portfolio construction forum

The UK now faces years of volatility

Anatole Kaletsky | GaveKal | 08 September 2014

The probability that the United Kingdom will break apart now appears to be at least 50%. The weekend's crop of opinion polls agree with each other, and support last Tuesday's poll showing a powerful swing in favor of a Yes vote in next week's referendum on Scottish independence. Given that up until last Tuesday most investors and analysts (including me) saw no more than a 10% to 20% probability of independence, what has happened in the past few days amounts to a genuine exogenous shock of seismic proportions. In response to such a shock, it is reasonable to expect further large market movements, especially in the pound, which has now fallen 2.4% against the US dollar in just one week.

The biggest risk to the pound sterling and gilts lies not in the economic uncertainties that will be generated by future arguments about Scotland's relationship to sterling, the sharing of the UK's national debt, or the distribution of North Sea oil revenues. These are all issues with relatively marginal investment impact, which will only be felt in the long term.

Much more important are three political questions, not about abstract ideology, but of a kind that is highly relevant to investors:

1. What will a Scottish independence vote mean for British politics and economic management in the next nine months?
2. What will be the impact on the 2015 UK general election and subsequent economic policies, especially taxation?
3. What will all this imply for Britain's membership of the European Union?

The answers to all three questions are more alarming than almost anyone would have predicted a week ago:

1. If the Scots vote for independence, it is likely that David Cameron will feel forced to take responsibility and resign as prime minister. If he fails to stand down, a putsch against him by right wing Tories is almost certain. A mutiny may or may not succeed, but Conservative Party politics is extremely febrile and ruthless, and the risk to Cameron's position is not remotely discounted in the markets. In September 1990, nobody imagined that Margaret Thatcher was vulnerable; less than two months later, she was ousted by her closest supporters. Whether Cameron is replaced or not, Britain's government will be reduced to lame duck status between now and the May 2015 election. The only issues on the political agenda will be the terms of Scottish separation and apportioning blame for the referendum debacle.

2. The sense of shock and national failure resulting from an independence vote would make it much more difficult for the present coalition to win the 2015 election. The probability of a Labour-led government would rise from 40% to 50% today to something like 70%. This prospect should be very alarming to investors in sterling. Labour will campaign on a platform of higher taxes and public spending, a tougher property tax regime, hobbling and shrinking the City of London, and abolishing the concessions to foreign residents which make Britain one of the world’s most effective tax havens. If anything, the Liberal Democrats, who would probably be Labour's coalition partners, would be even tougher both in terms of personal tax reform and in their antagonism to the financial sector. To make matters worse, a Labour or Lab-Lib government would lack the political legitimacy to enact the measures promised in its manifesto, since the government's majority would rely on Scottish members due for expulsion from the English parliament in 2016. A constitutional crisis would therefore ensue. Presumably, Labour would respond by promising another general election in mid-2016, immediately after the Scottish secession. The result would be two years of unprecedented political and fiscal uncertainty for all businesses and investors in Britain.

3. Even in the unlikely event that the Conservative Party or a Conservative-Liberal coalition is re-elected in a 2015 election after a Scottish independence vote next week, the political consequences would be dire. In the event of such an unexpected victory, the Conservative Party would regard its hold on power as assured following the expulsion of Scotland's 59 members of parliament (only one of whom is Conservative). As a result, the party would swing decisively towards the Euro-skepticism favored by its grassroots activists. A referendum on EU membership would be held in 2017 in which the new prime minister (who might conceivably even be David Cameron after a Damascene conversion to Euro-skepticism) would either adopt a neutral position or actively campaign for an exit. Either way, the odds on the UK leaving the EU would climb above 50%.

In the more probable scenario discussed in option 2 - that a Scottish independence vote would lead to a Labour-Liberal victory in the May 2015 general election - there would be no EU referendum in 2017 as promised by the Conservatives. At first that might seem to offer some relief on the European front. In reality, however, it would do nothing to secure Britain's EU membership. On the contrary, a Lab-Lib government would have to call another general election immediately after Scottish secession in 2016 - an election in which EU membership would be straight back on the agenda. The Conservatives, emboldened by their 'natural' majority in the UK-minus-Scotland would swing towards outright Euro-skepticism and campaign for an immediate post-election referendum, laying down conditions for renegotiating EU membership which Brussels, France and even Germany would be sure to reject.

Thus, a Conservative victory in a 2016 election would make Brexit almost certain a year later. If, as is quite possible, the Euro-skeptics overplayed their hand and the Tories lost the 2016 election, the UK would be saddled with a high tax Labour-Liberal government until 2021.

As a result, if Scotland does vote for independence next week, it is hard to come up with a positive scenario for British assets, whatever happens subsequently. Of course, there is always the hope that the polls may be wrong or the Scots will change their minds at the last moment once they realise what a Pandora's box of political uncertainties they are about to open. But hope is not a strategy. We recommend selling sterling and other British assets, apart from those such as resource shares which have little exposure to British politics and which benefit directly from a weak pound.

Anatole Kaletsky is co-founder and GaveKal Research, GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.
