The Secret Service & Indirect Taxes

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Allen Gillespie, CFA®
Chief Investment Officer

Mercer Treadwell, CFA®
Senior Vice President, Investment Advisor

David Lewis CFA®,
Chief Financial Officer

Thomas Sheridan,
Financial Analyst

Holland Church,
Data Analyst

EXECUTIVE SUMMARY

- **Monetary Policy:** Neutral. The Federal Reserve has kept short-term rates high, but this has led to declines on the long end of the yield curve.
- **Fiscal Policy:** Inflationary. The CBO projects federal budget deficits to average 6.3 percent for the next ten years.
- **Economic Vital Signs:** Inflationary pressures have moderated and markets are pricing in a Federal Reserve rate cutting cycle.
- **Yield Curve Watch:** The yield curve continues to be inverted.

Q3 2024: The Secret Service & Indirect Taxes

Q: Allen, why title this WMQ "The Secret Service & Indirect Taxes?"

Since the attempted assassination of Donald Trump, I have been contemplating whether there might be any economic or market implications. In reviewing the stock market's reactions to political assassinations attempts, I found it to be a mixed bag of performance. At the same time, I can easily make the case that the event will increase investor demand for perceived "safe haven" assets like t-bills, short-term bonds, and gold, as well as cryptos and other non-dollar currencies as political hedges.

While on a recent walk, I was contemplating the potential safe haven trade, when I decided to listen to the Congressional hearing and testimony of Kimberly Cheatle (former Director of the U.S. Secret Service). The hearing consisted of strong bi-partisan questioning and criticism of U.S. Secret Service for its perceived failures on July 13. Rightfully, Congressional members from both sides of the aisle are sensitive and concerned about political violence against candidates and elected officials. Given the bi-partisan pressure, Cheatle resigned her post shortly after the hearing.

While much of the hearing focused on the events of July 13, I found the discussion regarding staffing levels at the U.S. Secret Service the most intriguing. It made me think. If Congress thinks the U.S. Secret Service is not performing up to task, possibly due to staffing—should investors be concerned about the Secret Service's performance in relation to its larger investigations mandate? I also found myself wondering whether the Congressional focus on the U.S. Secret Service tells us anything about the investing climate.

I concluded that it does given trends in cybercrime and inflation. It then dawned on me that our readers might not be familiar with the U.S. Secret Service's financial mandate.

Q: What can you share with us about the Secret Service's financial mandate?

The Secret Service's original mandate was counterfeit currency investigations. Due to the financing requirements of the American Civil War, President Lincoln and Congress passed the Legal Tender Act of 1862. The Act authorized the US Treasury to issue $150 million in paper "greenbacks" which would not be redeemable in gold or silver at a national level. The following year, Congress passed the National Currency Act of 1863 which created the Office of the Comptroller of the Currency (OCC). Congress then substantially amended the law in 1864, and it came to be known as the National Banking Act. Together, these Acts led to the creation of a national non-metallic currency—(aka "the greenback") and a national banking system for the United States.

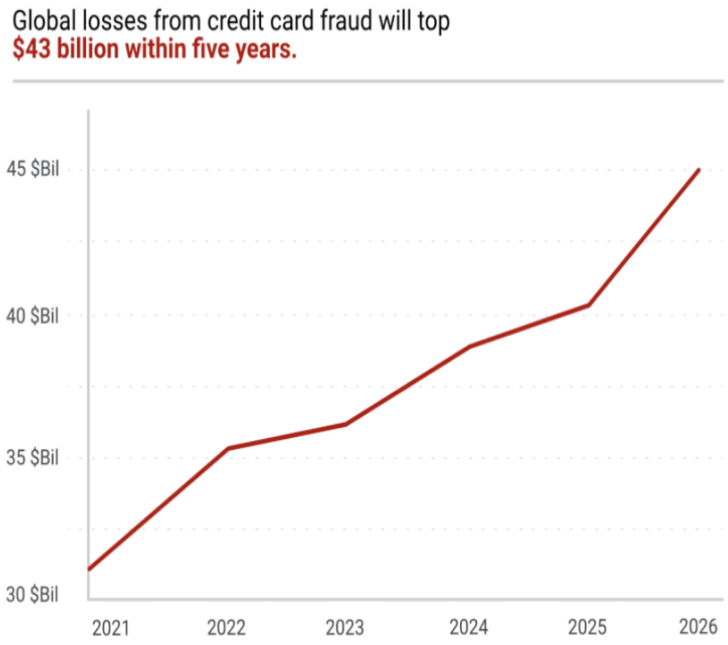
Major Asset Class Returns	2024 YTD
T-Bills	3.69%
Investment Grade Bonds	-0.71%
Large-cap Stocks	15.29%
Mid-cap Stocks	6.17%
Small-cap Stocks	-0.72%
International Stocks	5.75%
Emerging Market Stocks	7.68%

Source: Morningstar Direct, As of 6/30/2024

The increased issuance of paper money and war bonds, combined with the material demands of the war, naturally led to an inflation. Consequently, greenbacks moved to a discount relative to the more scarce gold and silver coins.

