MONTHLY MARKET UPDATE: SCOTLAND SPECIAL

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BNY Mellon Conference Call – Thursday, 11 September 2014

OPERATOR: Thank you all for joining, and welcome to the Monthly Market Update from Simon Derrick. The statements and opinions expressed by Mr. Derrick during this call are those of Mr. Derrick as of today's date and do not necessarily represent the views of BNY Mellon and any of its affiliates. Much of the information referenced by Mr. Derrick during this call comes from publicly available sources that have not been independently verified. This call is being recorded for posting by BNY Mellon to its public website. I will now hand the call over to Mr. Derrick. Please proceed and thank you.

SIMON DERRICK: Thank you very much indeed, and welcome back everybody from summer vacations to our regular monthly calls. Given the events over the last few days with the changing focus of the foreign exchange markets, we thought it might be appropriate simply to give an objective rundown of some of the issues that are being raised by the Scottish referendum scheduled for next Thursday, just to give people both in the UK and elsewhere a simple checklist with a few of the topics that may come up for discussion.

As you will all be aware on this call, or at least regular listeners will be aware, we've been arguing for several months that the foreign exchange markets have been largely ignoring the referendum on Scottish independence set for September 18th.

This changed this weekend after the publication in the Sunday Times of the latest poll by YouGov showing that 51% of those surveyed were now in favor of independence once the undecided voters were stripped out of the findings. This marked a 4 percentage point shift in the wind and stood in sharp contrast to the 22 point lead the Better Together campaign held at the start of August.

It was also clear from the poll that the undecided count was shrinking in size. Once their results were added in, the Yes campaign support stood at 47% compared to 45% for the Unionist group. It's important to know that this was just one survey, and that polls can carry significant margin for error.

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The press association reported over the weekend that the separate poll by Panelbase found support for the No campaign still running at 52% once the undecided votes were excluded. That's unchanged from a week ago.

Similarly, a poll published yesterday by Survation in Scotland's Daily Record showed 53% voting No and 47%, Yes. Nevertheless, the publication of a poll on Tuesday morning by CNS showing an even split in support for the Yes and No camps amongst those saying they were certain to vote votes around 41% compared to 38% and 46% a month earlier provided further support for the view that the result is now too close to call.

So, what issues could face the financial market if Scotland votes Yes on the 18th?

I think the first one is again a fairly familiar one, and this is simply the issue of currency in Scotland. And to finalize, we want to discuss the three options which are most commonly considered to be out there.

The first of course is simply continuing to use the sterling. This was addressed by the governor of the Bank of England, Mark Carney, on Tuesday when he told the TUC Congress that there had to be three components to a successful currency union. There has to be free movement of goods and services across the different paths of the currency, a banking union underpinned by common institutions such as a central bank, and elements of shared fiscal arrangements. He added, "You only have to look across the continent to look at what happens if you don't have those components in place. A currency union is incompatible with sovereignty."

He also reiterated that all three main parties in Westminster have ruled out a currency union. While the government in London might refuse to enter into a currency union with Scotland, this does not mean that Scotland can't continue to use the pound sterling.

Panama and El Salvador for example use the dollar without being in a currency union with the United States. However, it means that Scotland would have no say over monetary policy nor have a lender of last resort for its banking system. Nevertheless, given the comments from First Minister Alex Salmond since the start of 2015, this looks the most likely option, at least for the early years of independence.

It's also worth highlighting Bank of England Governor Mark Carney's comments to MPs on the Treasury Select Committee yesterday. He argued that the experience from other countries was that central banks needed to have reserves equivalent to at least 25% of GDP if they used another country's currency. He cited the example of Hong Kong which pegs its currency to the dollar and has reserves around about 110% of GDP. This in turn would imply that the Central Bank of Scotland, if that were what you would call it, would need to accumulate a stockpile of between £32 billion to maybe over £160 billion. That's according to calculations made by the Financial Times this morning.

Mark Carney added when he was speaking yesterday, "Just having a central bank isn't by definition a credible lender of last resort if that central bank is not an issuer of the currency. It needs to be backed up in any event by fiscal resources, but particularly if it is the currency of another jurisdiction. It’s a fact that the size of the reserves is one of the most important factors that determines the credibility."

