The Airline Industry Ascended to New Records in 2014
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by Frank Holmes
of U.S. Global Investors

Just as the U.S. economy is in full-recovery mode, so too is the airline industry. It’s lately made an impressive about-face from only a decade ago and, in 2014, soared to several new benchmarks.

This industry is flying high again.

In 2014, a record 98 million passengers flew to foreign destinations on U.S. carriers. Meanwhile, 662 million traveled domestically by air, the highest number since 2007.

According to the U.S. Department of Transportation, the percentage of seats filled in 2014 climbed to 83.4 percent—another fresh record.
This year, the daily number of available seats for international-bound flights out of the U.S. will rise to an all-time high of over 350,000. That’s 20,000 more seats per day than were available just last year.

### Daily Available Seats on U.S. Flights to International Destinations at an All-Time High

In Thousands

![Bar chart showing daily available seats on U.S. flights to international destinations from 2007 to 2015. The highest point is in 2015 with over 350,000 seats available.](image)

Source: Innovata, Airlines for America, U.S. Global Investors

And the success stories just keep on coming. Air travel in March and April is typically strong, but this season is expected to be the strongest since before the recession.

### U.S. Airline Onboard Passengers Expected to Be Highest Since 2007

All Services, March 1 Through April 30, In Millions

![Bar chart showing U.S. airline onboard passengers from 2000 to 2015. The highest point is expected in 2015.](image)

Source: Airlines for America, U.S. Global Investors

I often travel through Houston, and it’s a good case study to illustrate the boom in air travel demand,
domestic as well as international. In 2014, the city’s two main airports, the 46-year-old George Bush Intercontinental Airport—it was renamed in 1997—and William P. Hobby Airport, both broke passenger traffic records that had been set in the previous year. Intercontinental saw an increase of 9.2 percent in international travelers and 3.6 percent in domestic fliers, while Hobby’s total traffic for the year rose to 11.9 million passengers—an all-time high for the fifth straight year.

All told, over 53 million people from around the globe passed through these two Houston airports. And yes, you guessed it—that’s another new record.

**Waxing Wanderlust**

Some of the key factors driving this unprecedented air travel demand are an expanding U.S. economy, rising personal incomes and the highest consumer confidence level since before the recession.

In a recent poll, the travel website TripAdvisor surveyed 44,000 people around the world on a number of travel-related issues. Of the Americans who participated, 67 percent reported that they were planning an international trip for leisure, up from 50 percent last year.

TripAdvisor also wanted to find out where participants had been in the last 12 months, where they planned on going in the next 12 months and what their dream destination was. Although Australia topped the list of ideal vacation spots, followed closely by the U.S., less than 5 percent said they had actually made the trip down under.

On the other hand, about 20 percent of respondents, or close to 8,800 people, said they had visited the
U.S. in the last year, while the same percentage of people said they would likely travel to the U.S. in the coming months.

**Top Destinations for International Travelers: Past and Future**

Percentage of Those Polled Who Visited/Plan to Visit

Air travel between the U.S. and China is expected to increase now that multi-entry visas for citizens of both countries have been extended from one year to 10 years. International flights out of China have already been trending steadily upwards for years, a result of a growing middle class. The visa policy revision should help ramp up Chinese outbound air travel even more.
As I pointed out last month, Chinese travelers are the world’s highest spenders while on vacation. The average Chinese visitor spends between $6,000 and $7,200 per trip to the U.S. The visa revision is welcome news not only for airlines such as Air China, but also hotels, restaurants, car rental companies and others in the travel and leisure services industry.

It should also be a tailwind to luxury retailers that are increasingly setting up shop in international airports.

The “Sixth Continent” and Luxury Shopping

For the first time in 2013, more than one billion people traveled internationally, prompting luxury brand executives to name this cohort “the sixth continent.” With there being such a huge surge in captive consumers, we are entering a golden age of luxury shopping opportunities in airports that might very well supplant tacky souvenir shops and cell phone accessory kiosks. In many airports around the globe, you’re now just as likely to pass by a Coach as you are a Cinnabon.
According to retail consultancy firm Verdict Retail, sales in airport gift shops is expected to grow 73 percent between 2013 and 2019, at which point the entire global market will be worth an astounding $59 billion. Leading the way are beauty products and alcohol, as shoppers seek to avoid value-added taxes and duties.

Paris-based advertising firm JCDecaux, after conducting a study of people’s airport spending habits in eight countries, found that the three most frequently purchased types of merchandise were fashion items, cosmetics & high-end fragrances and general accessories. This is a clear sign that luxury shopping while travelers await their connecting flights is becoming more of the norm rather than the exception.

