Investment **Research**

By David Page, Research & Investment Strategy | 17 March 2017

Scotland Referendum II

Deferred poll limits market impact

On 13 March, First Minister of Scotland and leader of the Scottish National Party (SNP) Nicola Sturgeon called for a second referendum on whether Scotland should stay part of the United Kingdom. Although the referendum in 2014 (55%-45% in favour of remain) was billed as a "once in a generation event", Sturgeon campaigned in the 2016 Scottish election for a second referendum if "there is a significant and material change in the circumstances that prevailed in 2014, such as Scotland being taken out of the European Union (EU) against our will". Scotland voted overwhelmingly (62%-38%) to remain in the EU last year.

Sturgeon initially called for the referendum to be held between Autumn 2018 and Spring 2019, but subsequently suggested the timing could be flexible if Brexit negotiations took longer, to be "when the terms of Brexit are clear but before the UK leaves the EU, or shortly afterwards". Next week Sturgeon will ask the Scottish Parliament's agreement to seek the legal authority from Westminster to stage a referendum under a Section 30 order (of the Scotland Act 1998).

UK government response and Brexit

Beyond decrying Sturgeon's announcement as "playing politics", and "creating huge uncertainty", PM Theresa May stated "now is not the time" for another referendum. This was definitively not a refusal to hold another referendum: an outright refusal or prolonged resistance risks brewing resentment, which could prove politically dangerous. It is simply a question of timing.

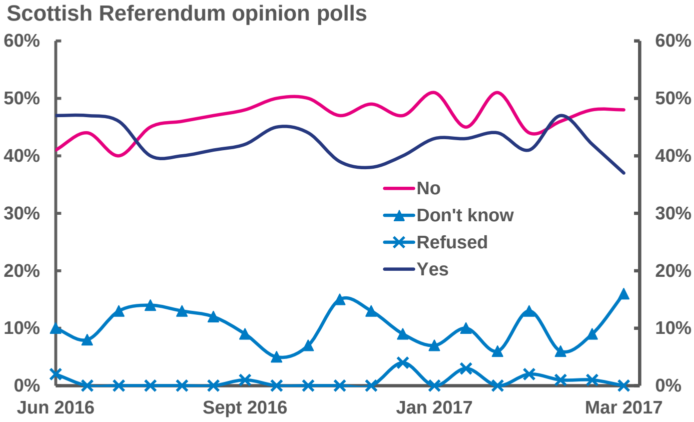
Despite the associated political risks, one official suggested that there would be "no negotiations" before Brexit. This suggests a second referendum is not likely until the 2020s and after the next UK General Election in May 2020. There is a significant chance that the terms of a UK-EU separation are not finalised until into the 2020s, aligning such a timing with Sturgeon's "when the terms of Brexit are clear". Moreover, a referendum after the next election would, from a Conservative perspective, remove the risk of a break-up of the Union overshadowing the election; create a firebreak from any immediate adverse economic reaction to Brexit and the poll; and allow for a waning in SNP influence.

Nicola Sturgeon's announcement was made on the day the UK government received Parliamentary approval to trigger Article 50 and appears to have had some impact on the Brexit process. While the UK government has denied it, many believe this delayed triggering Article 50 this week, the government quickly reversing growing speculation that Article 50 would be triggered imminently and reiterating its longer-term end-March deadline. This later trigger may delay a formal EU Summit gathering to agree negotiation guidelines until after the French elections (23 Apr/7 May). Looking ahead, this should increase the weight the government places on Scottish interests in the Brexit negotiations. Yet insofar as the government is already severely constrained in its room for manoeuvre in these negotiations, this is unlikely to greatly affect the direction of discussions. As such it may build the case for future concessions to Scotland.

Would Scotland leave the UK?

Following an immediate boost for secessionists after the Brexit referendum result, polls have resumed the status quo ante of a modest lead in favour of the remains (*Exhibit 1*). On balance this modest lead is consistent across polls and much larger than 18-months before the last referendum.