Finally, it's worth noting that Mr. Carney stressed that the Bank of England would remain the central bank and lender of last resort for the whole of the UK, including Scotland, during the expected 18-month transition period—obviously if there were a Yes vote to emerge next Thursday.

The second option would be adopting the euro. Membership in the European Union is a prerequisite in order to be considered for membership of the euro. This doesn't look likely given Mr. Barroso's very clear comments in early February that Scotland could become a path to the single currency straightaway. Nevertheless, it is possible that much like Montenegro and Kosovo it could use the euro without being part of the euro area. So that raises similar issues as using sterling when it comes to the matter of setting monetary policy.

It's also worth noting that Olli Rehn who stepped down in July as the European Commissioner for Economic and Monetary Affairs said last week that it would simply not be possible for Scotland to join the EU if it adopted so-called "sterlingization."

The final option is to relaunch the pound Scots. Prior to the 1707 unification of the kingdoms of Scotland and England, the unit of currency north of the border was actually called the pound Scots. It is entirely possible that a newly independent Scotland could relaunch the currency and establish its own central bank. And the reason for saying that is that when asked on BBC Scotland's Sunday Politics show about his currency plans last weekend, Alex Salmond insisted he had plans for a monetary authority if there was no currency union and a separate Scotland could no longer rely on the Bank of England.

Next issue to raise is that of the share of the national debt. And probably the clearest statement on the S&P's position regarding Scotland's share of the debt estimated that £143 billion by the National Institute of Economic and Social Research came on February 17th in Aberdeen when Alex Salmond said as reported by the FT, if there is no legal basis for Scotland having a share of the public assets of the Bank of England, then there is equally no legal basis for Scotland accepting a share of the public liability of the national debt.

And that point was reiterated by Sir James Mirrlees, the Nobel Prize-winning economist who manages Scotland's Council of Economic Advisers in an interview with the Daily Telegraph published on August 24th. He stated, "Britain inherits the debt. It is hard to see how Scotland can take on the debt unless there is a full currency union. This is implied by the hardline taken by Westminster. It is Scotland's bargaining position."

The potential impact of Scotland renouncing its share of the national debt was spelled out by Fitch Ratings on April 10th when it said, "The UK government has recently stated that in the event of Scottish independence, it would in all circumstances honour its issued stock of UK debt. This would lead to a one-off increase of 9.5% of GDP in the UK gross public debt ratio as Scotland was stripped from UK GDP from 2016."

And Fitch Ratings went on to say, "As we have previously emphasised, the UK's gross debt ratio will need to be lower than its current level and steadily declining before any upgrade back to 'AAA,' a prospect that would be delayed by such a debt shock."

Oil is also a topic that deserves to be raised. I'm going to quote actually fairly directly from an article written by David Smith in the Sunday Times last week. He highlighted the deteriorating picture for oil production. He noted that the North Sea will produce around 830,000 barrel a day of oil this year, and that's just 28% of the peak of 2.92 million barrels in 1999.

Oil and gas production stand to come to some 75 million tons of oil equivalent. That's 31% of the 1999 peak of 243.7 million tons. He noted that oil and gas production is in long-term decline, and that decline has averaged 7.8% a year since the 1999 peak.

Production, he noted, has fallen particularly sharply since 2010, mostly as a result of a sharp drop in production efficiency. He also highlighted that for 2013-14, Scotland's oil and gas revenues appear to have dropped to £4.2 billion, whilst the independent Office for Budget Responsibility forecast for North Sea revenues imply further falls over the next few years to sterling 3.3 billion this year, 3.4 billion for 2015-16, 2.9 billion for 2016-17, 3.1 billion in 2017-18, and 3.2 billion in 2018-2019. As I said, those are the numbers from the independent Office for Budget Responsibility.

Beyond Scotland, it’s also worth considering what might happen in London and particularly Westminster. Both main party leaders in Westminster could find themselves under pressure should Scotland vote to secede from the union. The FT reported on Monday that members of the Conservative Party 1922 Committee had been calling members of Parliament over the weekend to gauge support for David Cameron in the event of a Yes vote.

Following this, on Tuesday the Daily Telegraph reported senior Conservative MPs— that's how they described them—told the paper that Prime Minister David Cameron was in serious trouble with his party for risking the future of the union by agreeing to the referendum and could face a vote of no confidence from within the party if Scotland chooses independence. A vote of confidence in Mr. Cameron would be triggered if 46 Conservative MPs requested one.