Focusing on Shareholders

It’s easy to forget that between 2005 and 2008, about 70 percent of the U.S. airline industry was operating under Chapter 11 bankruptcy protection, including leaders such as Delta Air Lines, which we hold in our Holmes Macro Trends Fund (MEGAX). The industry’s recent recovery is in lockstep with many other once-struggling industries that were forced to consolidate and restructure their businesses following the financial crisis.

How things have changed. As I pointed out last month, airlines posted some of their best earnings ever last year. Many are now turning their attention toward making investors happy by paying dividends, boosting earnings per share and buying back their stock. According to SEC filings, 10 U.S. airlines—including Delta and Alaska Air, which we also own in MEGAX—are collectively paying down massive amounts of debt.
A recent Goldman Sachs equity research report finds that “U.S. airline stocks are trading at comparatively attractive valuations relative to the S&P 500. The discount is 48 percent.” It adds: “Not only are the U.S. airlines generating more growth, we expect their cash returns on cash invested (CROCI) to improve the most in 2015,” compared to previous years.

It will be challenging indeed for the industry to meet these expectations. Last year, after all, was “unusually strong,” according to management consultancy firm Oliver Wyman. But airlines have so far charted a very promising course.

Index Summary

- The major market indices finished lower this week. The Dow Jones Industrial Average dropped 0.60 percent. The S&P 500 Stock Index fell 0.86 percent, while the Nasdaq Composite declined by 1.13 percent. The Russell 2000 small-capitalization index rose 1.21 percent this week.
- The Hang Seng Composite fell 1.59 percent. Taiwan declined 0.69 percent this week, and the KOSPI lost 1.35 percent.
- The 10-year Treasury bond yield fell 13 basis points to 2.11 percent.

Domestic Equity Market

The S&P 500 moved lower for the third week in a row. The U.S. dollar continued to rally, and concerns are building on the impact to earnings and capital spending plans. Energy stocks also had a rough
week as oil fell 9 percent on rising inventories and production that has yet to really decline.

**S&P 500 Economic Sectors**
(Percentage return for each sector group from Friday to Friday, March 06, 2015 – March 13, 2015)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Return</th>
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<tbody>
<tr>
<td>S&amp;P 500 Energy Index</td>
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<td>S&amp;P 500 Info Tech Index</td>
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<td>S&amp;P 500 Materials Index</td>
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<td>S&amp;P 500 Cons Staples Index</td>
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<td>S&amp;P 500 Telecom Serv Index</td>
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<td>S&amp;P 500 Cons Discret Index</td>
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<td>S&amp;P 500 Utilities Index</td>
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<tr>
<td>S&amp;P 500 Financials Index</td>
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<tr>
<td>S&amp;P 500 Health Care Index</td>
<td>0.53</td>
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</tbody>
</table>

**Source:** Bloomberg, U.S. Global Research

click to enlarge

**Strengths**

- The health care sector was the best performer in a tough week. Mylan lead the way, rising nearly 8 percent as fellow generic drug maker Teva Pharmaceutical was rumored to be in talks to acquire Mylan. Generic drug makers in general rallied on this news, and managed care companies also had a good week.
- The financial sector was also a relative outperformer as real estate investment trusts rallied on lower bond yields and bounced back after a rough stretch over the past six weeks.
- Urban Outfitters was the best performer in the S&P 500 this week, rising 5.27 percent. The company announced earnings that beat expectations and showed positive momentum in all of the company’s brands.

**Weaknesses**

- The energy sector was the worst performer as oil prices fell 9 percent and diminishing prospects for a near-term catalyst pressured the shares. Coal companies and offshore drillers were the hardest hit, with loses approaching 10 percent.
- The technology sector was also a poor performer this week as Intel warned for the quarter and cut revenue estimates by about $1 billion. Companies that were also hard hit include EMC, Seagate Technology and Western Digital.
- Avon Products was the worst-performing company in the S&P 500 this week, falling 13.26 percent. The company has had challenges in recent quarters, and with its heavy emerging market exposure (strong dollar and weakening markets), the company took a hit this week.
Opportunities

- Financials have been relatively good performers in recent weeks. The stress tests have been generally well-received and a modestly steeper yield curve should help margins.
- A strong dollar continues to benefit domestic consumers, maintaining an advantage for certain U.S.-focused retailers and consumer products.
- We will get an interesting mix of earnings next week, which could be a positive catalyst for the market. Names to watch for include Oracle, FedEx, Nike and Lennar Corp.

