AIR TRANSPORT MARKET ANALYSIS
JULY 2010

KEY POINTS

- International air travel and freight markets continued to show above trend expansion in July, showing little adverse impact from the uncertainties emerging about the global economic expansion. Air travel volumes (RPKs) were 9.2% up in July over the same month last year and air freight was up 22.7% over the same period.
- These year-on-year comparisons were lower than June data showing 11.6% growth in travel markets and 26.6% growth in air freight. The apparent slowdown was entirely due to the comparison with a period in 2009 that was already seeing a strong recovery from the first quarter lows. In fact, even after adjusting for seasonality (which is strongly positive in July for air travel), the expansion in both air travel and freight was faster month-to-month in July than it was in June.
- But air transport markets do appear to have moved into a slower – though still above-trend – phase of growth. The fastest period of the current expansion was the post-recession rebound in 2009 when air travel was rising at annualized rate of 12% and air freight 28%. 2010 has seen a shift to more moderate growth reflecting the same shift in the economic recovery. Between the end of 2009 and July this year air travel has expanded at an average annualized rate of around 8% and air freight 17%. Both of these growth rates are less than those seen in 2009, but both are higher than the 6% annual trend of the past few decades.
- There has also been a shift in the geographical pattern of the market expansion. Reflecting the geographical pattern early in the economic recovery, airlines in Asia-Pacific and Latin America were the major beneficiaries of rebounding air travel and freight. However, so far this year the biggest gains have benefited airlines in North America and Europe. This likely reflects increased business travel and international trade from these regions, reflecting strong corporate profits, business confidence and capital spending. The lack of a revival in leisure travel – due to weak consumer confidence in the major economies – remains a weak spot to the outlook.
- Another key feature of this second phase in the post-recession expansion is the return of capacity to passenger and freight markets. The year-on-year comparisons in the table below look much less than the rise in demand. However, this offers a distorted picture. All the improvement in load factors took place in 2009. Now capacity is returning at a similar pace to the rise in demand and load factors have improved no further during 2010. As a result the largest rise in fares and airline yields took place in 2009. Average fares have risen just a further 3.5% so far during 2010. With resurgent new aircraft orders and planes being taken out of storage there is potential for excess capacity to develop and put downward pressure on yield gains. However, announced schedules suggest moderate expansion and stabilizing, though not improving, load factors over the rest of this year.

Year on Year Comparison	July 2010 vs. July 2009						YTD 2010 vs. YTD 2009					
	RPK	*ASK*	*PLF*	*FTK*	*AFTK*	*FLF*	*RPK*	*ASK*	*PLF*	*FTK*	*AFTK*	*FLF*
Africa	13.0%	10.4%	71.7	35.2%	12.9%	27.2%	13.1%	9.2%	68.3	45.2%	13.4%	28.7%
Asia/Pacific	10.9%	5.1%	80.8	25.3%	20.1%	65.2%	10.6%	1.6%	77.8	33.2%	15.6%	66.3%
Europe	6.2%	4.6%	84.5	12.1%	2.2%	50.1%	3.6%	0.2%	78.5	12.5%	-3.6%	52.5%
Latin America	14.2%	9.0%	79.9	25.3%	11.4%	41.6%	10.9%	4.6%	75.6	44.3%	22.7%	42.4%
Middle East	16.8%	12.8%	81.0	30.1%	17.1%	45.5%	19.4%	13.2%	75.9	33.2%	16.0%	46.5%
North America	7.9%	5.8%	87.2	27.1%	8.9%	41.9%	6.3%	1.0%	82.0	30.6%	2.7%	43.9%
Industry	9.2%	6.1%	82.9	22.7%	11.9%	52.4%	8.1%	2.5%	78.0	27.5%	7.7%	54.1%

RPK: Revenue-Passenger-Kilometers; ASK: Available-Seat-Kilometers; PLF: Passenger-Load-Factor; FTK: Freight-Tonne-Kilometers; AFTK: Available Freight Tonne Kilometers; FLF: Freight Load Factor;
All Figures are expressed in % change Year on Year except PLF and FLF which are the load factors for the specific month.

