Global Economic Outlook

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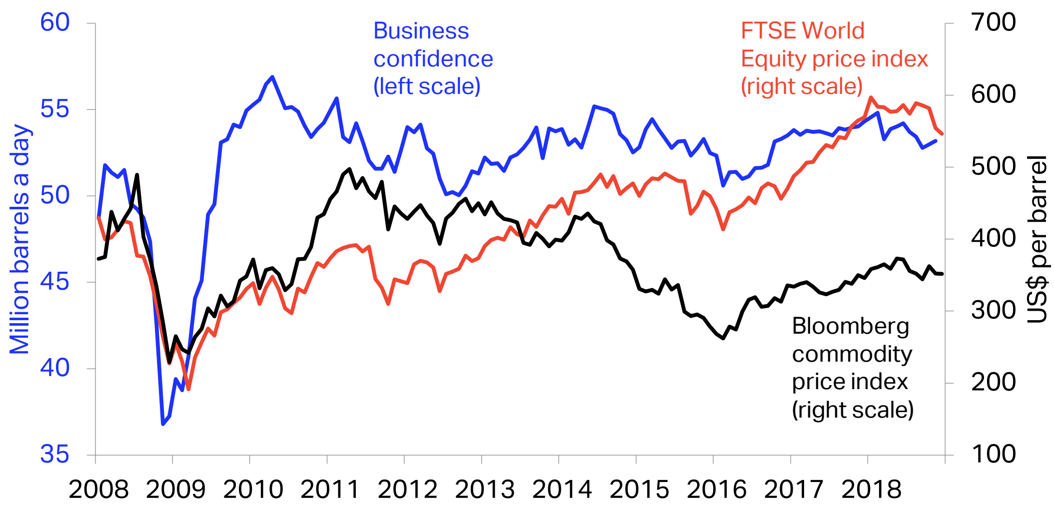
Are the markets signalling recession ahead?



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Source: Datastream, Markit

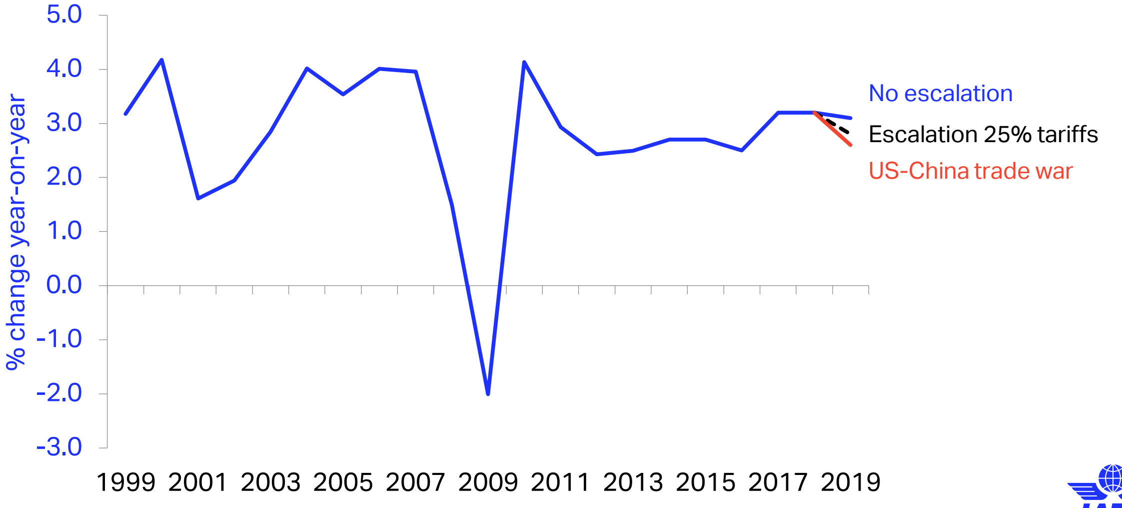
There is a lot of uncertainty and volatility in politics and financial markets today.

The US Treasuries yield curve has almost inverted and world equity markets have fallen 8% since the start of 2018, commodity prices have weakened.

Some suggest this means a recession in 2019, which would clearly be bad news for the airline industry.

However, financial markets rose substantially from 2016. Although equity prices have fallen 8% this year they are still 20-30% higher than where they were in early 2016. That's still consistent with good corporate earnings and an expansion, not recession.

Trade wars damaging but not expansion stoppers



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Source: IMF, Citi 'US-China Tariffs-Limbo on the Verge of Trade Wars' 3 December 2018

But there is a lot to worry about.

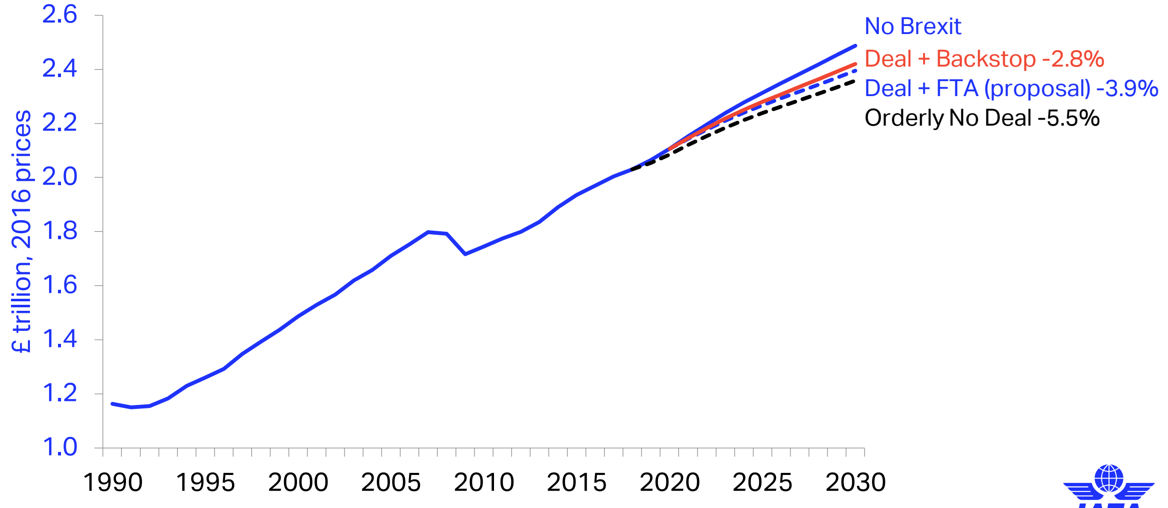
A major worry is protectionism and the US imposition of trade tariffs on China and threats on others.