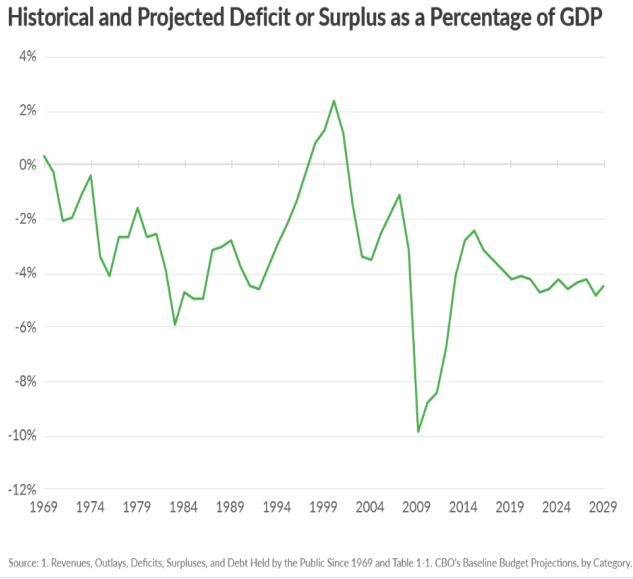
In addition to inflation, the growth in fiat currency usage during the Civil War brought along with it an increase in currency fraud. As a result, Congress created the Secret Service to investigate counterfeit currency frauds.

According to its website, www.secretservice.gov/about/history, The United States Secret Service is "one of America's oldest federal law enforcement agencies, originally created in 1865 to stamp out rampant counterfeiting in order to stabilize America's young financial system. By the end of the Civil War, nearly one-third of all currency in circulation was counterfeit. As a result, the country's financial stability was in jeopardy. To address this concern, the Secret Service was established in 1865 (July 5th) as a bureau in the Treasury Department to suppress widespread counterfeiting."



Source: Merchant Cost Consulting.com

Our modern day equivalent would be that credit card fraud has grown right alongside the increased usage of credit cards. Merchant Cost Consulting estimates global credit card fraud will reach $43 billion annually by 2026. Meanwhile, the Secret Service estimates that it prevented over $6 billion in fraud during the latest federal fiscal year.



Today financial investigations involve financial fraud, counterfeiting, and cybercrime. The Protection mandate was given to the Secret Service following the assassination of President William McKinley in 1901.

Q: What does this mean for investors?

According to the OCC's website, "One of the purposes of the national banking legislation introduced in December 1862 was to stimulate bond sales and generate a rush of cash for the hard-pressed U.S. Treasury." Thus, one can see that legal tender laws are the mechanism through which government moves from direct taxation which constrains its spending, to indirect taxation through currency inflation. The initial move towards indirect taxation and inflation historically leads to a recovery or expansion because the government is spending money it does not have. At the same time, the private sector does not have the burden of a direct reduction in its cash-flows due to taxes. The initial tax, if you will, is paid for by currency and fixed interest bond holders. Later, down the road, inflation becomes problematic because currency and bond investors gradually wise up and demand either higher interest rates or they flee the currency and the country. Based on the Congressional Budget Office ("CBO") reports and projections, I believe the U.S. may be moving towards the problematic stage.

"If the government had to rely on direct taxes, then everyone's taxes would need to be nearly 40% higher, or government spending would need to be 40% less."

Municipal and Treasury Yields (%)

Maturity	Treasury	AA Municipal	A Municipal	BBB Municipal
1 Year	5.118%	3.343%	3.36%	3.899%
2 Year	4.755%	3.292%	3.313%	3.844%
5 Year	4.377%	3.136%	3.10%	3.709%
10 Year	4.397%	3.169%	3.062%	3.840%
30 Year	4.559%	4.235%	4.216%	4.687%

Source: Bloomberg as of 6/30/2024

Q&A with the Research Team

Q: What do you see in the CBO reports that concern you?

One way to think today's situation is this. In 2023, the U.S. government brought in $4.9 trillion in revenue through direct taxes, but it spent $6.8 trillion. Therefore, indirect taxes equaled $1.9 trillion. If the government had to rely on direct taxes, then everyone's taxes would need to be nearly 40% higher or government spending would need to be 40% less. Furthermore, as of June 2024, the CBO projects that the gap between direct taxes and spending is going to average 6.3% for the next 10 years.

Our readers can see in the second chart on the previous page, deficit spending of more than 4% of GDP is generally reserved for severe recessionary times. The U.S. clearly has a spending and structural budget issue that is going to have a lot impacts for investors depending on how it is resolved.

