

### Summary

- Scotland's referendum on independence is too close to call. Markets disliking uncertainty are putting pressure on UK's currency and credit markets, driving downside risk to UK equities.
- Secession weakens the economic fundamentals for Scotland, exposes the rest of the UK to unwarranted credit risks and diminishes London's political clout. UK mid and large cap equities are at risk of being de-rated.
- Until the dust settles it may be prudent to hedge long positions in UK bonds and equities. Investors who share this sentiment may consider the following Boost ETPs:

[www.boostetp.com/products](http://www.boostetp.com/products)

#### Short UK government bonds:

Boost Gilts 10Y 3x Short Daily ETP (3GIS)

#### Short UK equities:

Boost FTSE 100 1x Short Daily ETP (SUK1)

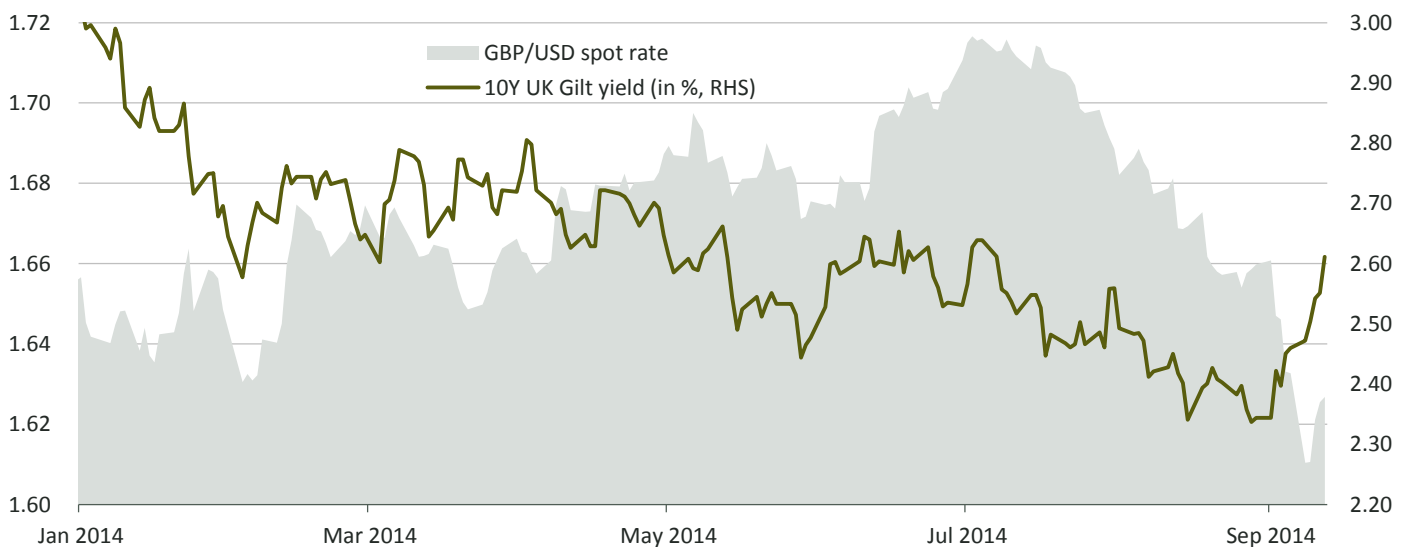
Boost FTSE 100 2x Short Daily ETP (2UKS)

Boost FTSE 100 3x Short Daily ETP (3UKS)

Boost FTSE 250 1x Short Daily ETP (1MCS)

### Scotland secession undermines the pound and UK credit

#### Cable vs 10 Year UK Gilt Yield



source: Boost ETP Research, Bloomberg. Data as of 12 September 2014

Scotland's independence vote is too close to call. With uncertainty overhanging Scotland's future, long term damage has been done to the UK's political and economic credibility. Scottish secession would weaken its fiscal fundamentals and expose the UK to unwarranted credit risks. Coupled with diminished political clout within the EU and internationally, and an increased risk of 'Brexit', UK equities risk being de-rated. Until clarity emerges well after the vote on Thursday 18 September, it may be prudent for investors to hedge their exposure to UK debt and equities.

Investors who share this sentiment may consider the following short debt and long equity ETPs:

#### Short UK government bonds:

1. Boost Gilts 10Y 3x Short Daily ETP (3GIS)

#### Short UK equities:

1. Boost FTSE 100 3x short Daily ETP (3UKS)
2. Boost FTSE 100 2x Short Daily ETP (2UKS)
3. Boost FTSE 100 1x Short Daily ETP (SUK1)
4. Boost FTSE 250 1x Short Daily ETP (1MCS)

## Too close to call referendum shakes sterling and UK credit markets

The latest YouGov survey, conducted on behalf of The Times and The Sun, puts the No vote (i.e. those against Scotland's secession from the union, i.e. the UK) at 52%, with the Yes vote at 48%. With the No camp again leading by 4%, this is a reversal from YouGov's previous survey (held between 2 and 5 Sep) when the Yes camp stood at 51%, to lead the No camp by 2%. The final results, due around market opening on Friday, are now too close to call. The No camp's lead has dissipated since August, with a negative impact on UK financial markets. Whether permanent damage has been done to both safe haven and risk assets in the UK is too early to tell, but the pound has lost 1.7% against the dollar in August and 2% in September so far. Downbeat sentiment has also hit the UK's bond markets, with bond yields on 10 year UK Gilts having risen back to 2.7%, effectively recouping the 27 basis points lost over July and August. Sentiment in UK money markets is also tense, as evidenced by the spike in short term interbank lending rates and UK government bills this month.