Aviation depends on open borders and itself facilitates the free movement of people and goods.

Border frictions are bad news for aviation and the economic development it brings.

However, analysis by economists at Citigroup shows an escalation in January 2019 to 25% US tariffs would be damaging – but by cutting global growth a further 0.3%, it would not stop growth. They also modelled a more extensive trade war between the US and China which would cut 0.5% from growth but again would not on its own stop the expansion.

Brexit chaotic but slows rather than stops long-term



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Source: Oxford Economics, NIESR Brexit Impacts Report 26th November 2018

We don't know what the outcome will be with the Brexit negotiations. We are not even certain that it will happen.

The uncertainty is damaging. Businesses cancel investment and hiring, which weakens the UK economy. The pound falls. This has already weakened the UK economy and aviation.

However, these confidence effects are impossible to model with any certainty.

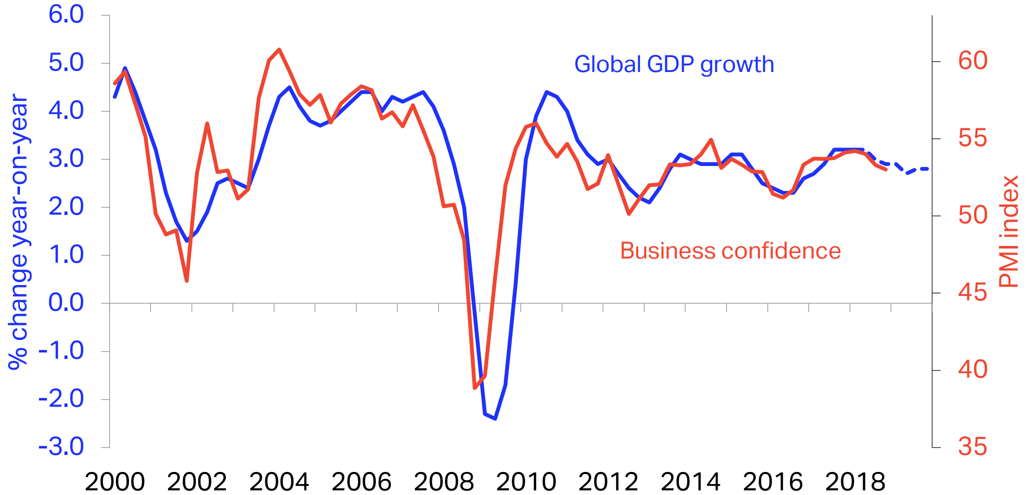
More certain are the long-term increases in costs due to exiting a single market, a customs union or a free trade agreement.

The UK's National Institute of Economic and Social Research modelled the options. We show their 2030 impacts here but not any shorter term confidence effects.

Clearly Brexit in any form will lower UK GDP relative to staying in the EU. This will lower the demand for air transport and damage aviation. Airlines have faced costs already in adjusting their business models to comply with changes to ownership and control and market access regulations.

But Brexit will lower the slope of economic growth in the UK, rather than stop it in the longer term.

Forecasters still expect economic growth in 2019



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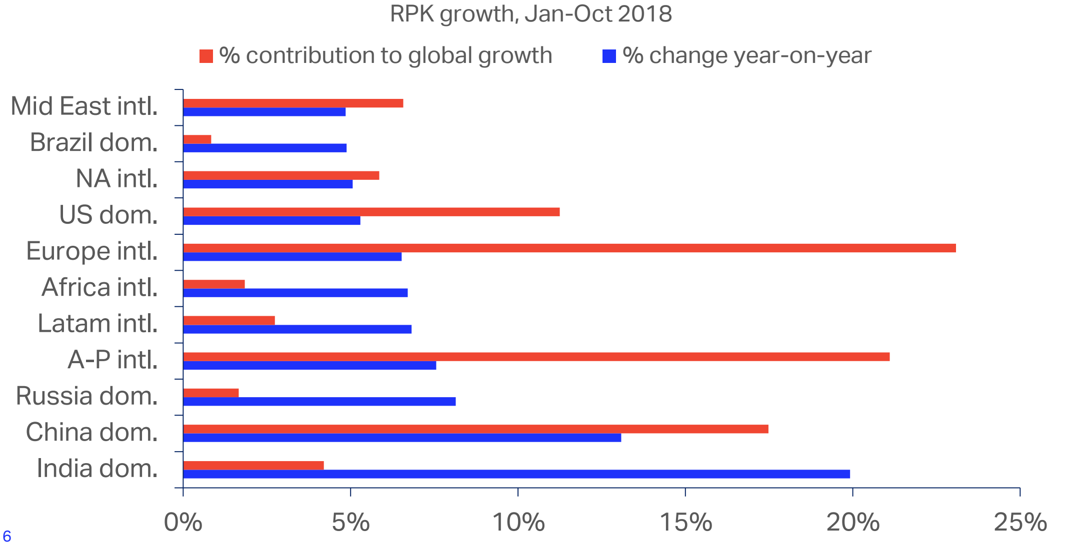
Source: Markit, IMF World Economic Outlook October 2018

Jobs are still being created at a healthy rate in the US, business investment is still rising, government fiscal policies are supporting growth, monetary policies are not yet holding growth back.