Threats

- Retail sales were disappointing in February. Even though weather had a negative impact, it is still a little surprising that the low oil price gasoline “tax cut” is not having a bigger impact on consumer spending patterns.
- An improving global economy and U.S. economic data that supports an improving jobs market might very well be enough to encourage the Federal Reserve to raise rates as soon as June.
- Yield proxies have been hit hard in recent weeks, and if the Fed continues on its current path, they may not get any respite.

The Economy and Bond Market

U.S. Treasury bond yields moved lower this week, reversing about half of last week’s move. The market reacted to weaker economic data here in the U.S. but also to the beginning of quantitative easing (QE) in the eurozone. The European Central Bank (ECB) began QE this week, which sent yields lower in Europe. The chart below shows the German 10-year yield falling about 15 basis points this week. U.S. Treasuries moved by a similar magnitude and there remains considerable speculation on whether the Federal Reserve will hike interest rates later this year.
Strengths

- The ECB began its long-awaited QE program this week, which sent yields lower in Europe. This was also a factor in moving yields lower in the U.S.
- Job openings—commonly referred to as JOLTS—hit a 14-year high, and more firms are commenting that filling positions has become more difficult.
- Sentiment indicators are generally moving higher as consumers' optimism toward housing hit a new high, and small business sentiment remained at a high level.

Weaknesses

- Retail sales disappointed in February. Although weather was a factor in parts of the country, the weakness surprised most economists.
- The Producer Price Index (PPI) declined 0.5 percent in February and fell 0.6 percent on a year-over-year basis.
- While other sentiment indicators improved, the University of Michigan Sentiment Index for March was disappointing.

Opportunities

- European economic data was already on the mend and that should get an intermediate term boost as QE just began.
China inflation recently hit a five-year low. Economic data out this week disappointed, making more easing. Yields in the U.S. remain the highest in the developed world, and funds will likely continue to flow into U.S. fixed income, which is likely what occurred this week.

**Threats**

- One of the themes from the recent earnings season was that the strong U.S. dollar has negatively impacted companies’ bottom lines and capital spending plans. That will likely be the case for the first quarter as well, as the dollar was quite strong again this week.
- Next week’s Federal Open Market Committee (FOMC) meeting will be very interesting. The market will be looking for clues from the Fed regarding the timing of a possible interest rate increase as well as its view on the dollar’s recent strength. The Fed’s rhetoric has been hawkish lately, which is a risk to the market.
- With a global easing cycle underway, economic growth expectations have already started to improve making it an easier decision for the Fed to possibly raise rates.

**Gold Market**

For the week, spot gold closed at $1,158.55 down $8.64 per ounce, or 0.74 percent. Gold stocks, as measured by the NYSE Arca Gold Miners Index, lost 3.42 percent. The U.S. Trade-Weighted Dollar Index gained 2.63 percent for the week.

<table>
<thead>
<tr>
<th>Date</th>
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<th>Survey</th>
<th>Actual</th>
<th>Prior</th>
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<td>Mar-17</td>
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**Strengths**

- The new Apple watch could revive the allure of gold for young consumers. Apple, which called gold “uniquely luxurious” in its advertising, has a history of swaying consumer tastes. U.S., U.K. and Italian demand for wearables made out of gold has been cut in half over the past decade, according to data from the World Gold Council, as shoppers favored white-colored metals such as silver and platinum. Apple’s status as the arbiter of cool means its new $10,000 gold watch and yellow iPhones and MacBooks may entice consumers to buy gold wearables and ornaments again.
- South Africa’s Deputy Mineral Resources Minister Godfrey Oliphant said lessons learned from a
record platinum-industry strike last year will help prevent a similar stoppage during gold wage talks in 2015. Pay negotiations between labor unions and gold mining companies are set to begin next month.

- Atico Mining announced it has drilled solid extensions to its El Roble copper gold mine, which comprises a series of massive volcanogenic sulphide pods. The extensions could meaningfully boost mine life at its Colombian property. In addition, the company reported the results for three diamond drill core holes, which included 86.4 m of 5.04 percent copper and 3.71 g/t gold and 116 m of 3.05 percent copper and 2.38 g/t gold.