Exhibit 1
Scottish referendum opinion polls



Source What Scotland Thinks and AXA IM Research

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Many argued that the economic case for independence was weak in 2014, but it appears weaker today. The fall in oil prices since 2014 has highlighted the reliance of the Scottish economy on oil revenues. In the latest Government Expenditure and Revenue Scotland report (2015-16), the Scottish public deficit was estimated at 9.5% of GDP (compared with UK 3.8%); oil revenues contributed just £0.059bn from North Sea oil taxation, compared with £9.6bn in 2011-12.

Yet plebiscites and elections over the last few years have clearly illustrated that broader economic interests are not voters only consideration. Broader issues of identity, sovereignty and affiliation have proved important recently. Political detachment may also be a feature in a second referendum. When Scotland last voted on independence it had 11 seats in the ruling government (10 Liberal Democrats, 1 Conservative) and 40 seats in the major opposition (Labour). The SNP's landslide gain of 50 seats to a total of 56 in 2015 ended this with only 1 seat for each Conservative, Labour and Lib Dem. With polls currently suggesting Tory dominance and an ineffective Labour opposition, the fact that Scotland has not voted for more than 1 Tory MP since 1992, may leave Scots feeling frustrated at their ability to affect policy in Westminster and underpin a determination for independence.

Scotland's relationship with the EU

Another key feature of a second referendum would be Scotland's future in the EU. Scotland voted to remain in the EU, but some that voted to leave the Union in 2014 also voted to leave the EU in 2016. For them, a decision to leave the UK, to remain in the EU may be a difficult one. Accordingly, Nicola Sturgeon has been coy about ambitions in this regard. She has discussed leaving the Single Market, not the EU per se, suggesting Scotland might join the European Economic Area (EEA) after any separation.

Scotland's separate future in the EU would be a journey into unknown territory for constitutional law. Even with a referendum before the UK left the EU, there would be no guarantee that Scotland could remain in the EU. While untested, most believe that once the UK triggered Article 50 it would start an irreversible two year negotiation: the UK could not change its mind mid-way and remain in the EU; it is not obvious that any separate part of the UK would be able to. Scotland may thus have to apply to join the EU as a new entrant (which would also include a commitment to adopting the euro in the future).

In 2014, countries that faced their own secessionist concerns (Spain, Belgium for example) publicised opposition to Scotland's joining the EU. It is not obvious that this opposition will have faded. However, in the broader context of EU unity in the face of Brexit, Scotland may benefit from a more sympathetic reception.

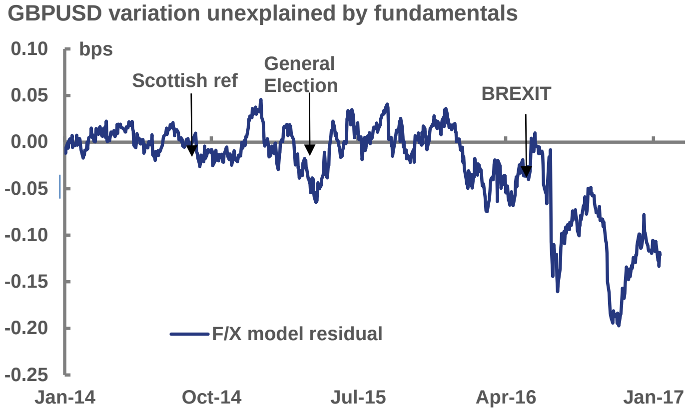
Market implications

Market performance in 2014 saw gilt spreads rise against both US Treasuries and German Bunds rose from May 2014 into the referendum by around 20bps. Both unwound these effects by year-end. Sterling credit markets also posted modest underperformance (a few basis points) versus euro and US credit in September 2014, centred on banks with no discernible impact on non-financial corporates. Sterling also recorded modest declines compared with interest rate changes (*Exhibit 2*).

With a referendum now appearing unlikely over the coming years, we do not expect a discernible market reaction. As another referendum date is set we would expect a modest echo of 2014's moves – downward pressure on sterling, a modest rise in gilt yields and underperformance in sterling financial credit. We would expect this to become more discernible closer to the referendum date and subject to polls at the time.

Exhibit 2

Political uncertainty and sterling



Source: Datastream and AXA IM Research

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