These factors make mainstream forecasters continue to expect economic growth in 2019, despite the current financial market volatility.

Forecasters like the IMG, Goldman Sachs, Citi, Oxford Economics are all projecting continued growth next year, slower than 2018 but still relatively good and supportive for the airline industry.

Air travel has certainly got a lot of momentum



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Source: IATA Statistics

The 1st 10 months of this year has shown strength in air travel growth across markets.

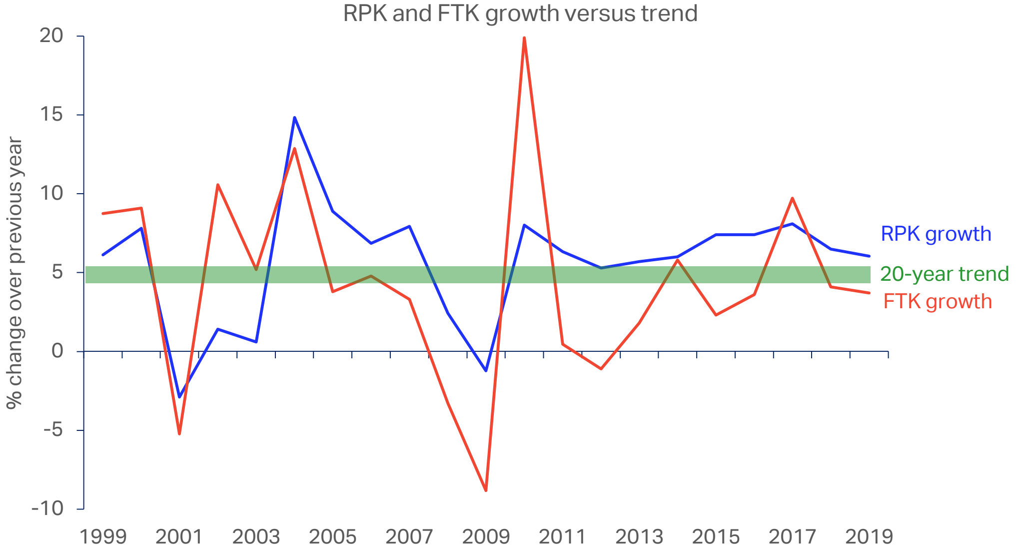
The blue bars show year-on-year growth for the 10 months to October.

Asian domestic markets have been particularly strong.

As you can see from the red bars large market areas like Europe and Asia-Pacific international RPKs have contributed almost half of the growth seen so far this year.

There is considerable momentum to travel growth as we go into 2019.

Expect slower travel growth, but still above trend



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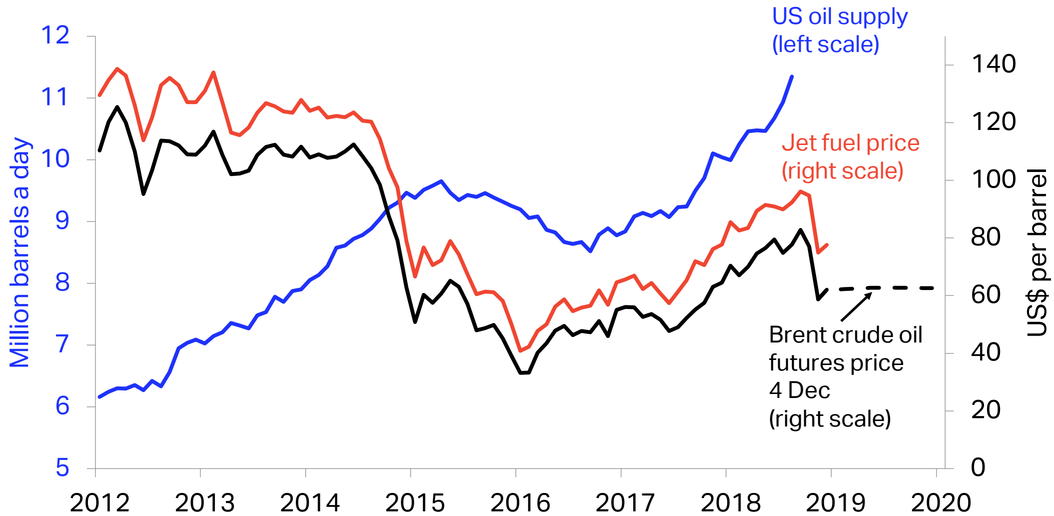
Source: IATA Statistics, IATAs own forecasts

Growth will inevitably slow but we still expect 6% RPK growth in 2019, which is still above the 20-year average.

Air cargo will slow under the impact of new tariffs and protectionism, to 3.7% which is lower than its 20-year average.

