Why Canadian Airlines May Face a Hard Landing in 2017

Description

The two major Canadian airlines **Air Canada** (TSX:AC)(TSX:AC.B) and **WestJet Airlines Ltd.** (TSX:WJA) have enjoyed the benefits of a protected oligarchy (thanks to the Canadian government) as well as a reduction in fuel costs and relatively stable corporate-union relationships over the past year. I'll be looking at two key reasons why these trends may reverse in 2017.

Global oil prices expected to rise in 2017

Besides labour costs, fuel prices are the second most important cost driver in the airline business. Jet fuel prices are generally tied to crude prices but fluctuate primarily due to increases and decreases in the refining costs for jet fuel, driven by supply and demand considerations and refinery capacity. In 2016, airline investors were able to reap the benefits of pervasively low jet fuel prices, as the price of crude oil continued to plummet in the first quarter of 2016 and remained subdued for the remainder of the year.

A number of organizations, including the International Energy Agency (IEA), have reported that crude oil prices, and therefore jet fuel prices, will be on the rise in 2017. The December 2016 report notes that fundamental supply and demand factors are at play in the crude oil market. Crude inventories have declined in December and are anticipated to continue to decline in 2017, while demand from Asia remains strong. The IEA has raised their 2017 demand expectations on the back of continued anticipated strength in global crude demand.

Hedging may be a driving factor for investments in 2017

One of my 2016 articles on WestJet specifically talks about the risk/reward relationship between airlines' hedging strategies (specifically focusing on WestJet as a case study). WestJet moved away from a fuel-hedging strategy in September 2016, noting that the marginal benefit the company receives from hedging oil prices doesn't justify the cost of the hedging portfolio.

While this fact may remain true for the time being, as oil prices and volatility begin to rise in 2017, re-instituting a hedging strategy doesn't come without its costs. It will simply become costlier for the company to engage in future contracts as prices continue to rise. Prudent investors have clamoured for increased hedging, while airlines have been eliminating hedge positions of late.

Labour costs remain stable, but work stoppages always pose a significant threat

Perhaps one of the biggest risks facing investors with exposure to airlines is the risk of a sustained work stoppage. For airlines, the loss of revenue combined with the potential for a loss of market share, along with other long-term negative externalities, make work stoppages one of the most dreaded events; indeed, airline stock prices follow such stoppages closely.

Various contracts for Air Canada and WestJet employees are coming up for renegotiation, and investors may need to brace themselves accordingly.

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