momentum

Scottish Independence

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On Thursday the 18th of September, Scotland votes in a referendum to determine whether it will separate from the rest of the United Kingdom and become an independent nation. The most recent polls suggest that the outcome is now too close to call. Protagonists from both sides of the debate have clearly increased their activity levels in the past couple of weeks as a diminishing margin between the electorate's apparent intention to vote 'Yes' or 'No' has provided scope for both sides to shift the balance sufficiently before Thursday. This shrinking of what was a comfortable margin for the 'No' campaign mere months ago has led UK Prime Minister, David Cameron, to join with the leaders of the Liberal Democrats and opposition Labour parties in assuring Scotland that a 'No' vote would lead to fresh devolution of power to Edinburgh; this "devolution max" option had been explicitly ruled out at an earlier stage of the process by the UK government, a decision which looks increasingly like a mistake for the pro-unionists as polling grows closer.

In the context of the Union, this is an historic vote. It stands to permanently break up a nation which has existed since the 1707 Act of Union. Indeed, as Philip Stephens noted in The Financial Times last week[1], "the referendum […] leaves no room for buyer's remorse. Once dissolved, the union cannot be recovered". In the event of a 'Yes' vote, 18 months of discussion will begin to determine how an independent Scotland would take shape; or rather, how the split would play out. It is interesting to note that the referendum essentially only provides Scotland the opportunity to negotiate the terms of its exit from the United Kingdom; to date there are precious few known facts about how the extraction would take place, to the frustration of many. This has been a key criticism of the 'Yes' campaign, but one on which the 'No' campaign has been unable to capitalise. What is important to bear in mind at the outset is the relative size of the two economies in question. As of today, Scotland represents approximately 9.2% of UK GDP[2] and 8.2% of tax revenues[3] and as a result, while it is meaningful, it is not a pivotal component of the overall total.

Impact of a 'Yes' vote

Opinion is mixed over the likely long term impact of a 'Yes' vote to both the remainder of the UK and Scotland. Even in a long term scenario where both Scotland and the rest of the UK are an economic success, both nations may enjoy less economic and geopolitical clout than the consolidated United Kingdom currently does. In the short to medium term, however, the uncertainties and complex politicking involved in a separation of this magnitude will undoubtedly weigh on an independent Scottish economy and the rest of the UK too. It is fair to say that there is a large proportion of financial commentary that views the split to be negative. For example, Deutsche Bank's David Folkerts-Landau has likened the size of the potential mistake of a 'Yes' vote to Churchill's reintroduction of the Gold Standard in 1925 or the US Federal Reserve's missteps which led to the Great Depression in the US[4]. George Soros agreed in an article for the FT[5]: "This is the worst possible time for […] Scotland to break with Britain. A vote for Scottish independence would weaken – in political and economic terms – both a truncated UK and Scotland." Our view is that some of these opinions are overdone, but it is unquestionable that a 'Yes' vote brings with it significant administrative upheaval, uncertainty and cost. This is, in part, reflected in the recent weakness of sterling and a drift up of UK gilt yields.

Over the next eighteen months, the difficulties of separation, and the process involved in setting up or adapting the broad and totally interconnected institutions that form a nation-state will be significant. In the early days, the ebbs and flows of this process will inevitably pivot on which currency Scotland will use. The uncertainty around this issue will, almost certainly, be the cause of increased volatility in UK markets and to that end, it is in the interests of both a newly independent Scotland *and* the rest of the United Kingdom to come to a concrete solution to this issue as soon as possible. Therefore, although we may see markets react to the increased uncertainty – indeed, since the polls have started to tighten we have seen a modest fall in UK equities and a depreciation in sterling – we do not envisage a chronic shock to the UK market.

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[1] *The world is saying no to Scottish separation. FT September 12 2014*

[2] *Independence debate: Yes, Scotland?. FT February 2 2014*

[3] *Scotland in numbers. BBC. 25 November 2013*

[4] *Scotland: Wrong turn. Deutsche Bank. September 12 2014*

[5] *Britain needs greater unity not a messy break-up. FT September 11 2014*

In our view it is likely that Scotland will continue to use sterling in the years following independence, with some support from the Bank of England in the transition period. Joining the euro is untenable in the foreseeable future, and the risks to Scotland's economy posed by a new free-floating currency are significant. Moreover, while the majority of people in Scotland want to keep the pound, a currency union with the rest of the UK has been dismissed outright by all of the major Westminster parties and the Bank of England (BoE) Governor, Mark Carney. This is a view echoed by ex Federal Reserve Chairman Alan Greenspan, who noted recently [6] "There's no conceivable, credible way the Bank of England is going to sit there as a lender of last resort to a new Scotland". Moreover, it is difficult to see international markets react favourably to a formal currency union in absence of a political one. The dangers of such an arrangement have been demonstrated starkly within the euro area in the past decade. Mr Carney has warned that should an independent Scotland wish to use sterling, without a formal agreement with the rest of the UK, it would need to build significant currency reserves. Building such reserves would likely require the Scottish economy to run a budget surplus, something which makes it very difficult for an independent Scotland to continue without a measure of either taxation increases or public spending cuts. Indeed, Bloomberg notes that [7] "An independent Scotland faces a fiscal gap of 1.9 percent under the IFS's most optimistic scenario. This would require 8 percentage points of increases to the basic rate of income tax or 7 percentage points to the standard sales tax rate; alternatively, the Scottish government could reduce spending by 6 percent, or cut public services by 8 percent if spending on benefits didn't fall." Crucially, however, from the perspective of market stability, Mark Carney reiterated that the BoE would remain the lender of last resort for the entirety of the breakup period, as it is in the interest of all parties concerned to make clear that Scotland's currency is supported during this period and quite possibly after.