Jet fuel price lower as market over-supplied



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Source: Datastream, Platts

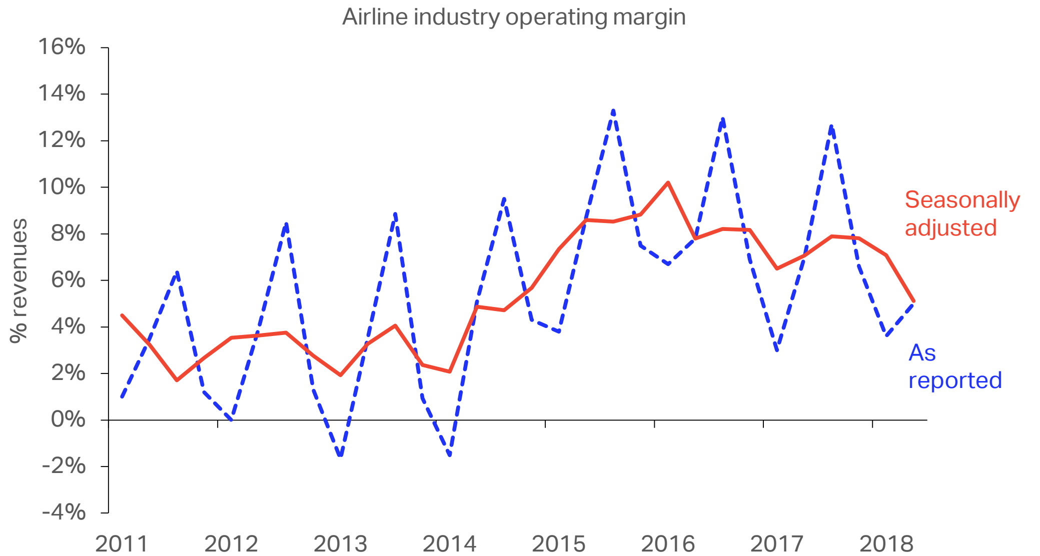
One major short-term positive for the industry is that it's 2nd biggest cost (labor is 1st) fuel has fallen sharply in price over the past month

This fall was driven partly by a reassessment of the impact of Iran sanctions. But fundamentally the oil market is over-supplied with increased production from the US. OPEC cuts are not expected to stop a build up of oil inventories.

The expectation is that Brent crude oil prices will stay in a $60-70/barrel range over the next year. Our assumption for 2019 is $65/barrel, which is significantly lower than 2018's $73/barrel.

However, the full benefit of lower oil prices will not be felt by airlines in 2019 because of the delay caused by hedging in some regions (Europe in particular) and the impact of increases in diesel demand from shipping responding to the IMO 2020 Sulphur regulations. So the fuel bill will rise in 2019 to hit $200 billion, which represents 24.2% of operating costs on average.

Relieving the downward pressure on margins

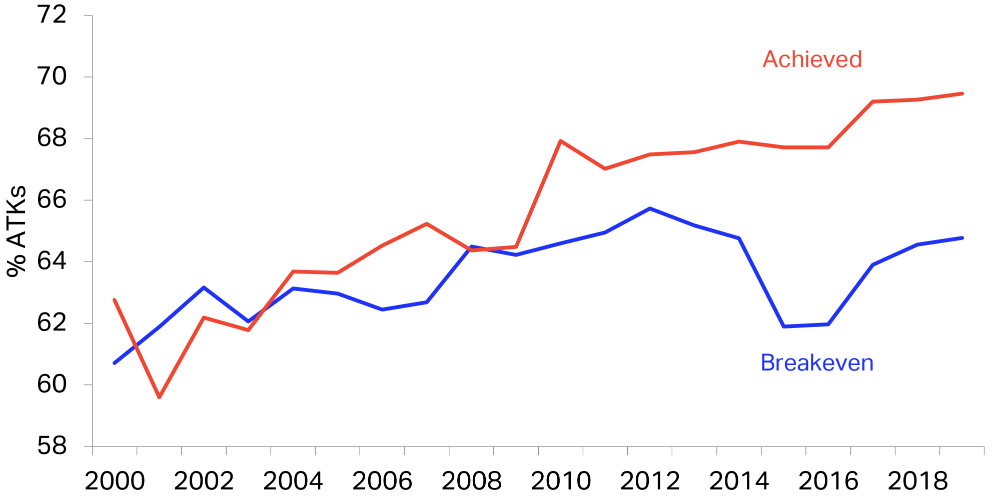


Source: IATA Economics using data from The Airline Analyst

Lower spot fuel prices will bring some relief (at least where hedging ratios are low) from the intensifying downward pressure on airline operating margins, which squeezed margins in Q2 and Q3 of 2018. Q4 results should show some improvement. Note that margins are still significantly higher than just 4 years ago.

Breakeven stabilizing and asset utilization rising

Breakeven and achieved load factor



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Source: ICAO, IATA Statistics, IATA forecasts

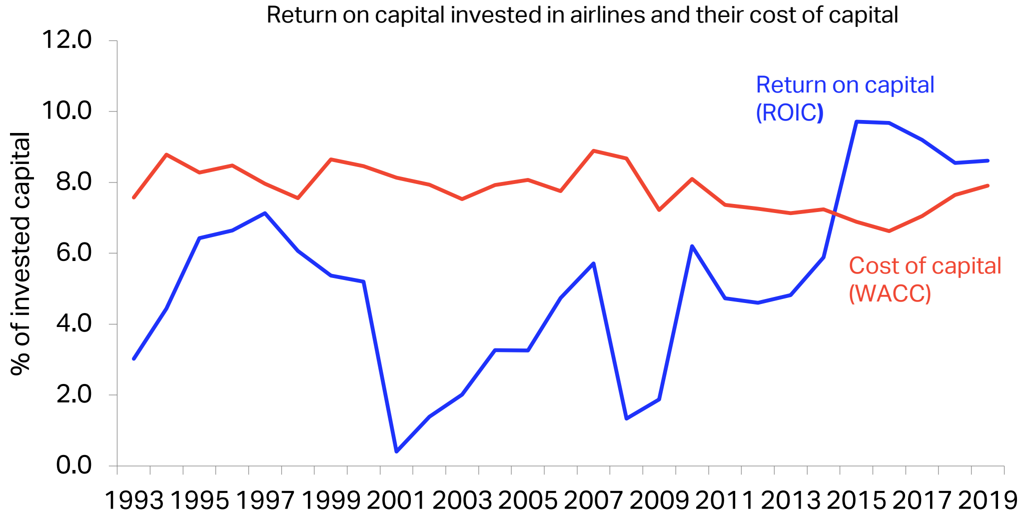
Margins remain good, despite the downward pressures from costs, because of structural improvements to airlines financial improvement that we have seen since the GFC.