The most direct impact we have seen recently has been higher interest rates. While interest rates may be moving lower on a cyclical basis because the private sector slowed, I generally estimate interest rates will remain elevated due to the fiscal gap over the coming decade.

A second impact, just as in 1862, is that an inflated currency will move to a discount relative to more scarce alternatives. Today, investors see the prices of gold, silver and cryptocurrencies near record highs as Congress spends increasing amounts of money.

As previously detailed, a growing market and inflation also brings increasing amounts of fraud, which the Secret Service is tasked with investigating. In the 2023 Homeland Security Budget Overview, one can easily see the accelerated growth in the number of cybercrimes. Last year, the Secret Service recovered over 1.5 million financial accounts. The Secret Service has also increased its cybercrime staffing from 1,900 individuals in 2017 to 5,800 in 2023 (20% annual growth).

Q: What does the growth in cybercrime mean for investors?

At the most basic level, it means there may be an opportunity in cybersecurity related equities and exchange traded funds. Identify theft protection and insurance are practical necessities and purchases in this day and age. Anyone who works with computers or in industry realizes that cybersecurity protocols and software are as fundamental as turning on your utility power.

Meanwhile, in the area of cybercrime, one of the main uses for blockchain technology is the improvements it brings to fraud detection and prevention. Governments, however, still have mixed views regarding cryptocurrencies and blockchain solutions. The technology can enable either the most decentralized solutions or the most draconian centralized solutions, depending on how they are implemented. This is making cryptocurrency regulation a political battleground.

Q: Government policy and political attitudes toward cryptos seems mixed, can you comment on that?

It is mixed. Various agencies have taken actions and issued guidance, but there has not been government wide consistency in the country's approach to the technology. At the most basic level, the IRS declared cryptocurrencies to be assets, so they could be taxed. The commodity regulators view certain cryptocurrency assets as currencies or commodities, however, tax and regulatory law on commodities work differently than securities. The SEC meanwhile has been differentiating between true cryptocurrencies and those that meet the definitions of securities. It has recently allowed the issuance of exchange traded funds which hold cryptocurrencies, so this should help expand the market. The difference is that a bitcoin has been determined to not be a security, but a bitcoin ETF would be a security. The Secret Service and the U.S. Marshall, meanwhile, are tasked with investigating cyber related crimes, and due to their efforts, the U.S. government actually holds an estimated $14 billion in bitcoin.

At a higher economic level, I also believe government attitudes toward cryptocurrencies are mixed as they represent a real time example of Gresham's law in practice. Gresham's law states that bad money drives out good money, as good money will be hoarded while bad money will be spent. As a 2005 paper from the Cleveland Federal Reserve Bank stated, "In the absence of such market imperfections (government intervention and imperfect information), good and bad monies will both circulate and be priced according to their quality."

Q: Allen, any final thoughts for investors?

The Secret Service has a "zero fail mission" and its missions include cybersecurity and monetary integrity. Unfortunately, the US government relies on indirect taxation and every politician desires to spend more, so the Secret Service may have an impossible task. This clearly establishes that there may be opportunities in inflation fighting and cybercrime prevention investments. On the risk side, it creates the risk of higher taxes in the future or federal budget cuts down the road.

As it relates to more taxes or less spending, investors should probably be watching Argentina as a barometer. The country is undergoing a significant policy change under Javier Milei. The country has devalued its currency and reduced its government spending to be in line with its tax receipts by cutting thousands of government workers. At this point, the country has eliminated entire government agencies and 15,000 government jobs, as it aims to eliminate 70,000 government positions. This is clearly having disparate impacts at individual levels, but for investors, it has created a rebound in private sector performance and its stock market has been amongst the best performing in the world.

In conclusion, since it first received its protection mandate, the U.S. Secret Service has seen one president killed (JFK), two candidates shot (Teddy Roosevelt and Trump), another president shot (Reagan) and attempts on all the others. In that regard, its track record is admirable over the last 123 years. At the same time, Congress itself believes the Secret Service is understaffed and failed on its protection mandate on July 13. For investors, if we assume those same percentages of a failure, it would translate into the risk of a major cyber event or currency failure being 3% (4/123). Something worth considering.

Sincerely, Allen R. Gillespie

QUICK TAKE

MAJOR ASSET CLASSES

Cash and Cash Equivalents

The market is pricing in an aggressive Federal Reserve interest rate cutting cycle beginning in September. While this is consistent with cyclical data, we believe long term Federal deficits as a percentage of GDP will keep interest rates elevated. We believe the Federal Reserve policy is now neutral to restrictive, so allocation to short-term cash and cash equivalents may produce competitive returns over time.

