Scottish referendum implications

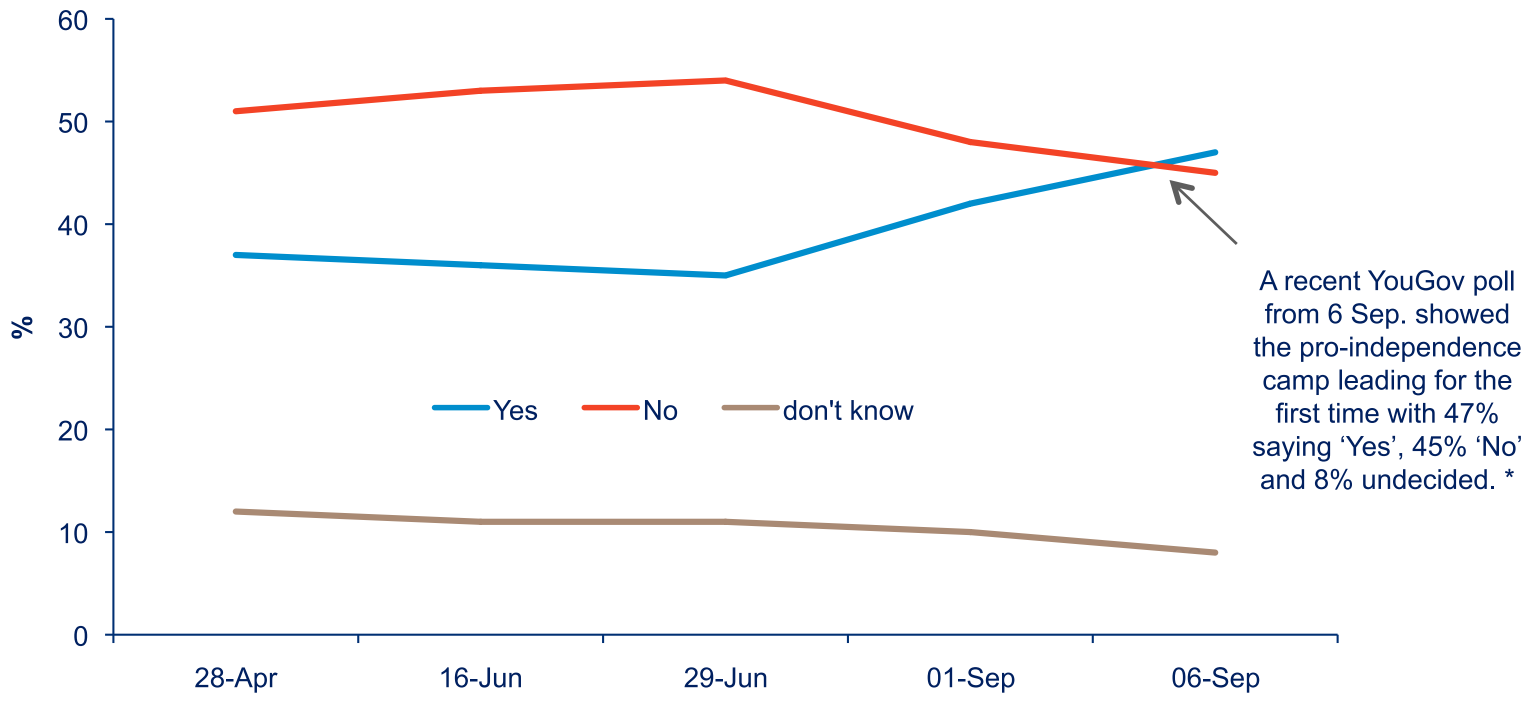
PERSPECTIVES

SEPTEMBER 2014

Recent opinion polls on voting intentions in the Scottish referendum on 18 September have suggested a distinct narrowing of the majority for the pro-unionist 'No' camp, with one YouGov poll even suggesting a narrow victory for the pro-independence 'Yes' camp.*

YouGov opinion polls

Question: Should Scotland be an independent country?



