Trade Booster

23 September 2014

UK political uncertainty adds risks for UK gilts and FTSE 100

Summary

- **Scotland's no vote creates an uncertain outlook for the UK as details on the fiscal and economic implications remain unclear until mid-October. Dissolving UK's central government powers feeds fringe party rhetoric and weakens UK's coalition government.**
- **Calls for UK leaving the EU are growing. At risk is UK's political leverage and benefits to free trade within the EU. Faced with potential unwarranted competitive disadvantages for UK large-cap exporters, the FTSE 100 may de-rate.**
- **A delayed interest rate hike by the BoE and a devaluing pound raise inflation risks short term. Longer term, a fractured fiscal structure portends a higher risk premium for UK gilts.**
- **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)***

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)

Chart 1: with UK assets under pressure...

UK benchmark bonds and sterling

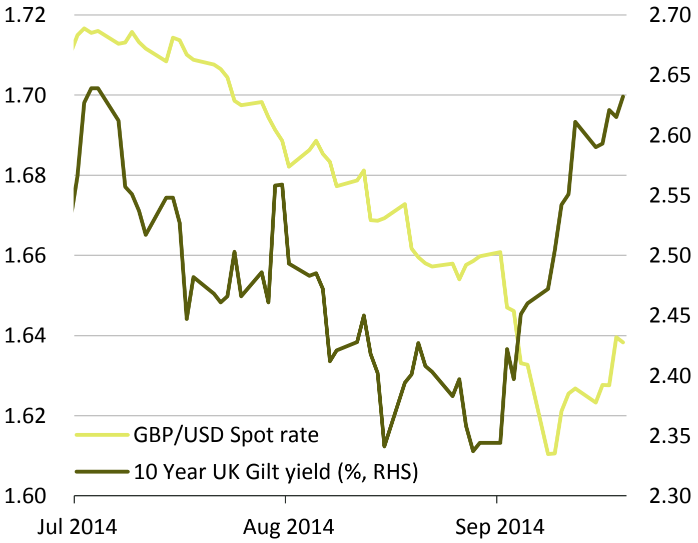
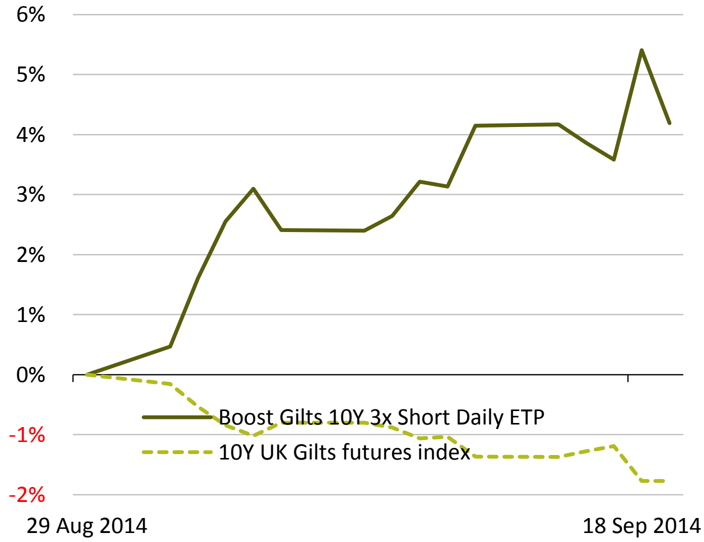


Chart 2 ..it pays to be hedged

Total return performance , rebased



Source: Boost ETP Research, Bloomberg. Data to 19 Sep 2014

Scotland's stronger than expected vote against independence leaves the UK in an uncertain path. Clouding the outlook for the UK is not just the extent to which central powers will be dissolved, but the threat the popular nationalist parties pose to the stability of the coalition government and UK's partnership with the EU. The political and economic uncertainty is expected to negatively impact UK's equity and bond market, with UK's exporters seeing their competitiveness in the EU erode, even as a delayed interest rate hike by the BoE pose rising inflation risks for UK bond investors. A fractured fiscal structure would furthermore compel investors to discount UK gilts with a higher risk premium. Until more details regarding the dissolvement of central government powers emerge, the uncertainty overhanging the UK may keep investors on the sidelines. Against this backdrop, 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:

Contact Information: ☏ +44 (0)20 3207 9050 ✉ info@boostetp.com www.boostetp.com

Short UK government bonds:

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

Short UK large-cap 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)

A no vote majority has come with significant fiscal concessions to Scotland

With the no camp's capturing 55% of vote, Friday's defeat of the Yes camp was larger than expected. The reaction on the UK equity market was initially bullish, but the rally soon fizzled out, leaving the FTSE 100 and FTSE 250 benchmarks to close the day at 0.27% and 0.87% higher, respectively. While uncertainty around Scotland's future is removed, the uncertainty regarding UK's political and economic outlook is just beginning.