Capital flight

Following a 'Yes' vote a flight of capital from Scotland to the rest of the UK is a distinct possibility, as moving money to English banks would be straight forward and not restricted in the first 18 months. What is absolutely clear is that during the initial eighteen month unwind period the Bank of England will remain the lender of last resort to the whole Union, including Scotland. This should serve to remove outlandish risks in the short term, but also creates the potential for the BoE to become a major creditor to Scotland, if its banks come to rely on it for funds. This would leave the BoE and tax-payers in the rest of the UK at risk of a currency devaluation north of the border, much like how commercial banks with outstanding loans in Scotland would be similarly faced with this risk. While a range of businesses have endorsed either campaign, it appears that the majority of financial services firms would be keen to avoid any such uncertainty, and stick with their present lender of last resort in the event of a 'Yes' vote. As a consequence, it would be reasonable to expect to see a wealth of Scottish banks, insurers and investment companies make greater use of their London addresses as formal group headquarters.

Economically, therefore, there are a large range of possible outcomes in an independent Scotland and the rest of the UK, but it is clear that on many issues the interest of an independent Scotland and the rest of the UK would be best served by a well-managed transition. When Ireland seceded from the UK and launched the Irish pound in 1927, a pragmatic solution to the Irish currency was adopted to maintain strong economic ties between the two countries. The BoE continued to underwrite the new Irish pound, until Ireland joined the euro with a solution that entailed neither a formal currency union, nor a free-floating currency, but was ultimately a sensible solution for both countries. Due to the homogeneity between the Irish and UK economy, this solution worked well, even during periods of economic distress. As Scotland establishes itself as an independent nation-state and builds up greater currency reserves, a full separation may become attractive. In the short term, this seems unlikely. In a world where Scotland retains an informal currency relationship with the UK, one key issue of sovereignty will ultimately remain with London; namely that the BoE will set interest rate policy to suit the rest of the UK and as a result Scotland will have its interest rate dictated by an external party.

Our investment thoughts

At Momentum, we are valuation driven managers and we will continue to assess the opportunities presented to us by the movement of prices prevailing in the markets. In the event of a 'Yes' vote, we would not be surprised to see

[6] *Greenspan and Zoellick join calls for a no vote. FT September 16 2014*

[7] *Divorce settlement haggling key for independent Scottish economy. Bloomberg September 16 2014*

greater volatility in the UK stock market and something of a sell-off in the short term. Ultimately, however, there are few companies in the UK stock market that are totally reliant on business in Scotland and as a result, overdone fears in the short term would be an event that we would consider carefully as a potential buying opportunity. A 'Yes' vote, while wrenching from a perspective of sovereignty and administrative policy, may prove to be modest in its impact to businesses and ultimately, therefore, from a shareholder perspective. Were Scotland to become a foreign country, it should not, in and of itself, destroy the business case for the great majority of large companies in the UK which already generate large proportions of their revenues abroad.

The prospects for the gilt market are somewhat more difficult to judge. As of today, we believe that the gilt market is significantly overvalued and as a result, a potential cause for yields to drift up – if not too disruptive overall – is welcome. Over the longer term, there is a possibility that an independent Scotland could walk away from its 'share' of the existing gilt pool. While this serves to increase the repayment burden on the rest of the UK, it would not do so to the extent that it imperils the UK's ability to repay its debt. Importantly it has been confirmed by the Treasury that, in the event of a 'Yes' vote, the entire existing stock of outstanding UK government debt would be supported by the Treasury. As a result, in a future where all gilts remain an obligation on the UK government, yields will likely rise, but there are a number of peripheral European states, for example, whose fiscal position is worse than that in which the UK would find itself, that have a lower fixed income yield today. Gilts may therefore come under pressure in the immediate aftermath of a 'Yes' vote, but will be unlikely to lose their status as a 'safe-haven asset', not least because the rest of the UK will retain sovereignty over its currency and central bank.

In light of this, we believe that although there is a distinct risk of uncertainty to the UK economy, the underlying importance of stability for Scotland, as well as for what would be the remainder of the UK, is profound. As value investors, we will be looking to make strategic allocations to UK assets if they become more attractive from a valuation perspective. Having said that, we appreciate the uncertainties that a vote for independence would create and are mindful of the effects this would have on investments. As global investors, we utilise a high level of diversification across asset classes and geographies in all of our portfolios, as this provides a means to reduce the potential severity of impact from idiosyncratic risks such as these. Furthermore we will remain alert to any investment opportunities that will present themselves as a result of any uncertainty.

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Important notes