will not diminish any time soon—in fact, those needs will become only more acute as time progresses.

Onward

As detailed in our *2020 First Quarter Review*, on an overall basis, our investment strategy during the pandemic crisis remained consistent with the investment strategy that we have followed in the past—essentially: to invest in high-quality businesses at the right valuations and hold them for as long as they remain high-quality businesses. In fact, the competitive strengths of these businesses, in many cases, *increased* as a result of the pandemic as lower-quality businesses failed to survive. As a result, this dynamic drove the valuations of companies held in *Windward*'s portfolios dramatically higher than previously seen.

Similarly, crises usually accelerate real, pre-existing trends in society and technology—they do not create or destroy them. Subject to constraints, therefore, we believe that there is a deep underlying propensity for human habits to persist over time, and that, human nature being what it is, individuals will have a strong inclination to return to their former way of life as soon as reasonably practicable. As a result, we did not make changes in *Windward*'s strategies to invest in those companies that were deriving benefits from near-term coronavirus trends (e.g., telecommuting, media streaming, etc.) because we believe that those trends will not persist. In addition, we did not invest in any speculative Healthcare companies involved in the discovery of a therapeutic or vaccine because we believed that the benefit to be derived from this discovery will primarily accrue to the existing businesses held in *Windward*'s portfolios. We continue to believe that the long-term secular investment themes that we have previously identified remain intact.

We believe that, at the March 2020 lows, the oversold nature of the markets served to highlight an extremely compelling risk-reward tradeoff, and helped to neutralize the overwhelming sense of negativity that prevailed with respect to the economic and earnings outlook. This sentiment shift should continue to drive the accumulation of stocks and help slow the magnitude, and speed, of future declines—and lend weight to rally efforts.

Indeed, the financial markets should continue to be supported by an ongoing U.S. economic rebound driven by the following factors:

- ✓ There is nothing fundamentally "broken" in the economy that needs to heal. Unlike the last two cycles, there was no obvious financial bubble driving excessive activity in any one economic sector when the pandemic hit. There is no excessive investment that needs to be unwound, and the financial sector has escaped largely unharmed.

- ✓ The indiscriminate nature of the shutdowns last Spring provides the economy with a solid base from which to grow. The economy collapsed in the Spring because, in an effort to get ahead of the virus, approximately one-third of the economy (on an annualized basis) was shut down. That created a lot of opportunity to rebound when the unnecessary casualties of the shutdown came back online and began to grow despite the virus. That process should continue.

- ✓ Household balance sheets were not crushed like they were in the last recession. Instead, the opposite occurred. Reduced spending, fiscal stimulus, rising home prices, and a buoyant equity market have all helped push household net wealth past its pre-pandemic peak.

- ✓ The demographics are incredibly supportive of growth. During the last recovery, the U.S. economy was still adapting to the Baby Boomers aging out of the workforce with a much smaller cohort of Generation Xers behind them. At the time, the larger Millennial generation was just entering college. Now, the Millennials are entering their prime homebuyer years in force and will be moving into their peak earning years soon. The resulting strength in housing is fueling higher home prices and durable goods spending, and that trend is just beginning. Housing activity should remain strong for the next several years.

- ✓ As discussed above, household savings have grown by more than $1.6 trillion, providing the fuel for a robust economy on the other side of the pandemic. Sooner or later, that money is going to come out of savings and into the economy, and it seems logical to expect it to flow into the sectors like leisure and hospitality where there is considerable pent-up demand.

- ✓ Most importantly, coronavirus vaccines are here. As the vaccines become widely available and distributed, the sectors of the economy most encumbered by the virus (the same as those for which consumers have pent-up demand) will be the primary beneficiaries of its demise. Moreover, schools and day care centers can reopen, allowing working parents to return to the labor force, thereby providing additional support to the economy.

Although the long-term societal and economic implications of the pandemic, if any, remain unclear, specific companies are taking advantage of the changes in their operating environment to create long-run opportunities for their businesses. Those leading companies whose superior business models are best positioned to withstand the current shocks to the system will emerge even stronger as the economy continues to recover.

Our goal, as always, is to identify those companies and invest in them for your *Windward* portfolio. Our risk averse approach to managing your investments causes us to take a more measured and unemotional view of extremes in bullish or bearish sentiment and find ways to outperform the market with less volatility by focusing on specific companies' fundamentals. Our results over the course of various market cycles demonstrate our success.

Windward's portfolios of individual businesses, with their own company-specific fundamental dynamics, are continuing to thrive and prosper. In the short term, this fact may be obscured by "market action"—which results in highly-correlated security price movements during periods of increased volatility—and/or the negative influences of ETFs, asset allocators, and algorith-

mic traders—whose focus is on baskets of securities or on stock symbols, not on underlying business model fundamentals. However, financial history has proven, time and again, that, over the long term, investors are ultimately rewarded by being owners of these types of companies.