The promises made to Scotland are substantial. In fact, with Scotland to date not making full use of its powers it already enjoys, (for instance it has the power to raise or reduce the income tax rate by up to 3%, a right it to date has not excersised), the new powers coming into effect in 2016 will allow it to alter the tax rates by up to 10%. Hence, UK's base tax rate of 20% and highest income tax rate of 45% can be raised to 20% and 55%, respecticely, or cut to 10% and 35%, respectively. All tax brackets would need to move in tandem however, so if changes are made to the base tax rate, the same change needs to be made to the lower, middle and highest income tax brackets as well. However, more freedom for Scotland's tax policy is in the pipeline. Both the Conservatives and the Liberals have promised Scotland to also be in control of the tax bands, hence enabling Scotland to steepen or flatten the progressive income tax structure. Scared of the idea to have potentially presided over a secession of Scotland UK prime minister David Cameron has also offered more control outside income taxation, including control over VAT. In terms of fiscal policy therefore, not only will Scotland be significantly in control of its own budget, it will - willingly or unwillingly - be steering indireclty the tax and spending policies of the rest of UK along with it. The perception is that with such substantial powers over taxation, not to mention public spending and welfare for Scotland, the Leadership of UK's main parties, Ed Milibrand of Labour, Nick Clegg of The Liberal Democrates but in particular David Cameron of The Conservatives have overplayed their hand for the sake of preserving the Union.

The extent of concessions the yes camp has been able to extract from Westminister has soured the mood of many MPs both inside and outside the coalition government. Already unhappy with how the Scotland affair was handled by David Cameron from the beginning - not least with respect to having underestimated the strength of Scotland's independence movement and allowing former prime Minister and leader of the Labour party Gordon Brown to set the terms for Scotland and succumb under pressure too quickly – the rebel MPs representing the other regions of the UK will now look to extract more self-rule from Westminster too. David Cameron on Friday already announced to also devolve power for Wales. Having promoted equality and fairness as a British identity, it will mean similar powers to be given to Northern Ireland too. Because Scotland, Wales and Northern Ireland already have their own parliaments where they can vote on policies regarding regional issue but where England has no say, it is only logical that England, which next to its own MPs is subject to Scottish, Welsh, Northern Irish MPs to vote on matters regarding England, should be given similar autonomous powers as well.

A fractious government poses downside risk to UK's partnership with the EU

The political price David Cameron is willing to pay is steep, with major devolution of powers to not only have undermined his leadership but, at least short term, to also have shaken investor confidence in sterling assets. While details of Scotland's newly acquired powers will be announced on 16 October, investors are already assessing the fiscal and economic ramnifications the political drama has caused. On investor's radar screen is the attempt by UK's rebel politicians to attempt a much bigger accession, leaving the EU. With popular nationalism rising on the back of calls for independence, the UKIP (UK Independence Party) is likely to have received another boost. Having already gained significant seats at the expense of The Conservatives in the last elections, David Cameron will be under pressure to take a tougher stance on Europe and proceed with the referendum on UK's in or out EU membership referendum. But pressure for Labour to promote more autonomy for England is mounting too, given that Ed Miliband will face the loss of some 40 Scottish PM votes to implement legislation for England. Hence, while EU politicians may have been relieved by the No vote victory, it is likely that EU members will look towards UK with increased scepticism too. Many EU members, already struggling with their own fractious coalition governmernts and seperatist movements, would now think twice before siding with Cameron (or for that matter Milibrand) to extract concessions from Brussels. The result is that within the EU, the UK will have lost more political clout and goodwill and looks even more isolated.

The uncertainty compells investors to discount UK equities and gilts with a higher risk premium

Against the backdrop of such political and fiscal uncertainties are the larger economic risks to UK assets. Not surprisingly, the British pound has failed to regain strength against the US dollar on Friday. Furthermore, the pound's weakness is likely to only have given temporary momentum to UK's mulinational heavy FTSE 100 index. For instance, the largest gains in UK equities were seen in financials such as RBS which, following the no camp's victory, has announced to no longer be looking to relocate to London. But from a broader economic point of view, the removed threat of FX and cross boarder costs to trade between England and Scotland compare little to the much larger threat for most of UK's non-financial companies, both big and small: that of potentially losing the political leverage and the benefits of free trade agreements with the EU longer term. Over the 12 months to August 2014 the UK exported USD 230 billion of goods and services to the EU, representing more than 51% of UK's total exports. Hence, with the EU being UK's largest export market the potential costs for UK business will be significant were the UK to end its EU membership. A fundamental de-rating of UK equities, driven by investors compelled to translate a deteriorating export outlook for the UK into discounting UK equities against a higher opportunity cost, is a long term threat overhanging the FTSE 100.

UK bond markets may also succumb to more pressure, as the anticipated delay of the first policy interest rate hike by the BoE will likely signal a higher tolerance for inflation risk, at least until the details in mid October surrounding the fiscal implications are announced. While at 1.5% UK inflaton is low and on a downward trajectory, the weakness of pound and the strong rebounding domestic economy may help rebuild inflationary pressures and sharply reverse the falling trend eventually. As shown in Chart 1, UK gilts and sterling have been under considerable pressure and Friday's outcome has done nothing to alleviate it. This month, the geared short positions on UK gilts have helped investors to hedge their exposure efficiently (see Chart 2). Until more clarity arises in mid October on the political, fiscal and economic implications regarding the Scottish no vote, It may be prudent to stay hedged.

All data is sourced from Boost ETP, and Bloomberg