COMPARING JULY TO JUNE

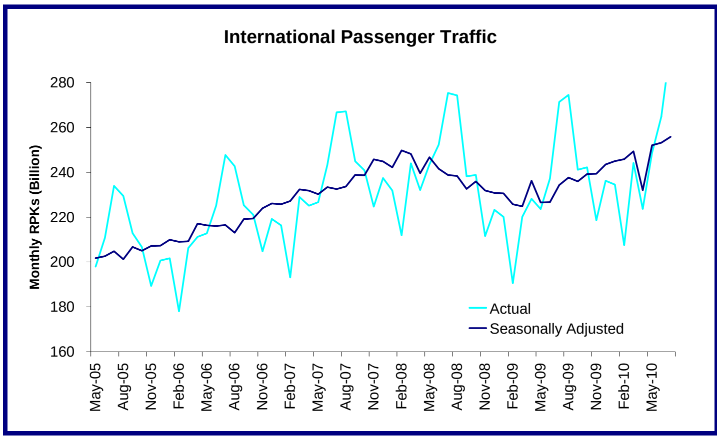
July 2010 vs. June 2010

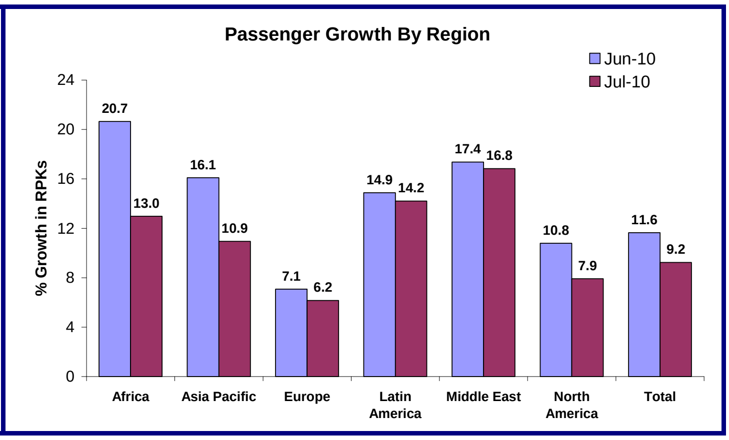
Month on Month Comparison	*RPK*	*ASK*	*PLF pt*	*FTK*	*AFTK*	*FLF pt*
Africa	-2.0%	0.3%	-1.6	-5.1%	-0.9%	-1.2
Asia/Pacific	1.4%	1.4%	0.0	1.0%	0.9%	0.1
Europe	1.7%	2.1%	-0.3	-0.9%	0.5%	0.8
Latin America	-0.1%	0.2%	-0.2	-1.4%	-0.6%	0.4
Middle East	1.0%	0.9%	0.1	0.7%	1.1%	0.2
North America	-0.2%	0.4%	-0.5	4.2%	1.5%	1.2
Industry	1.0%	1.4%	-0.3	0.8%	0.8%	0.0

Data are seasonally adjusted.
All figures are expressed in % change month on month except, PLF pt and FLF pt which are the percentage point difference between load factors of two consecutive months.

- There was certainly no sign of a slowdown in the rise of air transport markets in July. The 1% expansion of passenger markets was twice the pace of June, while the 0.8% rise in freight compared to a decline the previous month. Both are at or above an annualized pace of growth of 10%.
- Of course there is a degree of volatility month to month which seasonal adjustment does not strip out. This accounts for some of the regional differences.
- However, apart from apparently solid demand two other emerging trends are faster passenger capacity growth – causing load factors to slip – and capacity growth for freight that is just matching growth in demand.