**Weaknesses**

- Gold traders are the most bearish in four months on the outlook for a continuation in the dollar’s rise. Bullion slid 4.9 percent in the past nine days and this week reached a three-month low. Further, ANZ Bank cut its second quarter 2015 outlook to $1,100/oz from $1,240/oz while UBS lowered its three-month forecast to $1,170/oz from $1,200/oz.
- Allied Nevada Gold Corp. filed for Chapter 11 bankruptcy on Tuesday after negotiating a reorganization plan that gives holders of $315.5 million in senior unsecured notes 75 percent of the new common stock when it emerges from bankruptcy. Noteholders providing bankruptcy financing are to convert $25 million of that debt into the rest of the new equity.
- The precious metals analysis consultancy Metals Focus revealed that the world’s top ten gold miners had moved into a combined negative cash flow position during the last quarter of 2014. This is after three consecutive quarters where they had recorded positive free cash flow. Perhaps most significant was a 9 percent quarter-over-quarter rise in capital spending, mostly sustaining capital expenditures. The consultancy notes that while in 2010-2013 sustaining capex accounted for less than 50 percent of total capex, in the fourth quarter of last year that figured had risen to around 70 percent. Another factor pointed out by Metals Focus is the high level of net debt within the grouping. Cumulatively it stood at $27.5 billion at the end of 2014 and will take several years to pay off based on earnings before interest and tax. If the gold price remains weak or falls further it could take even longer.

**Opportunities**

- Kirkland Lake Gold reported financial results above expectations on lower costs. Fiscal year 2015 production guidance was revised upwards to 153,000–157,000 ounces as operational improvements take hold.
- Lake Shore Gold announced results of its annual reserve update which included a 29 percent increase in total reserves to 773,300 ounces. The company said it has numerous opportunities to grow resources through drilling for extensions at the existing operations and for new discoveries. In 2014, exploration drilling to the southwest of Timmins West Mine resulted in an important new discovery within 500 meters of Thunder Creek. The 144 Gap Zone is a large zone covering 350 meters along strike and 350 meters down dip, which remains open for expansion. The company continues to generate net free cash flow, with cash and bullion having increased more than $10 million to approximately $72 million. The company also continues to reduce debt, with three payments remaining in their senior secured credit facility.
- The charts below show that the S&P 500’s returns in the past six years have been the best since 1929 and 1999. In addition, earning momentum is U.S. stocks has reversed and is now in a
strong downtrend. Contrasting record gains to record lows, the price to free cash flow multiple of gold miners currently stands at 5.7x, making them historically very cheap. Given the stark contrast, it would be prudent to consider adding gold mining stocks as a means of portfolio diversification.

**Best Six-Year Performance in the S&P 500 Since 1929 and 1999**

![Chart showing best six-year performance in the S&P 500 since 1929 and 1999.](image)

*Source: SG Cross Asset Research, GFD, U.S. Global Investors*

**Gold Price vs. Gold Miners Price-to-Cash Flow Ratio**

![Chart showing gold price and gold miners price-to-cash flow ratio.](image)

*Past performance is no guarantee of future results. Source: Bloomberg, U.S. Global Investors*

**Threats**
• Venezuela’s central bank is in talks with Wall Street banks to create a gold swap that would allow it to monetize some $1.5 billion of the metal held as international reserves. Under the swap, the central bank would provide 1.4 million troy ounces in exchange for cash. After four years, it would have right of first refusal to buy the gold back. Venezuela would have to pay interest on the funds but the central bank would most likely be able to maintain gold as part of its foreign currency reserves. The country faces a cash crunch due to the combination of low oil prices and hefty debt payments, including the maturity of a 1 billion euro bond this month and coupon payments of nearly $700 million in April.

• All eyes are on India’s gold savings plan as it could negatively impact demand for physical gold in the country. With Indian households estimated to own about 20,000 tonnes of gold, even if 5 percent of it were to be unlocked by the new gold deposit scheme, it might reduce the country’s imports by 1,000 tonnes. For 2014, the country imported 769 tonnes of gold.

• According to commodities analysts, the plunge in the gold price following strong U.S. jobs data could be repeated over the coming months. There is speculation that jobs, which were never a big driver of gold, have now become a very big one.

Energy and Natural Resources Market

Strengths

• Utilities outperformed this week as the yield on 10-year U.S. Treasuries retreated. The S&P 500 Utilities Sector Index rose 0.15 percent this week.

• Construction materials stocks outperformed in a commodity depressed market this week, boosted by stronger prospects for U.S. growth. The S&P Supercomposite Construction and Materials Index rose 0.16 percent this week.

