

When You're A Jet

"When you're a Jet, you're a Jet all the way / from your first cigarettes to your last dyin' day..."
Leonard Bernstein

Personally, I would rather sing about a long-ago fictional street gang than recall actual encounters with the jet fuel market. It has been the proverbial widowmaker to more than one airline over the years and at present has provided them with the excuse to keep dinging their customers with fuel surcharges as if it was a wholly unexpected expense.

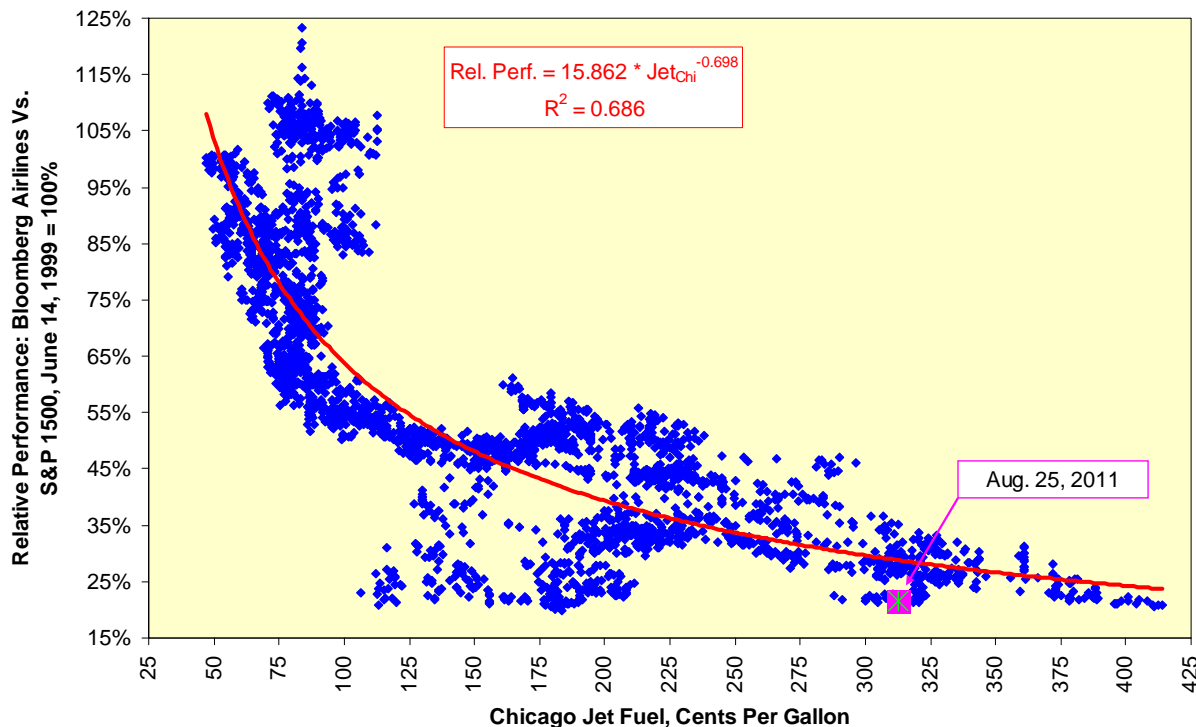
Even though jet kerosene comes out of the same cut of the barrel as heating oil, diesel fuel and other distillates, it is very tough to model and its spread to heating oil futures is exceptionally volatile. If we find ourselves in the midst of a war, which we seem to do with distressing frequency, the military can exert a first claim on supplies. Moreover, this basis volatility tends to go one way: Jet fuel prices rise relative to heating oil far more rapidly than they fall; this has made airlines' hedging programs a more inexact science than they would be otherwise.

As a result, the jet fuel market has been fragmented into a group of local basis swaps and indexed-hedges. To add to the mix, airlines have a nasty habit of visiting Chapter 11 bankruptcy like you or I visit the dentist. As futures-based hedges involve margin agreements and as all swaps involve counterparty credit risk, anyone could be excused from diving under the table when the airline fuel buyer calls. In a twist from how bankers like to lend money to people who can prove they do not need it, hedge counterparties do not like to deal with people who really, really need to manage their risks.