AIR TRAVEL VOLUMES CONTINUE TO EXPAND ABOVE TREND



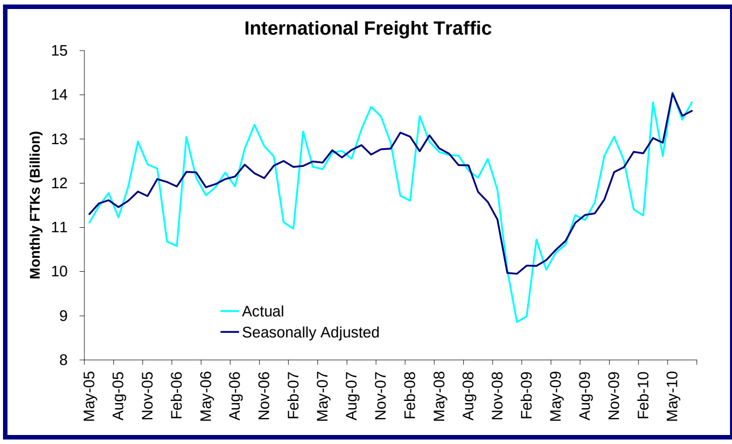


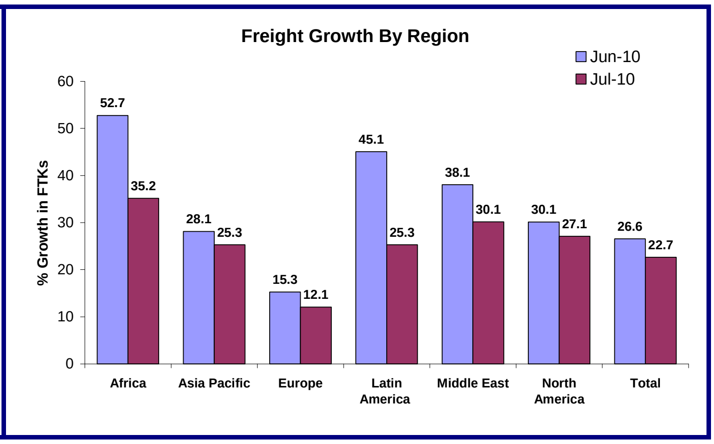
- The chart above with the seasonally adjusted series for passenger kilometers flown (RPKs) on international markets gives a clearer view of the trend, particularly given the one-off disruptions such as the volcanic ash plume in April. The main conclusion is that the trend continues to be up, with solid above trend growth in July. The low point in international air travel markets was at the end of the first quarter of 2009, so year-over-year growth rates are now moving into a period where the comparison is with rising 2009 numbers, rather than falling. This will tend to reduce the year-on-year growth rates. Indeed we saw an apparent slowdown in passenger growth from 11.6% year-over-year in June to 9.2% in July. In fact the month-to-month growth rose from 0.5% in June to 1% in July. But since there was a 3% month-to-month rise in July last year as markets recovered from H1N1 Influenza impacts, the year-over-year growth rate fell.
- Perhaps the best way of looking at the state of air travel markets is to see whether there are broad phases emerging. This seems to be the case. There was a very rapid phase of post-recession rebound from early 2009 until the end of the year when travel markets expanded at an annualized pace of 12%. So far this year a slower growth phase has been evident, with an annualized pace of expansion closer to 8%. June and July's results are consistent with that pace of growth. While slower than the 2009 rebound the travel market expansion we are seeing remains significantly above trend (6% pa).
- The level of the market is now 3% above early 2008 levels. However, had travel markets grown at trend during the subsequent period they would have been 10% larger than evident in July. Just under 2 years growth has

been lost and will only be regained if travel markets continue to growth at the pace of the first half of this year for a further 3 years, which seems unlikely given some of the pressures on economic growth emerging in regions like Europe.

- The geographical pattern of growth also seems to be changing in this 2010 phase of the economic expansion. The earlier post-recession rebound in air travel saw airlines in the Asia-Pacific and Latin American regions leading the recovery in passenger traffic. However, since the end of last year there has been little further gain – after seasonal adjustment – in the number of passenger kilometers carried by airlines in these two regions. Instead airlines in Europe and North America have seen the bulk of the industry's expansion during 2010 with 6% gains since December 2009, along with airlines in the Middle East and, to a lesser extent, in Africa.
- This geographical pattern seems to be driven by flows of business passengers, rather than leisure. International trade in goods and business confidence has been strong in both Europe and the US, whereas the earlier rapid economic rebound in China and elsewhere in Asia is being slowed by central banks now worried about inflation. Financial market activity is picking up. All of these developments are likely to have boosted business travel on intercontinental long-haul travel markets, to the benefit of European and North American airlines. But consumer confidence is fragile. With high unemployment, consumer debt and prospective tax increases or benefit cuts, leisure travel originating in both Europe and the US is being held back, as evidenced by the poor results of companies like TUI Travel. In contrast InterContinental Hotels reported buoyant second quarter results on the back of strong business travel, providing further anecdotal evidence to support this travel pattern.