Source: YouGov

* If undecided voters are excluded then the 'Yes' vote is 51% versus 49% for No.

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Scotland – some key facts

PERSPECTIVES

UK Oil

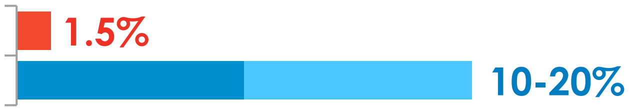
UK Oil Revenue: 1991-92 **£1.5bn** | 2011-12 **£27bn**

How much oil is left?

Higher estimate **£1.5trn**

Lower estimate **£120bn**

Tax revenue based on oil



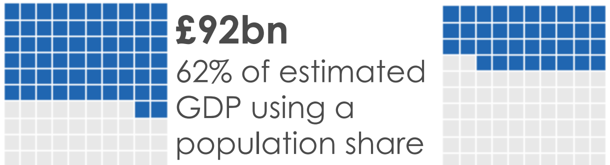
Geography and Population

Scotland 8.3% of the UK population **5.3m** in 2012

National Accounts

	UK	Scotland
GDP per person including oil and gas revenues	£22,336	£26,424
GDP per person excluding oil and gas revenues	£20,873	£20,571
Earnings per week	£506	£498
Disposable income per year	£15,727	£15,342

Scotland's possible share of National Debt



£92bn 62% of estimated GDP using a population share

£56bn 38% of estimated GDP using an estimated fiscal balance

Public Expenditure per head

Sources: ONS, Scottish Government, GERS, SNAP

Why a 'No' vote is still more likely...

Although polls have indicated a clear increase in support for independence, on balance, a 'No' vote is more likely on 18 September, based on:

1. **The totality of polling evidence** – While the recent YouGov poll has understandably attracted a lot of media attention, it's worth noting this has been the *only poll* (out of dozens) to indicate a *very narrow* 'Yes' preference. While there has been an undoubted shift in momentum in favour of the 'Yes' camp, a broader assessment of all opinion polls to-date still suggests a 'No' outcome to be more likely.

2. **Recent offers of increased Scottish autonomy** – In response to the shift in momentum in favour of the 'Yes' vote, the UK government has offered new unprecedented levels of autonomy for Scotland (short of full independence), which may help to convince some Scottish voters.

3. **Likely risk aversion of remaining undecided voters** – Partly as result of the hysteria created in the media around the possible adverse consequences of a 'Yes' vote and the offers of increased autonomy in the event of a 'No' vote, a majority of undecided voters can be expected to opt for the least risky option of backing the status quo.

4. **The Quebec analogy**– In 1995, the Canadian province of Quebec held a referendum on whether it should become independent. As is the case in Scotland, the pro-separatist camp pulled ahead in the polls two weeks ahead of the vote. However, in the end the 'No' camp narrowly won, with 50.6% of the vote. Significantly, post-election analysis showed that most undecided voters ended up voting for the perceived safety of the status quo.

The critical currency issue

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In the event of a 'yes' vote, the most important issue needing to be resolved would be the choice of currency. As 'Independence Day' would not officially arrive till 24 March 2016, there would be enough time to settle this. The four main options available to Scotland would be:

1. **A formal currency union with the UK, enabling Scotland to continuing to the use the pound** – this, the Nationalists' preferred option, would be broadly similar to the eurozone's currency arrangement. However, it would inevitably entail some loss of 'sovereignty' for Scotland with the Bank of England effectively controlling its monetary policy. Moreover, the official UK government position has been opposed to this and it is possible a referendum may be needed in order to approve such a union with 'another country'.

2. **Unilateral usage of the pound** – this so-called 'sterlingisation' option would see Scotland 'unilaterally' using the pound as its currency without explicit agreement or co-ordination with the rest of the UK, in a similar way to which Panama uses the US dollar as its de facto currency or Montenegro the euro.

