

ANALYST VIEWPOINT

OCTOBER 2008

CHECK HATCHES & HARNESSSES

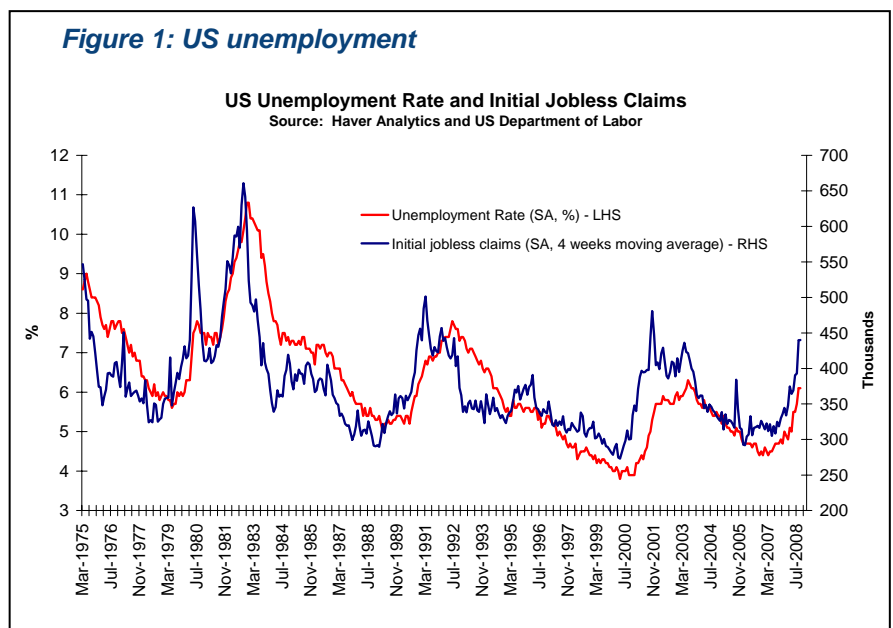
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Introduction

The H in the BUMFISH¹ pre-landing checklist stands for hatches and harnesses. Despite the US\$700bn bank bail-out package recently enacted by the US Government (not to mention arranged rescues for other troubled financial institutions in Europe), I think the world economy and the aviation industry are in for a very tough time over the next few years and that harnesses should be very securely fastened. Here's why, and unusually, I hope I am very wrong.

The Economic Outlook

Let's leave aside the most recent volatility in financial markets and troubles in global banking and credit markets for a minute and focus just on economic developments up until early September. Somewhat unbelievably there is still some debate about whether the US economy is in recession, firstly because the NBER has yet to officially announce a recession (something that always occurs well after the fact in any case) and secondly as there has not been one let alone two successive quarters of negative GDP growth (the latter is what economists refer to as the "technical" definition of a recession). I've always viewed the unemployment rate as the best overall guide as to whether an economy is in recession or not and as can be seen in Figure 1, the increases in the US unemployment rate associated with the recessions at the start of the 1980s, 1990s and 2000s are very clear. The current experience has seen the US unemployment rate climb by one and a half percentage points from a low point of around 4.5% in late 2006 and the first half of 2007 to 6.1% in September 2008. And the smoothed average of initial weekly jobless claims (not to mention recent weeks' financial market ructions) suggests that the unemployment rate increase has some way further to go, in my opinion confirming that the US economy is already in recession, with the likely depth and duration the key issues to be debated.