Investment Grade Fixed Income

The yield curve has inverted to levels last seen in the early 1980s. We are expecting the yield curve to return to a normal shape during 2024. The normalization of the yield curve will likely create some short-term pressures on investment grade fixed income markets, but we believe core bonds reasonably reflect both recessionary and inflationary pressures. As a result, we believe tactically rebalancing within the space will be increasingly attractive over the next few quarters.

Tactical Fixed Income

High yield commercial real estate markets are beginning to exhibit a few signs of approaching distress. While we moved our tactical fixed income allocations to be more in-line with bond benchmarks, at the margin, we believe investors should begin to extend credit risk over the next few quarters if spreads widen. Convertible securities also might become more attractive to corporate CFOs as a way to lower interest costs.

Core Equities

Given recessionary risks and the inverted yield curve, we would not overweigh equities beyond investor risk determined allocations. We believe a normalization of the yield curve will temporarily impact long-term growth assets. Given our inflation and valuation outlook, we are also more constructive on small cap, value, growth at a reasonable price, and international equities.

Tactical Equities

Due to the extreme conditions in core fixed income and equity markets, we think that tactical equity strategies may offer investors the best risk/reward tradeoffs. Tactical equity strategies, like long/short equity and option-based strategies have historically weathered bad bond markets and buffered bad equity market storms. We investors begin researching and considering whether commodities strategies may be appropriate for portfolios.

Other Markets

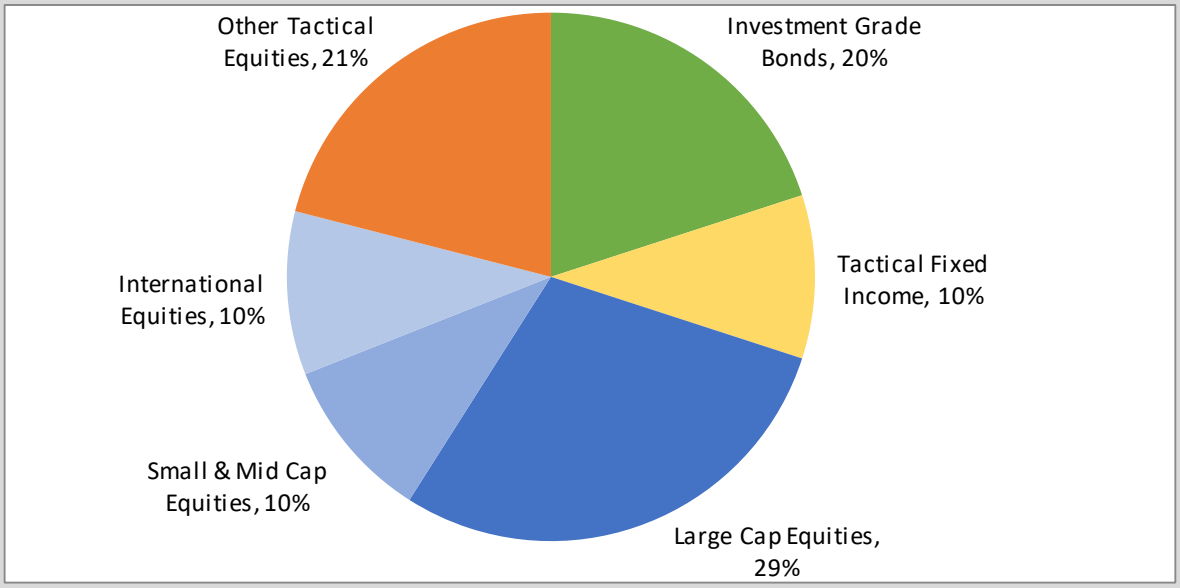
Other markets like gold, cryptocurrency, and real estate may offer diversification benefits to traditional portfolios. We believe commercial real estate in major metro markets may see pockets of distress due to shifts in product and populations. Gold appears to be regaining its status as a safe haven asset and cryptocurrency markets have been supported by favorable regulatory rulings recently.

Index Snapshot

	Earnings Yield	Dividend Yield	Price to Book
Large-cap Stocks	4.28%	1.35%	4.85
Mid-cap Stocks	6.06%	1.59%	2.47
Small-cap Stocks	6.40%	1.93%	1.76
International Stocks	6.59%	3.10%	1.90
Emerging Market Stocks	6.76%	2.65%	1.78

Source: Bloomberg as of 6/30/2024

FinTrust Allocations (70/30 Risk Profile) with Tactical



Positioning as of 6/30/2024. This model displays FinTrust's Funds & ETF Model with Tactical target portfolio guidelines. Each client situation is unique and may be subject to special circumstances, including but not limited to greater or less risk tolerance, classes, concentrations of assets not managed by FinTrust, investment limitations imposed under applicable governing documents, and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing and other factors.

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