We have been investing this way for decades, and have successfully navigated a variety of historic market environments.

We believe that the "indices" will become less relevant as time goes on and that successful wealth creation and capital preservation in the years to come will become increasingly dependent upon the identification and ownership of those businesses that, although possibly impacted by exogenous events in the short run, remain relatively immune to these global macroeconomic issues over the long run due to their own underlying growth dynamics.

We remain exceedingly optimistic on the prospects for the individual companies that we own in *Windward* portfolios and encourage you to contact us should you have any questions or concerns.

Sources:

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U.S. Federal Reserve
U.S. White House
World Health Organization

ADDENDUM

American Rescue Plan Act of 2021 (ARP)

The most significant measures included in ARP are the following:

- A third round of stimulus payments to individuals and their dependents
- Extension of enhanced supplemental Federal unemployment benefits through September 2021
- Expansion of the child tax credit and child and dependent care credit
- Extension of the Employee Retention Credit (ERC)
- $7.25 billion in aid to small businesses, including the Paycheck Protection Program (PPP) loans
- Increased Federal subsidies for COBRA coverage
- Over $360 billion in aid directed to States, cities, U.S. territories, and tribal governments; the Senate added $10 billion for critical infrastructure, including broadband internet, and $8.5 billion for rural hospitals
- $160 billion earmarked for vaccine and testing programs to improve capacity and help curb the spread of COVID-19; this includes funds to create a national vaccine distribution program that would offer free shots to all U.S. residents regardless of immigration status
- Other measures that address nutritional assistance, housing aid, and funds for schools

Here are details for many (but not all) of the provisions of ARP:

Measures Affecting Individuals

ARP includes several measures to help individuals who have been adversely affected by the impact of the coronavirus pandemic on the economy. The additional round of stimulus checks, in conjunction with supplemental Federal unemployment benefits, should provide some measure of relief to individuals. A temporarily-enhanced child tax credit offers another area of assistance.

Cash Payments

An additional $1,400 payment will be sent for each dependent of the taxpayer, including adult dependents (e.g., college students, parents). The previous two stimulus payments limited the additional payments to dependent children 16 years old or younger.

The amount of the stimulus payment is based on information in the taxpayer's 2020 tax return if it had been filed and processed; otherwise, the 2019 return is used. The amount of the payment will not be taxable income for the recipient.

The stimulus payments are subject to certain limitations with respect to a household's adjusted gross income. Households with adjusted gross income of more than $80,000 for single filers, $120,000 for head of household filers, and $160,000 for married filing jointly will not receive any payment. For taxpayers with adjusted gross incomes below those respective limitations, the stimulus is subject to a phaseout beginning at $75,000 for single filers, $112,500 for head of household, and $150,000 for married filing jointly.

Extended Unemployment Benefits

The current weekly Federal unemployment benefits (which apply in addition to any State unemployment benefits) of $300 is extended through September 6, 2021; the Senate cut back the $400 that would have applied through August 29 under the House version. The extension also covers the self-employed and individual contractors (e.g., gig workers) who typically are not entitled to unemployment benefits.

Additionally, the first $10,200 of unemployment insurance received in 2020 would be nontaxable income for workers in households with income up to $150,000.

Child Tax Credit

The child tax credit will be expanded considerably for 2021 to help low- and middle-income taxpayers (many of the same individuals who will be eligible for stimulus payments), and the credit will be refundable.

The amount of the credit will increase from the current $2,000 (for children under 17) to $3,000 per eligible child ($3,600 for a child under age six), and the $3,000 will also be available for children that are 17 years old. The increase in the maximum amount will phase out for heads of households earning $112,500 ($150,000 for couples).

Because the enhanced child tax credit will be fully refundable, eligible taxpayers will receive a refund for any credit amount not used to offset the individual's Federal income tax liability. Part of the credit will be paid in advance by the IRS during the period July through December 2021 so that taxpayers do not have to wait until they file their tax returns for 2021. The IRS will publish future guidance as to how the payments will be refunded.

Child and Dependent Care Tax Credit

The Child and Dependent Care Tax Credit will be expanded for 2021 to cover up to 50% of qualifying childcare expenses up to $4,000 for one child and $8,000 for two or more children for 2021 (currently the credit is up to 35% of $3,000 for one child or 35% of $6,000 for two or more children). The credit will be refundable so that families with a low tax liability will be able to benefit; the refund will be fully available to families earning less than $125,000 and partially available for those earning between $125,000 and $400,000.