The gap between load factors and breakeven load factors measures the scale of profitability and return on capital.

Breakeven load factors have risen in the past 2 years with higher costs, but airlines have limited this rise through the introduction of ancillaries. Through better asset management airlines have also continued to improve load factors.

As a result the gap has only narrowed a little and is expected to be held stable this year. That translates directly through to stable profits and returns on capital.

Airlines' return on capital should stabilize in 2019



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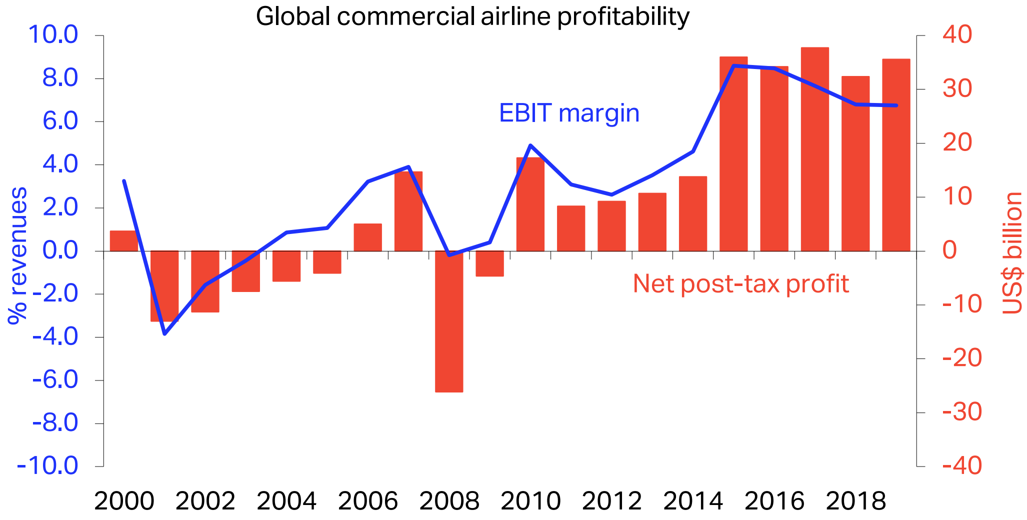
Source: McKinsey, The Airline Analyst, IATA forecasts

So we would expect the structural improvements, still robust economic growth and lower oil prices to enable the airline industry to stabilize profitability in 2019, with an average return on capital of 8.6%.

The cost of capital – or what investors expect to earn – is rising with higher bond yields. But the positive gap remains.

That means we forecast that the industry will create value for its investors for the 5th consecutive year in 2019.

Stable margins and 10th consecutive year of profit



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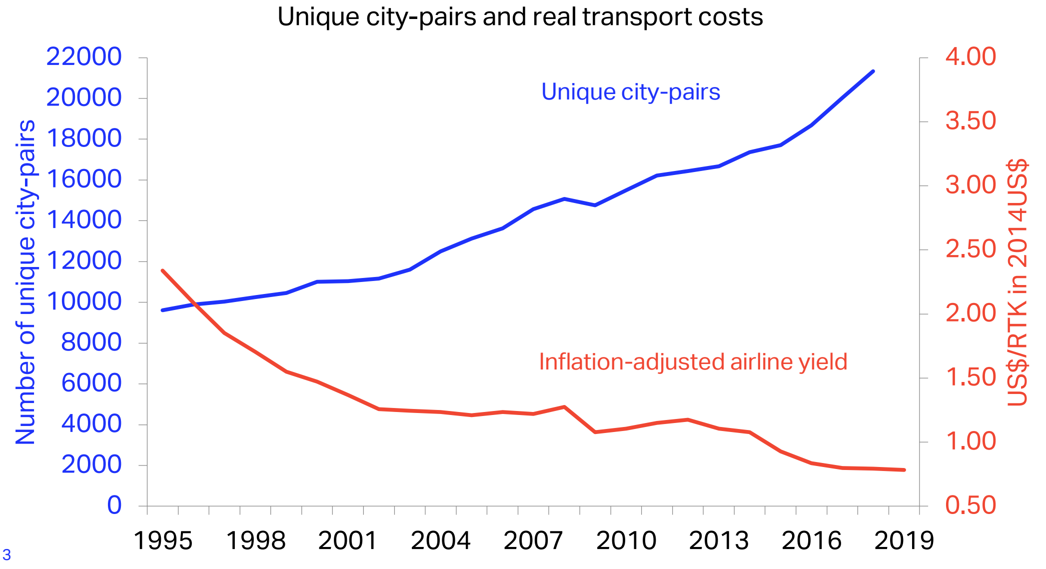
Source: ICAO, IATA Statistics, IATA forecasts

In terms of operating margins they are also expected to stabilize at 6.8%.

In terms of net post-tax profits we forecast that $35.5 billion in 2019 will be the 10th consecutive year of profit – the longest run of profits in the industry's history.

Increasing value for consumers and businesses



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Source: SRS Analyser, ICAO, IATA Statistics, IATA forecasts

As well as benefiting investors, the industry is creating value for consumers, businesses and the wider economy.

