Deutsche Asset
& Wealth Management

CIO Flash
Scottish Referendum

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Passion to Perform

Scottish Referendum

Macro view: "Yes" movement gains momentum, lots of open questions

On 18 September 2014 Scotland will hold a referendum voting on its independence from the United Kingdom (UK). The following highlights Deutsche AWM's macroeconomic assessment*:

— **Polls:** Until recently, those opposing the independence were leading the polls, but dynamics changed and the "Yes" movement gained some momentum. The main polls have recently shown a strong shift in voting intentions towards "Yes", one stating a slight "Yes" majority for the first time. However, there is still significant uncertainty regarding the final outcome.

— **Parallels to Quebec:** Running up to Quebec's referendum for independence in the 90s, polls showed a tendency for a "Yes" vote, but the outcome was the opposite. This might be due to a more nationalist response in polls compared to the actual behavior during a referendum.

— **No plan for a "Yes":** So far, the UK government has not presented any plan for what can happen in the event of a "Yes" vote. However, there are talks about an offer to Scotland, which would provide them with more autonomy on some issues should they remain in the UK.

— **Issues to resolve:** If the referendum was to result in secession, it might take around two years to come into effect and would require resolution of some significant issues, e.g. debt distribution, the currency and the EU membership (so far the EU rather rejected an acceptance as individual member).

— **Political landscape:** Scotland owns 59 seats in the House of Commons, 41 of them held by Labour Party members. Scottish independence would have a significant impact on UK national elections in May '15 leaving the UK leaning towards the Conservative Party, i.e. more pro-business and pro-market, but also potentially more anti-EU.

— **Base and risk case:** Although polls are showing momentum for the "Yes"-campaign, we still assume a "No" outcome to be the base case. Scottish independence remains the risk case, yet it has become more probable.

Asset-class reactions: Sterling faces headwind, Gilts with slight re-pricing

Equity:

— UK equities underperformed around 3%(1) over the month, which might reflect concerns about a potential "Yes" vote.

Fixed Income:

— **Rates:** Gilts have re-priced only slightly, i.e. a push back of expectations regarding the Bank of England's (BoE) first rate hike has taken place and is being reflected in a lower short end of the curve. However, Gilts maintain their high correlation with U.S. Treasuries.

— **Currencies:** Cable (the pound sterling exchange vs. the U.S. dollar) moved from 1.71 in July to 1.62 today, which was to some extent due to dollar strength, but an impact from independence concerns is clearly visible. The same is true for the sterling-euro cross: despite a dovish ECB and a subsequently weakening euro, the cross has remained broadly stable over the last 2 months.

Asset-class view*: Currency at risk, BoE potentially required

Equity

— **Base case**: In the event of a "No" vote, there might be some kind of relief rally. **Valuation then should have improved** due to recent underperformance and the market could offer some attractive buying opportunities. However, selectivity would be key.

— **Risk case:** There would be contractual issues to be resolved and some companies with direct exposure might suffer. **On the sector level, banks and utilities might experience a negative impact**. However, on the other hand, a weaker currency might offer some relief to those companies, which have felt some currency headwinds lately. UK's equity market is perceived as a low volatility market, but this might change.
However, potential political implications are likely to cloud sentiment towards European equities.

Fixed Income

— **Base case:** If a "No" result prevails, higher yields at the short end of the curve are likely as re-pricing regarding the BoE's first rate hike might reverse. The yield curve for Gilts might flatten. Also, sterling shows some potential for a relief rally in the aftermath of a "No" vote. Specifically for cable, this **squeeze potential** results from option-related short positions.

— **Risk case:**
BoE: Scotland separating from the UK would have uncertain implications for banks' balance sheets. Uncertainties regarding asset ratings and currency exposure etc. might cause banks' CDS spreads to widen and funding liquidity to fall short. In that case **the BoE would need to provide assets to the market to ensure liquidity**. BoE market-supporting measures would be very likely.
Cable: On the currency side we should see **further pressure on sterling especially against the dollar**, again somewhat dampened by supporting measures on behalf of the BoE.
Gilts: If as we approach the referendum the polls remain tight, or there is a further move towards a "Yes" vote, **longer-term Gilts might price in a risk premium** due to increased volatility. Thus, a **divergence on the curve** might be visible: a lower short end anchored in expectations on BoE actions and a higher long end due to the UK's reduced safe-haven status.
Euro: In the medium term a "Yes" might also have a significant negative impact on the euro as it would imply further growth and stability uncertainties. The discussion around a British exit from the EU and other countries' regions striving for independence (e.g. Catalonia) might intensify and thus weaken the sentiment towards the Eurozone. **International capital flows** might react to increased uncertainty in Europe and go to other regions instead.

Conclusion: "No" vote is base case; market partially pricing "Yes" vote creates investment opportunities

Polls are becoming tighter and if momentum for a "Yes" vote continues, volatility might persist or even increase further. **Reaction should be mainly visible on the currency side** with the cable especially influenced by the respective news flow. We may see **attractive valuations** in equities, but would be **selective on sectors** and check for potential cross-border exposure. It might be attractive to lock in Gilt yields and take the carry if a risk premium was priced in. However, continued volatility is to be expected.

Deutsche AWM expectations 2014. Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. No assurance can be given that any forecast or target will be achieved; (1) MSCI UK vs. MSCI World ,
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Glossary

Explanation of terms

Cable – The exchange rate pound sterling vs. U.S. dollar

CDS – Credit-default swap; A financial instrument, which is designed as an insurance against the default of a creditor and the related loss. The CDS seller offers a payment in case of default in return for regular payments by the CDS buyer (until maturity / default).

Curve – short for yield curve; the yield curve plots the respective yields against different maturities of bonds with the same credit quality. Here it refers to the yield curve of sovereign bonds.

GDP – Gross Domestic Product; measures a country‘s or region‘s economic output

Gilts – Bond issued by the government of the United Kingdom.

Hedge – An investment, which is undertaken to reduce the risk of adverse price movements. Here: to log in a certain exchange rate.

Risk premium – Monetary compensation for the risk assumed in an investment, e.g. by higher yields or lower prices.

U.S. Treasuries – Bonds issued by the government of the U.S.

Volatility – Measures the dispersion of returns and is often referred to as a measure of risk.

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