Earned Income Tax Credit (EITC)

The EITC will be expanded for 2021 to ensure that it is available to low paid workers who do not have any children in the home. The maximum credit will increase from about $530 to about $1,500, and the income cap to qualify for the EITC will go from about $16,000 to about $21,000. Further, the EITC will be available to individuals age 19-24 who are not full-time students and those over 65.

Measures Affecting Businesses

ARP contains provisions designed to assist small businesses, in particular:

Small Businesses and Paycheck Protection Program

An additional $7.25 billion is allocated to assist small businesses and the Paycheck Protection Program (PPP)-forgiven loans. The current eligibility rules remain unchanged for small businesses wishing to participate in the PPP, although there is a provision that will make more nonprofit organizations eligible for a PPP loan if certain requirements are met.

The PPP—which was originally created as part of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) enacted on March 27, 2020—is designed to help small businesses that have suffered from the disruptions and shutdowns related to the coronavirus pandemic and keep them operational by granting Federally-guaranteed loans to be used to retain staff at pre-COVID levels. A PPP loan may be forgiven in whole or in part if certain requirements are met.

The Economic Aid Act, which is part of the Trump Administration's $900 billion COVID relief package enacted in December 2020 (Consolidated Appropriations Act, 2021 (CAA)), had earmarked an additional $284 billion for PPP loans, with specific set-asides for eligible borrowers with no more than 10 employees or for loans of $250,000 or less to eligible borrowers in low- or moderate-income neighborhoods. The program has recently been extended from March 31, 2021 to May 31, 2021.

Employee Retention Credit (ERC)

The ERC, originally introduced under the CARES Act and enhanced under the CAA, aims to encourage employers (including tax-exempt entities) to keep employees on their payroll and continue providing health benefits during the COVID-19 pandemic. The ERC is a refundable payroll tax credit for wages paid and health coverage provided by an employer whose operations were either fully or partially suspended due to a COVID-19-related governmental order or that experienced a significant reduction in gross receipts.

The CAA extended the eligibility period of the ERC to June 30, 2021, increased the ERC rate from 50% to 70% of qualified wages, and increased the limit on per-employee wages from $10,000 for the year to $10,000 per quarter ($50,000 per quarter for start-up businesses).

The ARP also extends the ERC until December 31, 2021, under the same terms as provided in the CAA.

Other Measures

- Employers offering COVID-19-related paid medical leave to their employees would be eligible for an expanded tax credit through September 30, 2021.
- ARP increases the proposed subsidies of insurance premiums for individual workers eligible for COBRA, after they were laid off or had their hours reduced, to 100% through September 30, 2021.
- Funds are allocated for targeted Economic Injury Disaster Loan advance payments, as well as for particularly hard-hit industries such as restaurants, bars, and other eligible food and drink providers, shuttered venue operators, and the airline industry.
- Effective for taxable years beginning after December 20, 2020, ARP repeals IRC section 864(f), which allows U.S. affiliated groups to elect to allocate interest on a worldwide basis. This provision was enacted as part of the American Jobs Creation Act of 2004 and has been deferred several times. The provision is relevant in computing the foreign tax credit limitation under IRC section 904.
- ARP does not cancel student loan debt, but there is a provision that would make student loan forgiveness passed between December 31, 2020, and January 1, 2026, tax-free (normally the cancellation of debt is considered taxable income).
- A deduction will be disallowed for compensation that exceeds $1 million for the highest paid employees (e.g., the CFO, CEO, etc.) for taxable years beginning after December 31, 2026.
- The limitation on excess business losses of noncorporate taxpayers enacted as part of the 2017 Tax Cuts and Jobs Act will be extended by one year through 2026.
- The threshold for third-party payment processors to report information to the IRS is lowered substantially. Specifically, IRC section 6050W(e) is revised so that the current threshold of $200,000 for at least 200 transactions is reduced to $600. As a result, such payment processors will have to provide a Form 1099K to sellers for whom they have processed more than $600 (regardless of the number of transactions). This change, which applies to tax returns for calendar years beginning after December 31, 2021, will bring many more sellers, including "casual" sellers, within the 1099K reporting net.

HAS YOUR FINANCIAL CONDITION CHANGED?

Portfolio decisions are based on an individual's income requirements, tax bracket, time to retirement, risk tolerance, and other characteristics. If your financial condition has changed, or is about to change, please call us. We strive to prepare a portfolio that meets each investor's objectives, and the more information we have, the better the job we can do. If you have any questions regarding your portfolio, your asset allocation, or any investment within your portfolio, please let us know.

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If you have interest in these capabilities, or if you would like to receive a copy of our Form ADV Part II or Form CRS free of charge, please email Steve Pene at: spene@windwardcapital.com, or call Mr. Pene at our main number: (310) 893-3000.

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