Still and this should not be news to anyone, airline stocks have been at the mercy of jet fuel prices. Let's map the performance of the Bloomberg Airlines index relative to the S&P 1500 against jet fuel prices at Chicago. This index is broader than the S&P 1500's Airline index; its largest members are Southwest Airlines, Delta Airlines, United Continental, Alaska Air, JetBlue Airways and AMR Corporation.

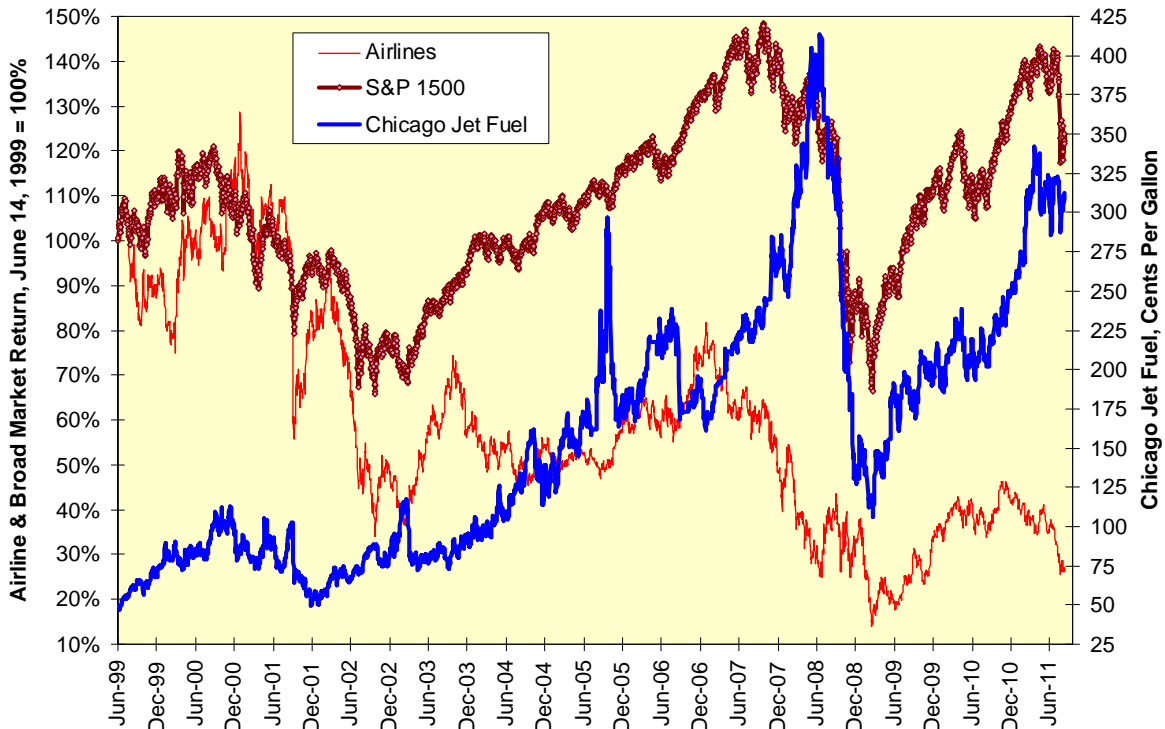
The relationship is well-defined over the past twelve years, which is all the more remarkable considering the extreme volatility of both the broad market and of jet fuel prices during this period.

Jet Fuel Prices Matter To Airline Stocks



A look at that “you-are-here” marker on the chart shows we are near the bottom range of airline underperformance. However, they have a long road to go or a long route to fly, if you prefer, before they move back toward market performance. If we decompose the data in the chart above, we can see the airline industry never really recovered from 9/11 and has entered a new leg of underperformance in our Great Recession. Jet fuel prices have been in a long-term uptrend marred only, and in spectacular fashion, by the 2008-2009 financial crisis.

Your Flight Has Been Delayed



What would it take for airlines to take flight again? A combination of economic recovery, lower jet fuel prices during that recovery and an abandonment of the trend to replace physical travel with technology. Of these three, the economic recover is most likely, and I am not going to hold my breath waiting for it.

Finally, and in a complete editorial comment, the airline industry has acceded in turning its customers into its least-likely advocates. If they want people to come to their aid or at least stand aside and let the paramedics through, they should try a little customer service. That would not help their stock prices next week, but it would not hurt in the grander scheme of things.