

Jetliners wait for hard times



BY ANY MARKET HEALTH INDICATOR, JETLINER production is long overdue for a significant fall. Looking at the broader economy, and at airline traffic, airline profits, and the prices and availability of used planes, this is a market that simply does not need new aircraft. In fact, capacity reductions among most major airlines indicate a need for accelerated retirements, not a continuation of record-level jet production.

Yet both Airbus and Boeing continue to insist that demand justifies these high rates. The likely reason for this insistence involves broader economic uncertainty. It is easy to find possible signs of a recovery, even as all meaningful indicators stay bad. It is also easy for manufacturers to take solace in record backlogs despite their lack of firmness.

Signs of hope (or not)

Any discussion of air travel demand, and therefore jetliner demand, must start

with acknowledging that we are in the worst economic situation since the jet age began. There is no disguising the magnitude of the world economic downturn. Until April, the International Monetary Fund had tentatively forecast that the world economy would grow at a 0.5% pace this year. But that has since been revised, with expectations now of a 1.4% shrinkage. This means that 2009 will be the first year without world economic growth since WW II.

One thing that is becoming clear is that the cause of this downturn—a devastating near-collapse of credit markets and financial liquidity—was a discrete event. Similar shocks may lie ahead, but the crisis that led the world's economy to its current condition ended sometime in the first quarter of this year. But the timing of a recovery, let alone a return to economic growth, remains quite uncertain.

It is quite possible that the world faces a prolonged period of structural re-

adjustment, with much lower levels of growth for the next five years or longer. Several prominent economists and commentators have stated the risk of development at about 20%. But nobody believes that a depression of this magnitude is a baseline scenario. Rather, what we are dealing with is an unusually difficult cyclical downturn.

On the positive side, it is possible the economy is better than it appears to be, and that we will enjoy a faster than expected recovery. The last two recessions were relatively brief—both the 1992 and 2001 downturns lasted a mere eight months each. But the difference this time goes beyond the mere severity of the numbers. The previous two were classic business cycle downturns, with consumer and corporate demand placed on hold and inventories built down. This time, in addition to a massive inventory build-down (evidenced by record air cargo shipment reductions), we also have a serious process of de-leveraging. The amount of money available for investment has been severely curtailed. Government stimulus programs, in the U.S. and other countries, are nowhere near enough to compensate for the fall-off in private-sector investment cash.

As a result, this downturn has already become the longest since the Great Depression of the 1930s. So far (starting in early 2008 and through the first quarter of 2009), the net worth of U.S. citizens has fallen by over \$12 trillion, almost 20%.

False starts likely

One characteristic of this business cycle will likely be high volatility and numerous “false start” recoveries. Stock markets, especially in the U.S., have made considerable gains since the precipitous drops of late 2008 and early 2009. Also important, corporate profits have made a slight recovery. However, the composition of these profits tells a different story. The only increase in profits has



Image courtesy www.AviationExplorer.com

come from a recovery in the financial sector. Some of that increase is related to the arrival of government funds, such as the Troubled Asset Relief Program, or TARP. Some of the recovery is also likely due to the sector's recovery from a wave of bankruptcies in the previous quarter.

By contrast, the manufacturing sector, what some term the "Main Street" economy, is still under heavy pressure, and manufacturing profits are still falling. Slack demand is still translating into lower sales. Unemployment is still rising, pushing 10% in the U.S. There is talk of another stimulus package, but in many sectors there is still overcapacity, and it is difficult to identify any particular growth drivers in sight.

Government intervention is also prompting growth elsewhere, with uncertain sustainability. In July, China said that its economy grew by 7.9% in the second quarter of this year. But much of this was due to a \$585-billion stimulus spending package.

Another reason to suspect that talk of a recovery might be premature concerns inventory build-downs. The International Air Transport Association (IATA) reports that year-over-year air cargo demand, as measured in freight ton kilometers, fell by over 20% starting in each month from December through April. In May, it declined a mere 17%. Also in May, orders for durable goods rose 1.8% from the previous month, a welcome affirmation of slightly greater demand. However, it is important to note that after an unprecedented destocking of inventories, there had to be at least a small recovery after warehouses were completely emptied. It is quite possible that the only good news story here involves a slight easing of credit, helping to facilitate orders for goods.