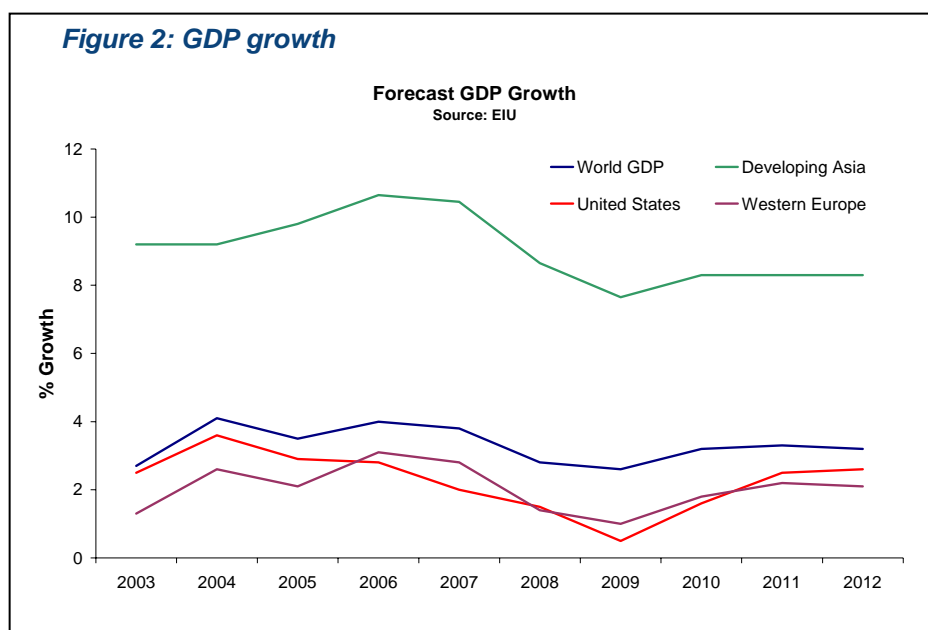


¹ Brakes, Undercarriage, Mixture, Fuel and Pumps, Instruments, Switches and Hatches and Harnesses

Comparing other major regions of the world, the Japanese economy has also slowed sharply (with unemployment rising around half a percentage point from its mid 2007 low point – similar-sized increases in the unemployment rate have occurred in NZ and Singapore); unemployment is just beginning to rise in Europe and the UK, while in Hong Kong, which I use as a proxy for China, unemployment has declined compared to a year ago.

Unemployment, while a useful short-cut indicator of overall economic health, is a lagging indicator of the economy. Economists' forecasts and surveys of business confidence contain expectations of the future (even though these are not always correct) and hence have some predictive qualities about where economies might be headed.

Table 1 and Figure 2 portray the September economic forecasts from the Economist Intelligence Unit. Forecasts for economic growth around the world have been revised sharply lower in recent months (again this is before the problems of the past few weeks), with economic growth expected to be extremely soft in 2009 in a number of countries, including the US, UK, Europe, Japan and NZ, before growth recovers in 2010. And in something of a recent phenomenon, growth



expectations in the previously decoupled emerging economies (including China and India) have been revised lower. This recoupling owes much to the global nature of the shocks currently impacting economies – the credit crisis, oil price rise and equity market weakness are all global events impacting all economies and markets both directly and indirectly.

Table 1: GDP growth

Real GDP Growth (%)	2006	2007	2008F	2009F	2010F	2011F	2012F
World GDP	4	3.8	2.8	2.6	3.2	3.3	3.2
US	2.8	2	1.5	0.5	1.6	2.5	2.6
Latin America	5.4	5.4	4.1	3.5	4.1	4.1	4.1
Japan	2.4	2.1	1.1	1.3	1.9	1.1	1.4
China	11.6	11.9	9.8	8.5	9.1	9	8.4
India	9.7	9	7.5	6.8	7.5	7.6	8.2
EU27	3.1	2.9	1.7	1.3	1.9	2.2	2.3
Sub-Saharan Africa	6.5	6.4	5.8	5.5	5.7	5.2	5.4
Middle East and North Africa	5.9	5.5	6.1	5.5	6	5.8	5.9
UK	2.8	3.1	1	-0.2	1.1	1.9	2.4
Canada	2.8	2.7	0.9	1.4	2.2	2.3	2.3
Eastern Europe	7.2	7.3	6.2	5.6	5.4	5.1	4.9
Western Europe	3.1	2.8	1.4	1	1.8	2.2	2.1
Asia & Australasia (ex Japan)	8	8.3	6.5	5.7	6.7	6.6	6.5