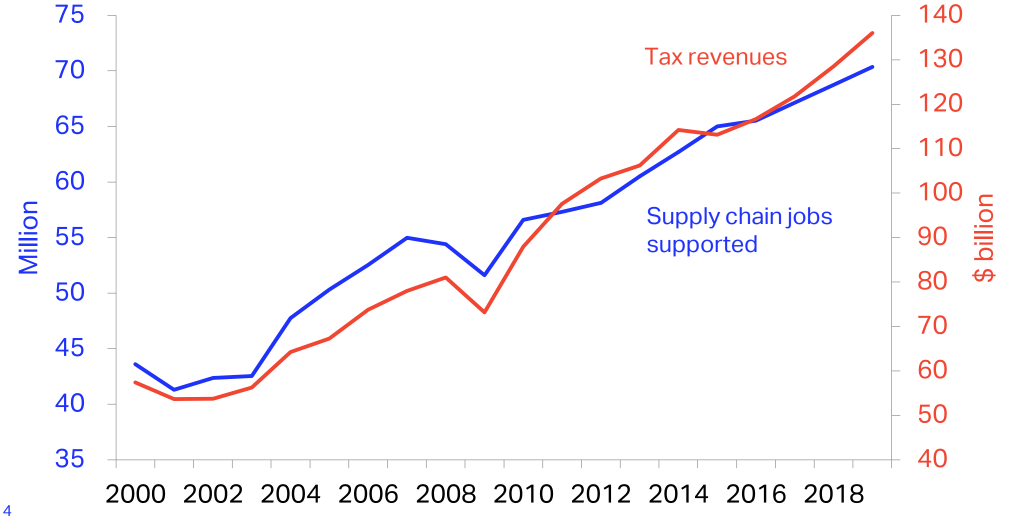
Last year the number of unique city-pair connections (between cities with at least once a day service, aircraft over 20 seats, counting services between 2 cities as just one) rose above 21,000 for the first time. City-pair connections have more than doubled in the past 20 years.

These connections offer consumers choice, and businesses fast connections to markets and sources of tourists, labour and capital. Developing countries can accelerate their economic development by becoming part of industries' global value chains.

And these economic flows and consumer value are stimulated by the further fall in air transport user costs in real or inflation-adjusted terms. The real cost of air transport for passengers and shippers have fallen by more than 50% in the past 20 years.

More revenues for governments and more jobs

Tax revenues and global supply chain jobs supported



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Source: ATAG Benefits Beyond Borders 2018, Oxford Economics, IATA forecasts

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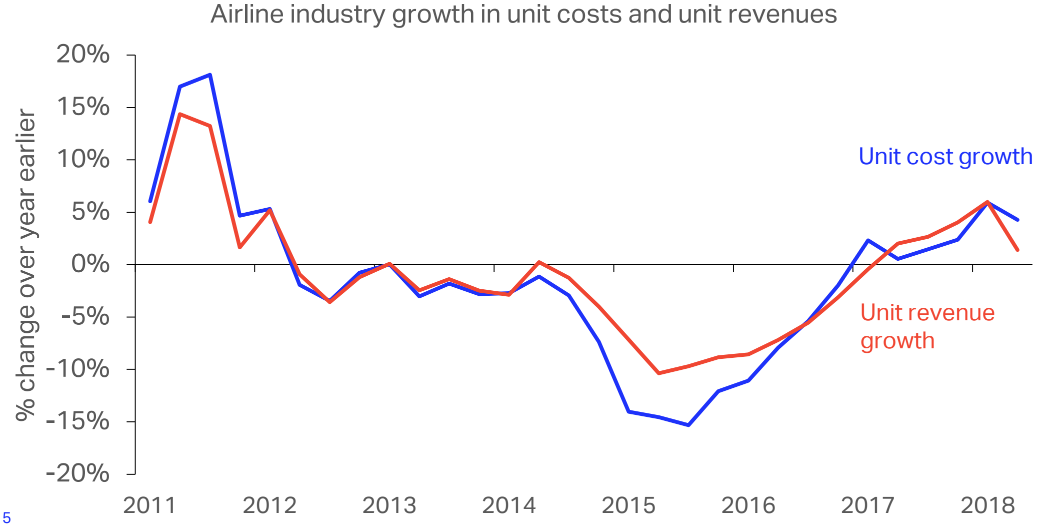
Next year airlines are forecast to generate more than $130 billion in taxes (payroll, corporate and ticket), which represents more than 44% of the value-added generated by airline businesses

As well as their own direct employment, airlines, through their supply chain and the spending of the tourists they carry, are estimated to support more than 65 million jobs (2016, source ATAG). This is forecast to grow to more than 70 million next year (source ATAG BBB 2018 report).

However, rising non-fuel costs are a challenge



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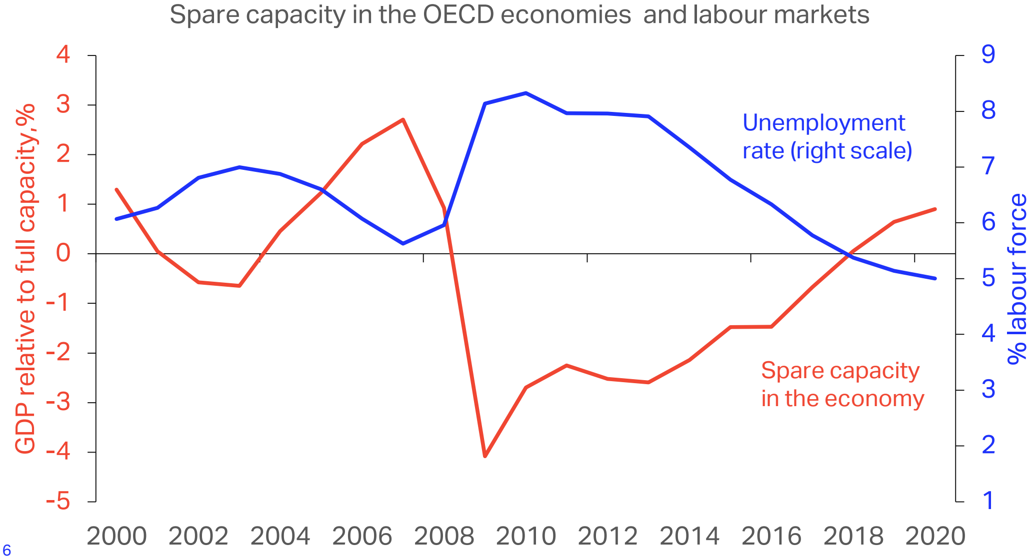
Source: The Airline Analyst

But airlines are facing challenges in delivering those benefits to investors, consumers and business, the wider economy and governments.