The situation on the other side of the House could prove difficult as well. At the last election Labor won 41 out of 59 Scottish seats, and therefore Labor's narrow lead in the latest polls indicate that the leader, Mr. Miliband, might find it very hard to form either a minority government or one in coalition with the Liberal Democrats without the support of those Scottish MPs.

Which brings us to the question of the 2015 general election in the United Kingdom. And questions have been raised whether a general election would be feasible given that MPs elected from Scotland could under the current arrangement still sit in Parliament in Westminster until March 24th, 2016. That's the date penciled in for independence.

This has led, according to the Guardian in an article published on September 3rd, to a number of Conservative MPs calling for legislation to postpone the election until May 2016. However, that would require the repeal of the Fixed-term Parliaments Act of 2011.

It's also possible that legislation could be brought in the House of Lords. The House's Constitution Select Committee published a report on May 16th of this year on the implications of the referendum, which noted fixation of a Parliament beyond five years will be an extraordinary step constitutionally. It may risk being seen by voters as self-serving, extending the time in power of the current government.

There's an alternative to this. The former Welsh secretary John Redwood wrote on his blog on Monday of this week that Parliament could in the event of a Yes vote pass legislation canceling the general election in Scottish constituencies only.

He argued, "There is no need to delay the general election in the rest of the UK. The new government for the rest of the UK should be formed from the winners of the election in England, Wales and Northern Ireland. The remaining Scottish MPs would be excluded from calculating the majority and would not be eligible to be ministers."

Finally, let's just talk about the impact to the financial markets. This potential shift in the economic and political landscape comes at the end of a period in the UK financial markets have to a large degree proved remarkably sanguine.

FTSE 100 traded back to its old time highs this summer. The sterling against the dollar saw its highest levels this October since 2008. The reasons for this are easy enough to see. The combination of the glacially slow pace of monetary policy timing in the US no doubt influenced by last year's taper tantrum, continued questions over whether Japan might need a further round of quantitative easing following the sales tax hike, as well as from April onwards great pressure on the ECB to ease monetary conditions further pushed investors into a search for yield during the first half of this year.

This was most apparent from the performance in currency sectors of the Brazilian real and the Indian rupee as investors flocked to the higher yields available there. As a result, the combination of a seemingly robust economic recovery in the UK combined with hints from Mr. Carney through Q2 that the time was coming for the first hike in UK rates saw sterling look like one of the easiest bets amongst the mainstream currencies leading in turn to sharp rise in speculative holdings.

According to the CFTC data, by the start of July this year, the net long positions in CME sterling contracts among speculative players reached its highest level since December 2007. Just to point out, that's when sterling stood at above 2 to the dollar.

The remarkably low levels of implied volatility that prevailed until recently for sterling against the dollar are also understandable when looked at through the lens of the carry trade as investors sold issuance in order to generate additional yield pickup.

Stirling Council losing shy from the start of August as some new realities within the UK commonly became apparent. Particular evidence started to emerge that the housing market boom was stalling, plus a modest rise in the industrial outputs in June and a far weaker than expected market SIPs manufacturing PMI for July hitting its lowest level since July of last year indicated a broad slowdown might be emerging.

Comments from Mark Carney mid-August following the publication of the latest quarterly inflation report also suggest that the rate of policy timing might be more moderate than investors had come to believe. The end result of this was a modest decline in the value of sterling and a quick reduction in the size of sterling net-long contracts from the CME. However, even by late August these speculative players remained long with sterling whilst implied volatility along with much that can remain not far off historic lows.

Given this backdrop, it's possible to see why last Sunday's poll in the Sunday Times provoked the reaction it did in the market. After six months or more of focusing almost exclusively on monetary policy issues and becoming used to a seemingly benign environment, investors were caught simply unaware.

It's worth noting that sterling against the dollar one month after putting forward implied volatility has risen from about 7.1% at the close of business last Friday to over 10% by the start of today.

That’s largely it on the current evidence and certainly the consensus opinion, the outcome of next Thursday's referendum is too close to call. It is certainly not my intention to give a call in either direction. However, hopefully what we've been able to do over the course of the last 20-odd minutes is maybe just highlight some of the potential factors that need to be considered over the course of next week, and possibly after next Thursday.

We hope this has been of value, and we look forward to talking to you next month.

Thank you very much indeed.

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