AIR FREIGHT VOLUME GROWTH SLOWING BUT REMAINS ABOVE TREND





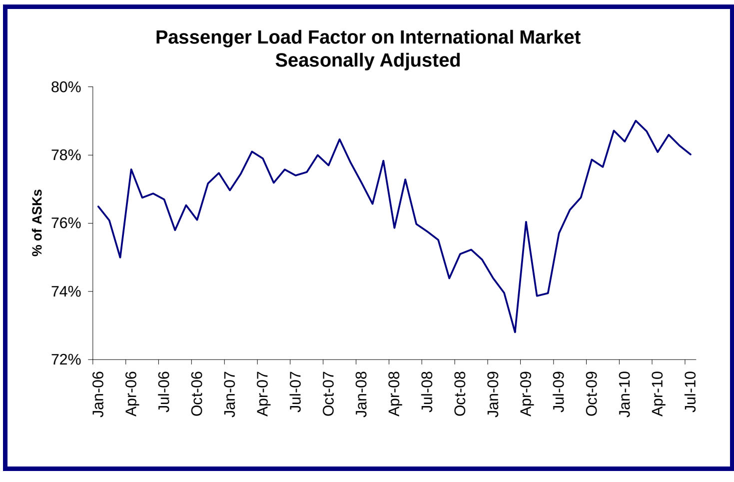
- The trend in air freight is less apparent because of the very volatile second quarter, largely due to the European air space closures in April. As with travel markets the comparison with the same month of 2009 is now going to reduce year-over-year growth rates because of the rapid second half of 2009 recovery. As a result air freight kilometers flown (FTKs) in July were up 22.7% in July compared with the same month last year, after 26.6% in June. In fact the 0.8% expansion in July over June this year was an improvement over the sharp month-to-month decline in June. These points are clarified in the first chart above.
- This chart shows a similar transition in expansion phase as seen in air travel markets. From early 2009 until the last quarter of last year, air freight markets were rebounding at the rapid annualized pace of 28%. As the chart shows the slope of the seasonally adjusted FTKs became less steep in 2010 – ignoring the down in April and post-ash rebound in May. During this period average air freight market expansion slowed to an annualized pace of 17%. After the volatile second quarter it is hard to pin down what underling growth in air freight market is today. But even month-to-month growth in July shows annualized growth of 10%. This is still well above trend.
- Some slowdown in air freight should be expected. The economic cycle is also is moving into a different phase with business inventory rebuilding having come to an end, with more comfortable inventory-sales ratios regained. The inventory cycle drove the very rapid expansion in air freight in 2009, as business needed the speed of air travel to get goods to market and components to assembly facilities on time. Now that cycle is complete air freight will expand more in line with final goods sales, like consumer spending and business capital

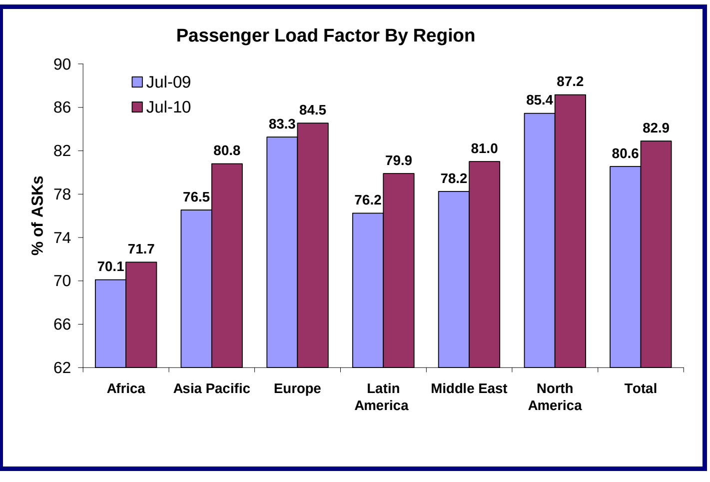
spending. Consumer spending has been soft in the western economies but corporate profits and capital spending has been strong. The latter may still be driving relatively robust above-trend growth rates in air freight.

- The geographical pattern in air freight markets is also shifting, though to a lesser extent than passenger markets because of the concentration of manufacturing facilities in Asia. But whereas the big expansion in air freight volumes benefited airlines in Asia-Pacific, Latin America and the Middle East during 2009, airlines in Europe and North America have both seen gains of 10% in the FTKs they carry since the end of last year. This reflects for example the improvements in demand for the German capital goods industry and the general rapid growth in international trade for both Europe and North America. There is also continued growth at a similar pace for Asia-Pacific and Middle Eastern airlines. African airlines have seen a 15% expansion so far this year.