Although fuel prices have fallen, other unit costs are rising.

For the past 12 months the challenge faced by airlines has been the significant acceleration in costs.

It will take a recession to stop cost pressures rising



Source: OECD Economic Outlook October 2018

Rising costs in the airline industry are a reflection of pressures in the wider OECD economies.

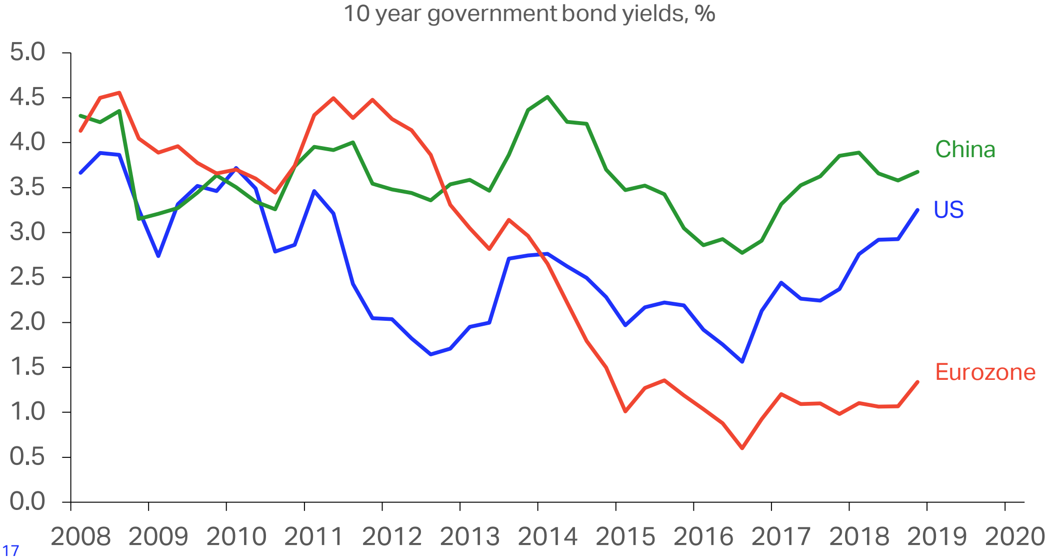
The OECD estimate that the 10-year-old economic expansion has already used up all the spare capacity create after the GFC. For the past year and into 2019 economies will be operating above full capacity and generating inflation pressures.

Unemployment has fallen below pre-GFC level. Wage pressures are rising as a result.

It will take a recession to stop these cost pressures, and that is not forecast for 2019.

IATA's cost-fighting programs are going to be an important help to the industry in 2019.

Interest rates will be pushed higher



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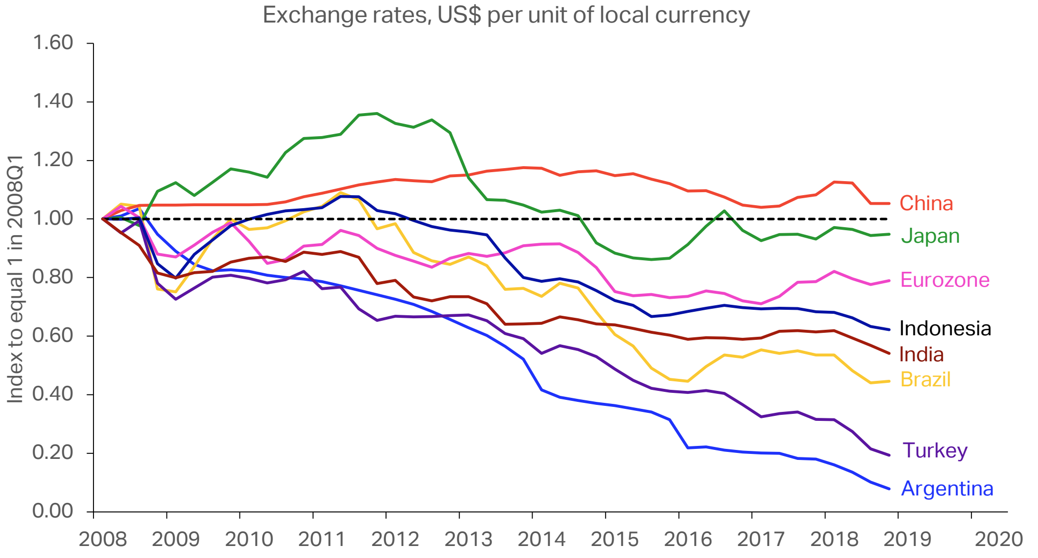
Source: Datastream

Higher inflation means that central banks will raise interest rates and bond yields will rise further.

The US economy has already seen higher interest rates, relative to other economies – which has strengthened the US dollar.

