51 Monroe St., Suite PW-06, Rockville, MD 20850

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How a New Federal Law Aids the Economy?
Executive Summary

On March 27, 2020, Congress passed and the President signed into law the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which provides economic support intended to be quickly available to workers and businesses. The law is innovative in targeting aid as quickly as possible to individuals and businesses, and for how it works with the Federal Reserve to support the U.S. financial system.

Whether the CARES Act is sufficient to end the selloff still depends upon the pace of infections. We continue to believe that the equity market will be extremely volatile in the next two to three weeks. Our original thesis that this would be a three to four week blip in the economy and stock market was incorrect.. We have reassessed the macro picture and push recovery out to the beginning of May. Keep in mind that the stock market is a forward discounting model that can rebound quickly if the duration of the pandemic is reduced, a vaccine is produced and available for distribution or the virus just peters out due to the emergence of warmer weather. We should see new cases peak and start to decline. After all, how can the virus spread if everyone is practicing social distancing?

We continue to focus on a defensive investment strategy. The cornerstone of our strategy is increasing or initiating new positions in utility stocks, hospitals/health care/biotech and some select technology stocks. In addition, selling options is offering our clients extra cash flow and a partial hedge. We did raise some cash earlier in the year by selling some stocks. One requirement for initiating new positions is that they offer a minimum of 5% dividend and over 35% price appreciation (there may be some exceptions). If we need cash to initiate the new purchases, we will sell floating rate assets. The logic is that the interest rate on floating rate assets will be lower over the next few months. In addition, we don t expect interest rates to go higher for at least the next six to twelve months. Net/Net we are accepting duration risk (interest rate risk) for more upside.

What is the detail behind the direct payments to households?

The Act sets aside approximately $269 billion for direct payments to individuals. Taxpayers with annual income of up to $75,000 ($150,000 for married couples in 2019 are eligible to receive a one-time direct deposit of up to $1,200 ($2,400 for married couples), plus $500 per child (under the age of 18). Treasury Secretary Mnuchin said Wednesday, March 25, that the government will make direct deposits within three weeks, and that there is no need to complete a form or sign up to receive a payment if the taxpayer has been paying taxes or received Social Security payments since 2018.

How are retirement plans affected?

In order to prevent investors from being forced to sell financial instruments while equity market prices are falling, the Act suspends the requirement for 2020 required minimum distributions (RMDs) for everyone. The suspension includes distributions for those who turned 70½ in 2019 and otherwise would have had to take a minimum distribution before April 1, 2020. Likewise, those who took a required distribution within the last 60 days can roll over their distribution to the same or a different IRA within 60 days of that distribution and not pay the income tax on the distribution, as long as the investor did not make an IRA withdrawal within 365 days preceding the distribution.

The Act also provides for investors, regardless of age, to take retirement-plan distributions of up to $100,000 without the usual 10% early withdrawal penalty tax for those younger than 59½. What's more, distributions taken in 2020 can be reported as income evenly over 2020, 2021, and 2022, or can be repaid within those three years to avoid income tax. These provisions apply to qualified individuals, defined as people who:

(i) are diagnosed with the coronavirus; or
(ii) have a spouse or a dependent with the virus; or
(iii) experience financial hardship as a result of quarantine, furlough, lay-off, or reduced hours at work; or
(iv) are unable to work due to lack of childcare; or
(v) own and operate a business that suffers closing or reduced hours.

Finally, the Act increases the loan limit from 401(k) accounts from $50,000 to $100,000.

Our perspective is that suspending RMDs gives investors choices. In general, we believe it is positive not to have to take a distribution while equity market prices are low and, instead, spread out distributions into the future when we could see higher market values. Still, investors who do not have much taxable income may want to study whether it makes sense for them to take the distribution this year to take advantage of the lower tax bracket. Investors may also want to consider whether this year is a good opportunity for a Roth IRA conversion. We favor avoiding withdrawals at this point, unless an investor has no other adequate source of funds. Otherwise, our strongest preference is to keep the IRA on a course to grow towards the investor's long-term goals.

How are unemployment benefits extended?

The Act includes roughly $250 billion to extend unemployment benefits – not only the period and amount of payments but also the eligibility. The states run the unemployment insurance, but the CARES Act provides federal funding through December 31 for an additional $600 per week for an extra four months. The program also extends coverage to those who ordinarily would not qualify for state unemployment.

How does the Act support small businesses in maintaining payrolls?

The Paycheck Protection Program is one of the largest sections of the Act and offers an estimated $349 billion in government-guaranteed loans to small businesses that have fewer than 500 employees, select types of businesses with fewer than 1,500 employees, 501(c)(3) non-profits with fewer than 500 workers, and some 501(c)(19) veteran organizations.5

Loans made through this program are capped at $10 million, and cannot exceed 4% in interest cost, but do not require collateral. The program also expands the existing network of over 800 lenders who can extend credit to eligible businesses, and allows borrowers to defer fees, principal, and interest for 6-12 months. In general, as long as a borrowing firm continues normal payroll payments (with caps for compensation exceeding $100,000/year) during the eight weeks after the loan is made, then the borrower can receive forgiveness in the amount of mortgage interest, rent payments, and utility payments.