PASSENGER LOAD FACTORS SLIP FROM HIGHS BUT OUTLOOK STABLE

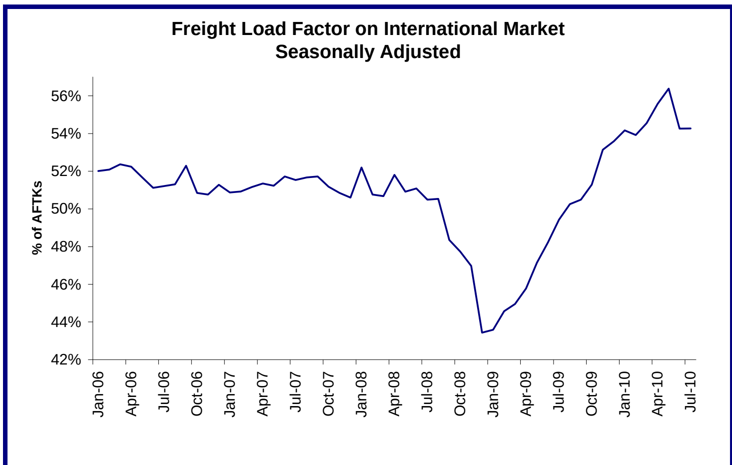
- The most distinctive feature of this second phase in the air travel market rebound is that airlines are bringing capacity back to the market, having kept available seat kilometers (ASKs) flat for the most part of 2009. Passenger capacity was up 6.1% in July against the same month last year, which compares with a 9.2% rise in RPKs. However, capacity was cut less than demand fell in 2009. Month-to-month capacity came back to market at a faster rate than demand (1.4% versus 1%) in July, as it did in June.
- Returning capacity is evident in load factors. Seasonally-adjusted load factors rose from a low point of 72.8% in March last year to a high of 79% in February 2010. Since then there has been a modest slide to 78% (seasonally adjusted) in July. The unadjusted load factor is so much higher at 82.9% since July is the peak month of the year for air travel. The modest set back has been the combination of some slowdown in air travel demand and the return of capacity. Since February demand or RPKs has expanded 4.1%. Capacity or ASKs increased by a larger 5.4%, causing load factors to fall back.
- Nevertheless, although there has been some slippage, July's load factor was still higher than the previous peak in 2007. Looking ahead to the end of this year we would expect air travel markets to slow to their trend annualized pace of expansion of 6%. What about capacity? Aircraft orders have surged at recent airshows and aircraft have been taken from storage at a rate of 195 in the second quarter and a further 84 in July. Despite this, airline plans to introduce these aircraft and utilize their existing fleet still look fairly cautious. The SRS Analyzer database of planned schedules shows increases at an annualized pace of 5% for the rest of this year i.e. a bit less than expected growth in demand. If reality comes close to these published schedules then there should not be any further slippage in passenger load factors.
- High load factors represent tighter supply-demand conditions on many air travel markets. Fares and yields are rising as a result. Given the pattern of sharply rising load factors in 2009 and stabilization this year it is no surprise that there was a 10% rise in average international air fares in the second half of 2009, slowing to a 3.5% gain from December to June this year. Average fares were 10% higher in Q2 of 2010 than the same period in 2009, but the pace of fare increase has been slowing – as load factors came off their peak. There are some distinct geographical differences with US airlines seeing yield gains double the industry average, as they continue to improve load factors whereas utilization is slipping in Europe and Asia-Pacific. The largest capacity additions continue to be seen in the Middle East but these airlines are still managing to keep load factors rising.

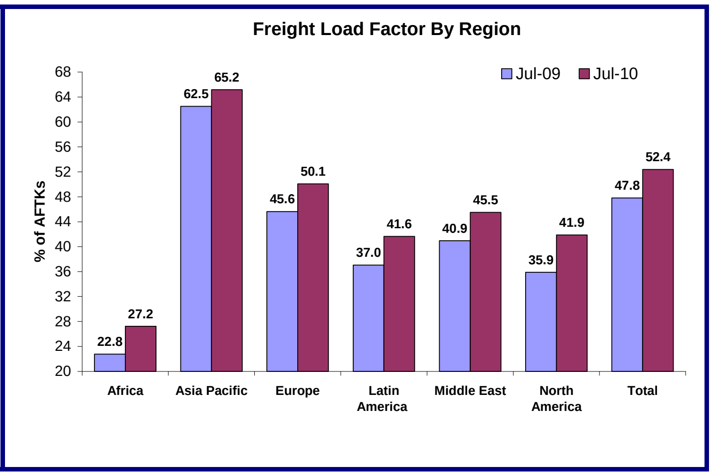




FREIGHT LOAD FACTORS DIP FROM RECORD LEVELS

- Air freight capacity grew by only 1% in 2009, so the surge in rebounding air freight demand pushed freight load factors up to relatively high levels by early 2010. Since then there has been an additional 9% of capacity brought back. But since air freight demand has been strong air freight load factors remained – after seasonal adjusted – a little higher in July than the beginning of the year. We have less information about prospective capacity additions for freight than we do for passenger markets. However, it does seem clear that significant further improvements in air freight utilization are now over.





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