## UK fixed income at risk

Until the results are released on Friday morning, UK fixed income is likely to come under more pressure as investors weigh the net effect a pro-independence outcome will have on the finances of the rest of the UK (rUK). Whatever the result, there is likely to be protracted negotiation thereafter (over the form of independence, or what powers will transfer to a 'devomax' Scotland). The biggest sticking points revolve around how much debt rUK should assume when it loses its claim on Scotland's tax revenues (and expenses) and how much risk is born with it? Given the UK Treasury's commitment to service all current outstanding government debt, the exclusion of Scotland's GDP from the national account would mean a higher degree of rUK government indebtedness vs. rUK GDP. This concern was heightened by Scotland's separatists threatening to stop servicing rUK's national debt if Westminster refuses to share the pound with Scotland. Because Scotland's and rUK's credibility are both at stake, a compromise should emerge, with Scotland paying some of its share to holders of UK government bonds and bills, possibly in the form of extending the maturity of debt and/or lower interest rates. Hence, while technically rUK's gross government debt as a percentage of GDP may go up if Scotland becomes independent, relative to tax revenues it may well not change much. Longer term however, the oil revenues that rUK loses from Scotland will likely be more than offset by gains derived from no longer having to finance Scotland's relatively high expenditure. Reliant on volatile crude oil prices and ever shrinking oil and gas reserves, Scotland's main revenue contribution to the union is uncertain and in decline. Yet Scotland's aging population is certain to drive higher fiscal transfers

from Westminster to Edinburgh, unless Scottish taxes are raised. Independent analysts generally forecast Scottish budget deficits at more than 5% of GDP for the foreseeable future.

And therein lies the real risk to the UK bond markets if Scotland votes for independence on 18 September: what interest rates will markets charge Scotland for its own debt issuance, to service both its remaining union share of debt and its own future liabilities resulting from higher spending. Set against weaker economic fundamentals not to mention a less diversified economy, for the most part reliant on energy and an anxious financial services sector, Scotland's debt will likely face a lower credit rating than the UK's historical rating, irrespective of whether it retains the pound or not. If the end result is a higher interest charge on any future borrowing by the Scottish government, it will ultimately make it harder for Scotland to shoulder its share of debt owed to the rUK too.

The currency question creates another layer of uncertainty for investors. If Scotland chooses the pound, its fiscal policy may well be misaligned with the BoE's monetary policy goals. For instance, given the current direction of austerity pursued by the UK's Conservative/Liberal Democrat coalition government, the BoE's monetary policy may be too loose for Scotland's socialist-leaning government. A similar problem occurs if Scotland pegs its own currency to the pound, a likely scenario given that the bulk of Scottish trade, some 2/3<sup>rd</sup>, is with rUK. With it also comes the question of Scotland having sufficient FX reserves to manage such a currency peg and avoid out of control (imported) inflation. In both cases, Scotland will be subjected to the BoE's monetary policy strategy. Alternatively, if Scotland aims to be fiscally prudent, then either a managed currency peg or retention of the pound would mean limited freedom to tax and spend, a very dependent independence.

The third option, adoption of the euro, is unlikely to happen soon given the uncertainty over Scotland's status vis-à-vis the EU and the timescales involved with ERM membership and euro accession. In any case, euro adoption would also mean the surrender of monetary policy independence, just to the ECB rather than the BoE. While such surrender seemed to make sense for many of the overleveraged economies that joined the Eurozone, without fiscal prudence it ultimately proved unstable.

## Scotland's secession worsens rUK's trade outlook, both with Scotland and with the EU

Even assuming Scotland secedes without major repercussions from its currency choice, the risks to rUK's financial markets remain. Independence would provoke calls from other regions, both inside the UK and elsewhere in Europe, for more autonomy, loosening the relationship with central governments. Such calls may grow more fractious against the

backdrop of fragile coalition governments torn between more austerity and more stimulus (i.e. deficit spending), and the rise of more extremist parties that seek to exploit the status quo. The rise of UKIP (the UK Independence Party), a right-wing populist party which promotes anti-immigration and anti-EU policies, has resulted in both the coalition government and the UK's largest opposition party, Labour, entering the 2015 election significantly weakened. Faced with such pressures, the likelihood grows that the Conservative led coalition government in the UK will harden its stance against the EU and shape its agenda around the in-out referendum on EU membership, thereby distancing itself further from EU integration.

A Yes victory would bring a reduction in the free movement of capital, labour, goods and services, further undermining sentiment in UK equities. Most at risk are the British banks, all of whom have exposure to Scotland to some degree. RBS and Standard Life, major financial institutions embodying a strong Scottish heritage, have warned of relocation to rUK if the Yes camp wins, disliking the currency risk on the one hand and the potential changes to taxation and regulation on income and financial assets on the other. Mining, energy and defence companies are also facing uncertainties with respect to extra costs, and uncertainty regarding contract renewals. At risk too are UK's midcap equities, servicing Scotland's energy and mining sectors. While longer term the weakened pound may help improve the outlook for UK exporters, short term the tensions on credit markets are set to dampen the sentiment on many of the FTSE 100 and 250 names, not least because with UK credit risks rising, investors will be looking to apply a higher discount rate to UK stocks. The BoE may postpone a policy rate rise initially. But while that will suppress short term interest rates, the rebounding economy feeding higher inflation expectations will eventually force long term bond yields to climb regardless. Either way, near term the risk to UK equities is to the downside.

*All data is sourced from Boost ETP, and Bloomberg*

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