3. **Adoption of the euro currency** – Scotland could negotiate for EU membership which would allow it to adopt the euro as its currency. A potential issue here could be resistance to Scotland joining from countries fearful of stoking nationalists movements elsewhere.

4. **A new Scottish currency** – An independent Scotland could go 'all the way' and create a new currency and central bank of its own. This option would give Scotland the most policy flexibility. However, this approach would introduce another set of risks and uncertainty, with significant technical issues to be resolved and the likelihood of greater currency volatility typical of smaller economic entities at least in the short-term.

Possible investment implications

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In the event of a 'Yes' vote, we should expect protracted negotiations between Scotland and 'RUK'. The issues include under what terms Scotland would retain Sterling, how its share of UK government debt would be calculated, and whether it would remain a member of the EU. Given the uncertainty, some investment implications in the event of a 'Yes' vote would be:

- **Negative for UK risk assets** – increased uncertainty regarding issues such as the new currency set-up and the knock-on uncertainty effect on the UK general election and EU referendum would be generally negative for UK risk assets in the short term, especially those located in or exposed to Scotland.
- **Negative for Scottish financials** – Any UK banks with significant exposure to Scottish assets would probably be marked down by investors, while companies in the insurance and asset management sectors could also suffer. Scottish banks would incur a permanent valuation discount relative to UK banks owing to the effective removal of the BOE's lender of last resort facility, i.e. greater potential vulnerability in the event of financial crises. This might encourage them to move headquarters to England in the event of a Yes vote.
- **Negative for GBP**– Uncertainty would weigh on Sterling. The loss of oil revenue would also have a detrimental impact on the UK's balance of payments/current account position.
- **Positive exchange rate impact for some UK multinationals** – a weaker pound would benefit those UK companies with large overseas earnings. Indeed, UK companies earn almost two thirds of their earnings outside the UK.
- **UK credit negative** – other things being equal, a reduced UK tax base and lower oil revenues would be credit and therefore Gilt-negative. However, increased economic uncertainty and potentially slower economic growth could lead to BOE keeping rates lower than expected which should be Gilt positive.

Views from our investment teams

PERSPECTIVES

"Over the coming days there will be much examination of how a 'Yes' vote may or may not impact key sectors both in the economy and in the stock market, as well as the potential political ramifications. The challenging thing for investors will be to see any positives in a situation of heightened uncertainty – in fact, even if the 'Nos' did prevail, we would still have next year's General Election and then a possible referendum on EU membership on the horizon, so any relief might be short-lived.

However, positives could exist for investors. It is worth remembering that the UK corporate sector (in contrast to the US, say) is broadly based with almost two thirds of earnings coming from abroad. Many of the companies that Fidelity researches had been growing uncomfortable about the level of sterling beyond the simple translation of profits, worrying more about the potential to remain competitive looking forward. In that light, weaker sterling (which will most likely persist over the medium term even in the event of a 'No' outcome) would be welcome for the UK corporate sector.

"The uncertainty represented by potential independence (and even the impact of an increased devolution of powers in the case of a 'No' vote) would probably also hold back the hawks within the Bank of England, so the risks to a fragile recovery represented by a sharp rise in rates has also, I would argue, somewhat abated. Having said that, a reappraisal of real credit risk within the corporate sector would be a welcome development – it should, in the end, increase the value of company analysis."

Paras Anand, Head of European Equities, Fidelity

Views from our investment teams

PERSPECTIVES

"The most recent sell off in the pound is linked to opinion polls showing the Scottish independence camp catching up ahead of the 18 September referendum. Sterling has weakened as much as the euro over the last month with the sterling vs euro cross tracking sideways. However, sterling weakness is starting to feel overdone. A strong bounce is likely on a 'No' vote, which I think is still very much the most likely outcome. In the event of a 'Yes', things would get messier, though we would still favour sterling over the euro. It's hard to argue the Bank of England would hold off tightening in 2015 due to what could be eighteen months of divorce negotiations."

Trevor Greetham, Asset Allocation Director, Fidelity Solutions Group

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