Another problem that will likely hobble the recovery is stagflation—slack demand coupled with high costs for commodities and other key goods. The best example of this is oil, whose price has been growing at rates completely disconnected from world economic numbers. The price of oil, of course, is the most important variable cost for the airline industry. And compounding its relatively

high price is market volatility, whose severity has helped to inhibit effective price hedging.

Assuming a baseline scenario of a longer-than-usual three-year recession that began in late 2007 or early 2008, we can expect world economic growth to remain negative or weak through the rest of 2009, and much of 2010. This means travel demand will remain anemic, with no hope for this year and only sluggish growth in 2010.

Unpleasant numbers

Airline losses can best be described as grievous. In 2008 the industry lost

15-20% in passenger traffic volume, and well over 20% in value (the greater value drop is attributable to ticket discounting, another unpleasant development). Typically, economy class travel is more sensitive to a financial downturn, and premium numbers hold up better. Because premium traffic is the source of most airline profit, this aberration from the norm is having a terrible impact on the industry.

It is also noteworthy that this downturn, unlike the last one, offers no identifiable safe havens. Even the fast-growth Mideast carriers have seen some recent market softness, with unprecedented

COMMERCIAL JETLINERS HISTORY AND FORECAST



\$10.4 billion, and it is on course to lose about the same amount this year. Although some of these losses are due to bankruptcies and other isolated problems, it is also quite clear that almost nobody is making money in this business.

Although passenger travel demand has not fallen as fast as the awful cargo numbers, it has been hit hard. For the past five months of this year, demand has declined about 7.7% year over year. There are no signs of improvement—May demand fell 9.3% year over year.

The type of traffic that has fallen off is also quite disconcerting. Business and premium travel numbers are off by about

traffic numbers, with a 2.8% decline last September. Russia, India, and China are no longer beacons of hope. And this time, low-cost carriers are not serving as new traffic stimulants, as they did in 2001-2003.

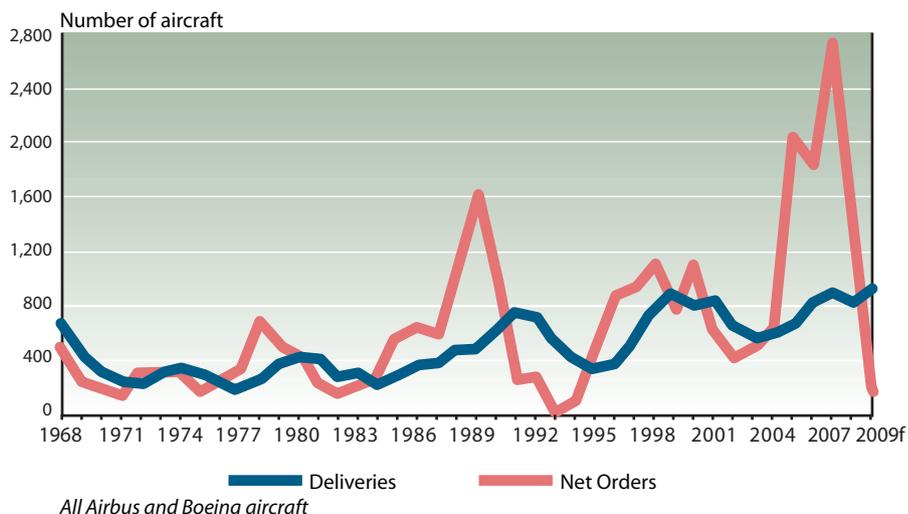
With a market environment like this, the only way airlines have been able to avoid a financial catastrophe is by mercilessly cutting capacity. Through May, IATA member airline capacity had been reduced 3.9% relative to the same period last year. These cuts have not been deep enough to avoid the terrible losses cited above, so clearly additional capacity must be eliminated.

Asset values and lease rates are falling, particularly for slightly older equipment. And, of course, orders have completely collapsed. In 2005-2008, Airbus and Boeing together booked a total of 8,099 firm orders. As of halfway through this year, Boeing had scored a single order, net of cancellations. Airbus's total was 68.

In short, there is not a single industry indicator that can be viewed as positive. If there are indeed "green shoots" in the broader economy, they have not translated into air travel demand. Jetliners are the ultimate lagging indicator of world economic health.