Problems from a strong US$ likely to continue



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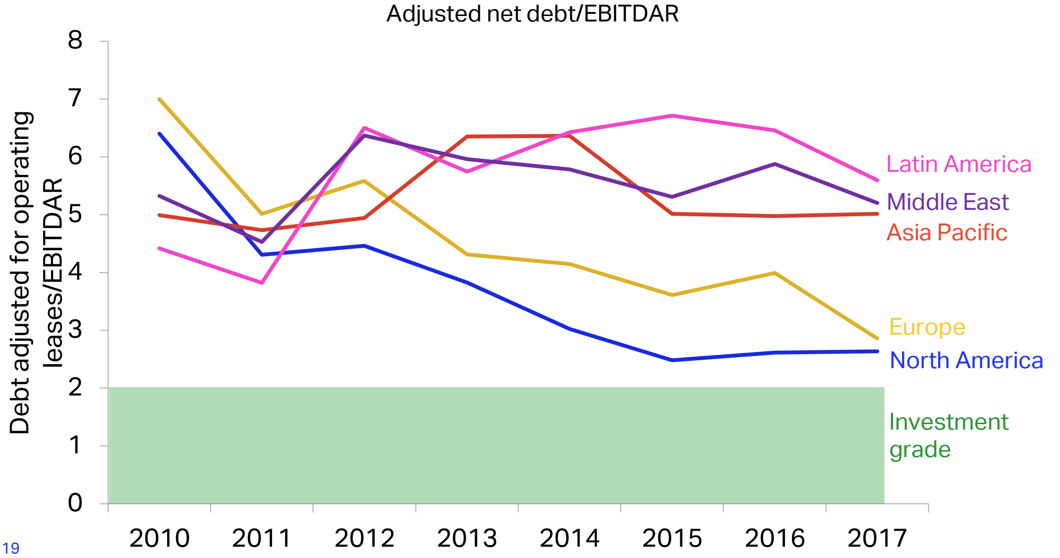
Source: Datastream

The strong US dollar has caused problems recently and in past years for airlines in a number of economies, particularly the big emerging aviation markets in the chart.

Key airlines costs (fuel, aircraft) are priced in US dollars so currency weakness against the US dollar leads to a large rise in these costs.

Exchange rate weakness against the US dollar is also a problem for those that have US dollar debt and local currency revenues.

Debt remains an issue for airlines in some regions



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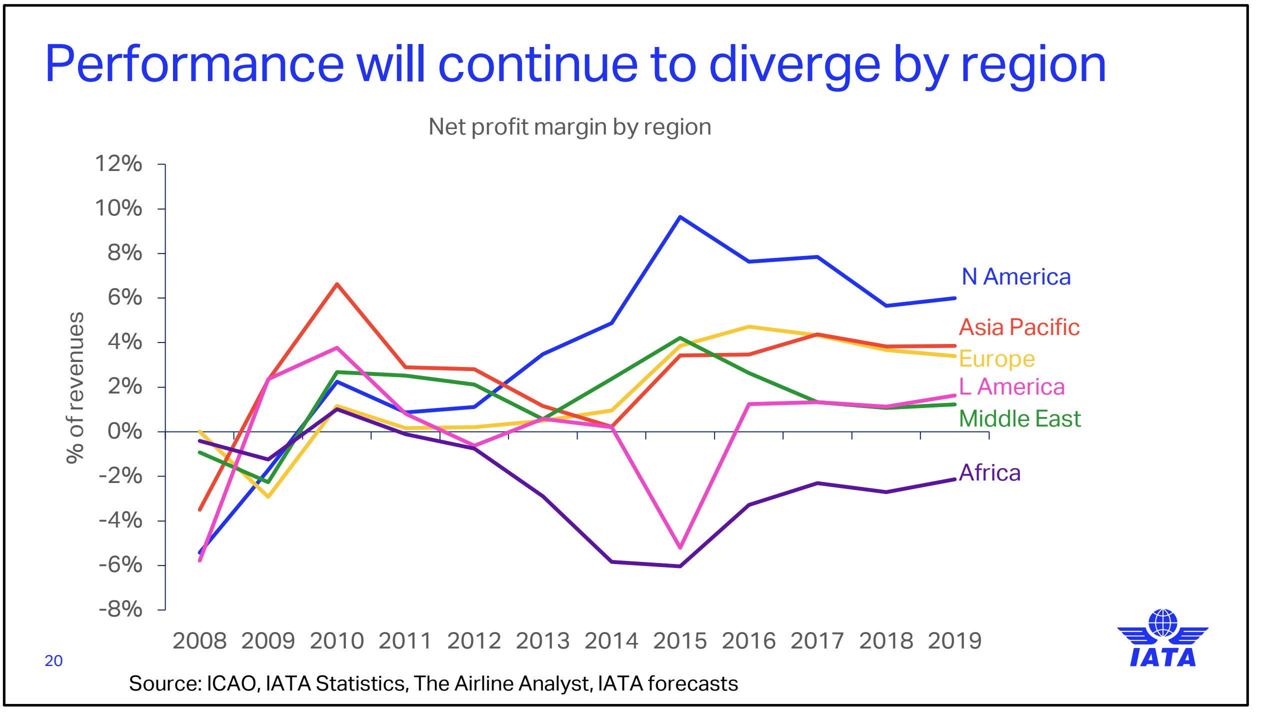
Source: The Airline Analyst

Debt remains a potential problem for airlines in some regions.

This debt/earnings metric is commonly used by Credit Rating Agencies.

Strong free cash flows for airlines in North America and Europe have allowed debt to be reduced. Now the average airline in these two regions is almost investment grade on this metric (a number of airlines are investment grade credits). This reduces their vulnerability to a cash flow shock or to rising interest rates.

However, some regions remain vulnerable.



To sum up the outlook for financial performance.

The industry as a whole is forecast to stabilize its profitability (measured here by the net post-tax profit margin) in 2019.

But the other feature of 2019 will be a continued wide divergence of performance between regions.

North American airlines are still in the best position with a robust economy, a restructured industry, and little fuel hedging so falls in fuel prices benefit the bottom line quickly.

Europe is less well placed for 2019, though its profitability remains good, albeit lower than 2018. High fuel hedging will delay the benefits to costs and profits.

Asia Pacific airlines on average have lower levels of fuel hedging, particularly China, and relatively strong economies to support profitability.

Latin America is expected to see some improvement, due to the economic recovery in Brazil and restructuring.

Middle East airlines are still in recovery mode from recent challenges to business models and regional conflict.

Africa continues to struggle in many of its markets as load factors remain low and regulatory costs high.

Thank you

Brian Pearce

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