Other benefits include tax credits and delayed tax payments connected to COVID-19 sales losses, as well as expanded eligibility for the Small Business Administration's Economic Injury Disaster Loans.7 The CARES Act significantly expands this disaster loan eligibility and may provide emergency grant cash advances that may qualify for forgiveness if used for paid leave, payroll maintenance, meeting higher supply chain costs, and other qualified expenses.

There are restrictions on businesses that receive the loans. These borrowers must maintain, as close as possible, at least 90% of their employment (as of March 24) through September 30. Also, these businesses may not issue dividends for a year after the loan is repaid.

What does the ACT do for industries hit directly by the COVID-19 virus?

The Act provides $500 billion in business loans, loan guarantees, and other investments. Congress wanted a dedicated inspector general to oversee these funds. The allocations include $25 billion for passenger and $4 billion for cargo airlines, and up to $17 billion for businesses critical for national security. The provisions limit the terms of loans to not more than five years, and the loans cannot be forgiven. Such loans and guarantees require that a borrowing company not repurchase shares, pay dividends or make other capital distributions, and maintain employment close to current levels through September 2020. As well, the loan restricts executive total compensation for up to one year after loan repayment.

Do hospitals and local governments receive additional help?

The Act allocates over $130 billion for the health care system, including $100 billion for hospitals, and the balance to acquiring personal and protective equipment for health care professionals, testing supplies, workforce training, accelerated Medicare payments, among other health needs, including free COVID-19 testing across the country. State, local, and tribal governments qualify for another $150 billion, including disaster relief, transit programs, and educational institutions.

Does the CARES Act coordinate with Federal Reserve financial system support programs?

Yes. Of the $500 billion allocated to business lending, $454 billion is available after the previously mentioned programs for aviation and national security. That remainder supports Federal Reserve programs that provide lending to the financial system and to eligible states and municipalities, in order to increase liquidity in financial markets, including the municipal debt market. The Act also allows the Treasury Secretary to use the Treasury's Exchange Stabilization Fund to establish a guarantee program for the U.S. money market mutual fund industry,until December 31, 2020. The Federal Reserve has established a facility to purchase assets from U.S. money market mutual funds in order to maintain money market fund liquidity.

Conclusion

An overriding theme through all these provisions is direct assistance to those whose incomes or revenues are under pressure from the pandemic, and greater flexibility for how and where the Federal Reserve may shore up financial markets. The recent increase in legislative tempo has encouraged financial markets, insofar as the Act allows workers and businesses to bridge the next few months. Most of the provisions of the CARES Act expire between September and December 2020, however. If it takes beyond the third quarter to see a peak in the virus, Congress may need to return with another package.

Ultimately, we believe that the federal government will extend, as necessary, and the economy should rebound by late 2020. Even a strong rebound is possible, once more typical spending rates resume across the economy. Our 12-month outlook is for a rebound in economic growth, earnings growth, and valuations, which should support a broad recovery in equity prices. Yet, beyond the next two years, the implications of today's strong fiscal and monetary response is likely to include a strong potential for higher tax rates, inflation, and somewhat higher interest rates, depending upon how much additional economic aid ultimately is added to counter the economic fallout from the virus.

If you have any questions feel free to contact customerservice@qfainc.com or Senior Advisor Mr. Joe Rinaldi, Mr. Andre Weisbrod, or our investor service contact Mr. Steven Nunez. Our main office number is 301-296-6203 or our Pittsburgh branch office number is 412-491-1963.

Footnotes

"COVID-19 and your IRA: Here's What You Need to Know",Forbes, by Bernie Kent, March 28, 2020.

Gig workers are independent contractors who enter into formal agreements with companies that use their services on an as-needed or on-demand basis.

U.S. Chamber of Commerce, "Coronavirus Aid, Relief, and Economic Security Act", by Sean Ludwig, March 27, 2020. Also, Forbes, "$2.2 Trillion CARES Act Provides a Lifeline to Small Businesses", by Rohit Arora, March 27, 2020.

The program builds on the existing Small Business Administration's 7(a) loan program that is already familiar to many businesses. For more details, please see www.SmallBusinessDisasterSupport.com for details.

For more information, please see "How to Apply for an SBA Disaster Relief Loan", U.S. Chamber of Commerce, March 26, 2020.

Losses can now be extended back by five years, excess loss limitation rules for pass-through entities are suspended, and more of a business' interest expense is deductible.

See also Forbes,The CARES Act Has Passed: Here Are the Highlights", by Leon La Brecque, March 28, 2020.