An update from Global Investment Solutions
Scottish independence referendum: A whisky hangover?

While 2014 marks the 700 year anniversary of the Battle of Bannockburn, a significant Scottish victory in the First War of Scottish Independence, it could also become the year when Scotland became independent from the United Kingdom. On September 18th Scotland will vote on independence. A first poll indicating a victory for the Yes (pro-independence) campaign saw the British pound (GBP) tumble from USD1.65 to USD1.61 and the FTSE 100 underperform other European equities indices. However, other polls still suggest a victory for the No campaign. Overall, it is our opinion that the probability of a Yes victory remains below 40%, based on experience with previous independence votes – particularly in Quebec – and the usual voting patterns of Swiss referendums, when undecided voters typically choose the less uncertain option at the last minute. In behavioural terms this might be explained by the average human being risk-averse and favoring the known over the unknown.

Nevertheless, a Yes vote is a significant possibility that could unsettle investors. Waking up the morning after their victory parties, Yes campaigners could face falling markets as well as a hangover. We have researched and debated the potential impact on financial markets in the UK and beyond in the event of a Yes vote. We think the main impact would be in the following areas.

GBP exchange rate

In the coming months, the GBP could suffer under the political uncertainties related to the negotiations of the terms of departure of Scotland. The date chosen by Scotland is March 24th 2016, but negotiations will increase volatility in the exchange rate and could motivate the Bank of England to stay on hold longer before increasing its leading interest rates, which could have a negative impact on the GBP. Furthermore, Scotland's population and MPs are more dominated by the Labour Party than UK's population and MPs as a whole. Therefore Scotland leaving the UK could make another Conservative Party victory more likely at the next UK election, which would increase the probability of a vote on UK's leaving the European Union. Moreover, we believe the Scottish population is on average more pro-EU than overall UK. In the longer term a different set of factors might influence on the GBP. The UK's current account balance is already sharply negative (-4.5% of GDP in March 2014), a development that could accelerate were foreign direct investment to slow down because of uncertainties related to the Scottish and EU votes. Supporting the GBP in the long term could be the possibility that a more conservative government could favour more conservative fiscal and monetary policies, therefore leading on average to lower inflation rates and a stronger currency. Finally, the reduction in North Sea oil extraction productivity seems to be correlated with the growing current account deficit. Having oil reserves transferred to Scotland would have a major impact on the trade balance, the current account and therefore also on the GBP's strength.

UK government bonds

Scotland could leave the UK without taking over part of its debt. This would of course be part of the negotiations, but if the UK government adopts a hard line against the possibility of Scotland participating in a monetary union with the UK, then Scotland could repudiate its share of the UK's national debt. Nevertheless, the UK's ratio of debt to GDP would be only marginally impacted by such a move. Overall, we would in this case rate the impact as marginally negative and expect some higher interest rates. Nevertheless, two arguments might support lower interest rates in this scenario. First, the UK government would, without Scotland's Labour MPs, probably become more conservative, therefore favouring a lower deficit policy over the long term. Second, Scotland's GDP per capita being lower than the UK's, the ratio of debt to GDP would, other things being equal, improve. If Scotland were to introduce a new currency, a tail risk would be a situation whereby the Bank of England were forced, in the transition period, to support the Scottish banking system by collateralizing its deposits and taking a loss if the new Scottish currency later devalued.

UK and European equities

Equities oriented to Scotland's domestic economy would be most affected by a Yes vote, above all if the economy fell into recession or trade restrictions were imposed. Also, it is not certain that an independent Scotland could automatically enter the EU, which could have dramatic consequences for its trading activity. The scenario of a recession would be a significant risk, particularly if a new currency were put in place and needed to be defended with higher interest rates, or if capital flows out of Scotland led to lower economic activity and higher unemployment. In this scenario, the financial services industry and domestic consumer-oriented companies would be the most likely to suffer. A currency devaluation would nevertheless open opportunities for more export-oriented companies, which could profit from a devalued new currency. In the longer term, the increased probability of a British vote to leave the EU could also have a negative impact on the local equity market. The UK greatly profits from the trade with the EU and while an exit would lead to fresh trade agreement negotiations, it is hard to imagine that the conditions would be more favorable compared to the actual complete free trade environment. In addition, a Yes vote could give encouragement to campaigners in some Eurozone countries seeking independence for certain regions. In recent years opinion polls have shown majorities in favour of Catalan independence from Spain, Flemish independence from Belgium, and independence for regions in northern Italy.

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