Source: EIU, September 2008

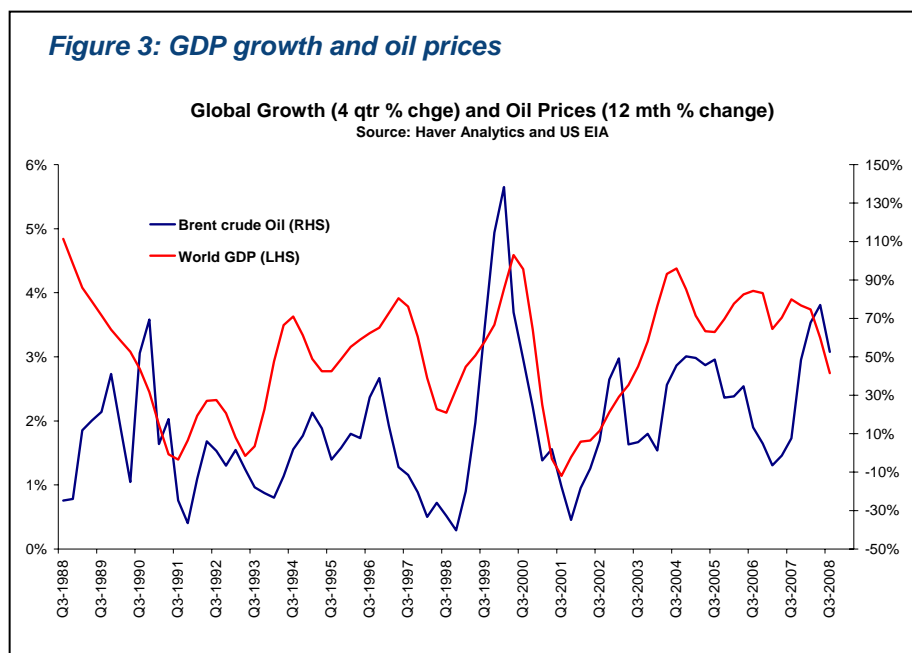
If there's a risk, it's that economic growth turns out to be even weaker in the period immediately ahead than the latest EIU forecasts suggest, given the synchronised slowing of major developed and developing economies currently underway. This risk is supported by the significant deterioration in

business confidence that has occurred across major economic blocs in recent months. And if history is a guide, downturns associated with significant asset price declines and/or banking system problems tend to be longer or deeper than predominantly sectoral recessions (contrast the experience of the world economy in the early 1990s to the early 2000s technology recession). Once again, cries of this time it's different and declarations of the demise of the business cycle (this time due to the emergence of China and India) have proven incorrect.

Implications for Aviation

First the good news - as oil (and other commodity) prices have proven remarkably cyclical across time, the emerging global recession is likely to provide further relief on the oil price front. Sub-\$100 oil seemed something of a dream a few months back as oil approached \$140 a barrel, but has been achieved just weeks later. Technical analysts I follow are suggesting prices could fall back towards \$50 per barrel over the next twelve months.

If realised, such a price fall would provide a very welcome reduction in costs for airlines (and for consumers and businesses more generally). It should also ease inflation concerns of many central banks. However, such an outcome is likely to be driven by a period of global recession, during which airlines will experience increased pressure on yields and load factors as unemployment rises. Increased aircraft deliveries (especially of freighter aircraft) over the next two years may well exacerbate these pressures, however, airlines are likely to retire older less fuel efficient aircraft and seek to defer deliveries to manage capacity growth to the weaker demand outlook. This is likely to especially be the case if oil prices were to remain elevated for a time before experiencing a further cyclical decline as profitability considerations would largely preclude price stimulation as a strategy to counter weakening demand.



It will also be interesting to observe the impact on the demand for travel on low cost carriers. I have been involved in debates that allege LCCs (low cost carriers) do not suffer in business cycles like FSAs (full service airlines), because of down-trading. Economists learn very early on when studying demand about the income effect and the substitution effect. When income drops/rises, demand drops/rises and at the same time, consumers substitute to cheaper/more expensive products. Almost invariably, the income effect (of higher unemployment) outweighs the substitution effect (here the increased demand LCCs would experience from consumers trading down from FSAs). I'm suggesting many LCCs, some for the first time, will also experience much tougher demand conditions for an extended period.

Conclusion

Unfortunately, my pre-landing checklist concludes that harnesses should be very firmly tightened. Airlines worldwide are again likely to manage for cash/survival and it is not too much of a stretch of the imagination to expect a further acceleration in consolidation or industry exit akin to what is currently occurring in the banking sector. Ultimately lower oil prices and lower interest rates will give rise to the next business cycle upswing, however, it appears a further painful period of industry restructuring lies ahead first.

The views expressed in this article are the author's and not necessarily those of IATA.