With capacity shrinking and the airline industry losing money, and with limited prospects of resurgent economic growth producing air travel demand anytime soon, all hopes for sustaining deliveries lie with getting rid of the existing fleet. Last year, over 1,100 jets were parked. As of mid-June, there were over

HISTORICAL JETLINER ORDERS AND DELIVERIES



2,400 parked jets. This includes 837 relatively new and competitive models, up from 266 just 18 months ago. Yet the industry will soon run out of obsolete jets to retire. Indeed, many airlines are starting to park some relatively new equipment, such as 737 classics or 15-year-old A320s. This too is contributing to declining asset values and lease rates.

It is possible, however, that this process of driving out used planes with new models will stay intact for artificial reasons. U.S. and European governments, through their export credit agencies (ECAs), are increasing their support for jetliner finance to an unprecedented extent, providing funding when airlines, private banks, lessors, and manufacturers balk. ECAs on both sides of the Atlantic have announced they are prepared to double the support they provided in 2008. As long as U.S. and European government credit ratings stay intact, it is quite possible that government money will become the cash source for as much as half of the transactions in the business. This would broadly mirror the "cash-for-clunkers" subsidies provided to the automobile industry—except in this case, many of the aircraft being replaced are far from clunkers.

In short, it is quite possible the government money will contribute to industry overcapacity and the premature obsolescence of existing equipment. This will hurt the leasing companies that own

those older jets. Thus, ironically, government money will be used in ways that hurt some of the financial institutions that have needed government money for bailouts.

Bizarrely, many executives and commentators have blamed inadequate financing for the industry's woes, implying that they would be bringing on new planes despite the awful market environment. Yet even with this financial distortion, much of the airline industry is talking of order deferrals, even when there is a financial penalty for not taking delivery of a jet.

Yet deliveries continue at a record pace. Because of the 2008 Boeing jet strike, deliveries this year will increase relative to 2008 even if rates stay the same. While production schedules have undergone a few minor adjustments, they primarily affect 2010 deliveries. Therefore, output this year will easily exceed 900 jets for the two primes.

To a certain extent, Airbus and Boeing are actually being rational by maintaining high production rates. Inadequate supply chain capacity can suppress jet production in good times, and if the two companies think the world economy will make a strong return to growth in 2010, it makes sense to stay the course. They do not want suppliers to cut capacity.

Nonetheless, at the Paris Air Show in July, many suppliers were quite wary, and several implied that they were ex-

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pecting significant production cuts starting in 2010. They too are quite rational. If they see little hope of that fast recovery, then there is much to be lost from having inventory, workforce, and a plant that is suddenly idle.

No help from the backlog

One certainty is that sustaining production rates depends on an economic recovery and greater travel demand, and has no relation to the much-touted backlog of unfilled orders. The two big primes alone have over 7,000 jets—seven years of production at current rates—on firm order. Airbus CEO Tom Enders said at the Paris Air Show that even if 1,000 jet orders were canceled, Airbus would still have years of production at current rates. Both manufacturers have spoken of overbooked backlogs, at least in the near term, implying that they could easily compensate for demand softness among some customers.

But in practical terms, this means little. The backlog, like the market, tends to behave as a surprisingly cohesive entity. At the last market peak (January 2001) there were 3,200 jets on backlog; at the bottom of the last market trough (January 2003) there were 2,700. That modest reduction was more than accounted for by deliveries. Only 80 cancellations were recorded in 2002/2003, so the core backlog remained intact.

Still, production rates fell by 30%. Airlines deferred *en masse*, and the backlog did nothing to protect the industry from the recession's impact. It is a simple and timeless equation: When airlines make money, they order planes. If airlines keep making money, they take delivery of those planes.

Assuming, therefore, that this backlog has no bearing on keeping production rates up in an economic downturn, and also assuming that there is no recovery imminent, it is a safe bet that 2009

will be the peak of the market. Sometime later this year, the manufacturers will announce production rate drops in 2010. Our forecast calls for narrowbody production rates to fall by about 30%, with a trough year in 2012. The twin aisle products, however, will likely stay intact, because international traffic will probably recover faster than domestic markets. Twin aisle numbers will also be boosted by the technological stimulant of new product developments, particularly Boeing's 787 and Airbus's A350 XWB.

Of course, paying for these new jets, and the associated engines and other components, is also a drain on Airbus, Boeing, and supplier resources. The need to keep revenue high to fund these products is arguably the biggest single factor that could keep jetliner production rates at higher levels than market demand justifies.

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