• Paper and forest products stocks were a relative outperformer as the dollar soared to multiyear highs. The S&P Supercomposite Paper & Forest Products Index fell by 0.38 percent.

Weaknesses

• Oil and gas drilling stocks sharply declined this week as oil sold off heavily. West Texas Intermediate (WTI) crude oil fell by 9.31 percent this week, while the S&P Supercomposite Oil & Gas Drilling Index fell by 9.26 percent.

• Dry ship stocks retreated for the third week straight as emerging market growth prospects remain a concern. The Bloomberg Dry Ships Index fell 7.96 percent this week.

• Metals and mining stocks continued to give back some of the gains received during the month of February. The S&P/TSX Capped Diversified Metals and Mining Index fell 3.37 percent this week.

Opportunities

• Copper prices are breaking out of the bear market the commodity experienced in the back half of 2014. Increasing speculation that China will fiscally stimulate its economy should boost the struggling commodity.
The European Central Bank (ECB) officially launched its bond-purchasing program. A revival of growth in the eurozone should be a significant catalyst for boosting global growth and commodity demand.

## Threats

- Crude oil inventories in the U.S. reached their highest level since 1982 according to the Energy Information Administration. The sharp rise in production and inventories signal that the supply and demand imbalance for crude oil continues to depress prices.
- The dollar reached multiyear highs this week. The dollar continues to grind higher on account of a depreciating euro.

## Emerging Markets

### Strengths

- Chinese equities outperformed as the government emphasized its intention to provide more fiscal support to the economy. The Shanghai Stock Exchange Composite Index rose 4.06 percent this week.
- Hungarian stocks rallied for the third straight week following the official initiation of the European
Central Bank’s (ECB’s) bond-purchasing program, which should have positive spillover effects for emerging Europe. The Budapest Stock Exchange Index rose 2.09 percent this week.

- After a severe period of volatility, the Ukrainian hryvnia managed to cement its third straight weekly gain. The primary driver for the currency’s rebound was the International Monetary Fund’s (IMF’s) approval of an official aid package for the struggling economy.

**Weaknesses**

- Russian equities fell for the fourth straight week as crude continues to test the lows and a rate decrease by the central bank failed to boost investor sentiment. The MICEX Index fell 5.82 percent this week.
- Greek stocks suffered this week as the government struggles to meet the demands of its European counterparts and cash supplies dwindle. The Athens Stock Exchange General Index closed down 9.42 percent this week.
- Turkish equities retreated this week as the dollar reached new highs and strong economic data from the U.S. fuels concerns that a rate hike is around the corner. The Borsa Istanbul 100 Index fell 4.57 percent this week.

**Opportunities**

- The ECB officially began its bond-purchasing program this week, and the market’s reaction was quite positive. Two-year Inflation expectations increased sharply, turning positive for the first time since early November of last year. Time will tell if the program will revive the eurozone. Nevertheless, it is off to a good start.
- The Polish Finance Ministry’s chief economist is expecting inflation to accelerate next year as prospects for the European economy improve.
- A key message sent by Chinese leadership in the National People’s Congress is a probable acceleration of fiscal policy measures to stabilize economic growth. Fiscal deficit spending is budgeted as much as 2.7 percent of GDP this year, the largest since 1979. The reported swap program converting existing local government debt into municipal bonds with longer duration and at lower interest rates is another major step toward de-risking the banking system. More positive surprises are likely to be generated from the public sector and benefit “old economy” industries this year.
The dollar surged this week, reaching its highest level since April of 2003. The dollar first broke out as real 5-year rates in the U.S. sharply surpassed those in Germany in the first quarter of 2014. With the real 5-year rate differential between the two safe haven assets mostly remaining positive through 2014, the dollar appreciated substantially. Similarly, the rapid appreciation of the dollar since the beginning of March corresponds with another sharp increase in U.S. rates relative to German rates. The increase is primarily the result of rising inflation expectations in Germany due to the official commencement of the ECB’s bond-purchasing program. Even more troubling for those fearing a stronger dollar is the recent rolling over of the 5-year breakeven inflation rate in the United States. With German nominal yields compressing and inflation expectations rising, the stage is set for real interest rates to decline further in Germany relative to the United States, thus adding more fuel to the dollar.
With the Turkish Central Bank facing increasing pressure from the government to cut rates further, the lira remains vulnerable to further depreciation.

Tremendous popularity of the online environmental documentary *Under the Dome*, self-funded by a former investigative journalist in China, should aggravate investor sentiment on heavy polluters in the coal, cement and steel industries and intensify their secular decline.

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