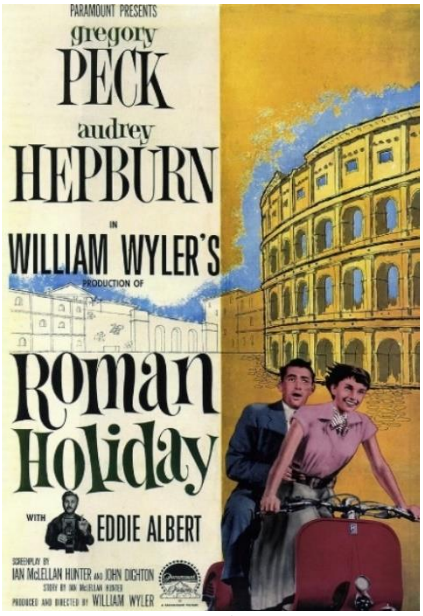
Investment Insight

ROMAN HOLIDAY

TRAVEL RETURNS WITH PENT-UP DEMAND AND SKY-HIGH PRICES

Everyone wants a Roman holiday! Americans are back in Paris! Hotels are full, restaurants are booked, luxury stores have long lines outside, and good luck trying to book a scooter. Friends who happen to live part of the year on the glamorous island of Capri told us that it takes three times as long to get to the harbour because it has never been so busy.



Source: Paramount Pictures

Over the Easter period, occupancy rates in Paris were at 91%, boding well for a bumper summer. Italy was no different. "There's a huge craving to travel, just like popping a [cork] from a bottle," said Bernabò Bocca, president of the Italian national hotel association Federalberghi. The moment Italy loosened safety measures in April, "a tsunami of bookings arrived from the United States at a speed never seen before".

Global air passenger numbers are up sharply. The [latest analysis] of global air traffic by the International Civil Aviation Organisation (ICAO) provides evidence of a strong global recovery in air traffic. The number of air passengers carried from January to April 2022 increased by 65% compared to the same period in 2021, while aircraft flight departures increased by 30% and airline seat capacity grew by 32%.

The US government's decision in June to follow much of Europe and lift pre-departure Covid-19 testing requirements for international travellers will further strengthen numbers. It makes it easier for tourists to come to the US and raises confidence among US travellers who no longer need to worry about being stuck overseas if they test positive for Covid.

Meanwhile, the World Tourism Organisation's (UNWTO) latest Tourism Barometer shows a 182% year-on-year increase in international tourism in January-March 2022, with destinations worldwide welcoming an estimated 117 million international arrivals compared to 41 million in the same period last year. Increases were expected given the significant downturn the travel sector suffered during the pandemic-induced travel restrictions (according to UNWTO 2020 was the worst year on record, with tourism declining to the levels of the early 1990s). But of the additional 76 million international arrivals during the first three months of 2021, about 47 million were recorded in March, indicating that the recovery is gathering pace.

The travel recovery has its challenges. After two years of a pandemic, the industry is struggling with capacity. The media is full of headlines about flight disruptions, long queues

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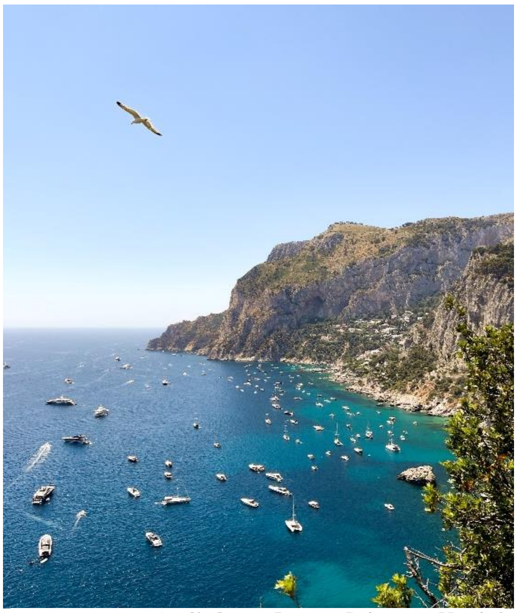
and lost luggage as airlines and airports struggle to find enough staff to cope with the demand. EasyJet recently said that staff absences were double their normal levels due to Covid, while German airline Lufthansa has warned passengers that the situation was "unlikely to improve in the short term," with stability only to be reached in the winter.

Source: Kipras Štreimikis on Unsplash

Another major challenge is the broader macroeconomic environment. The global economy is grappling with a significant rise in inflation, higher interest rates and continued disruption in supply chains. Inflationary pressures hurt lower-income households more than others, which will hit demand. Companies still see pressure in their supply chains, but many expect bottlenecks to improve as we move through the year

Travel and tourism have been a privilege for those who can afford them. Middle and high-income households have a greater propensity to consume even as the prices rise so demand for many goods and services is less elastic than many expect. According to the UNWTO, most world regions expect better prospects for 2022. Europe is most improved while the Asia Pacific still has the largest share of closed destinations.


Amalfi -Source: Branimir Balogović on Unsplash

Yet despite the recovery, travel is still below 2019 levels. According to the UNWTO, arrivals in Europe and the Americas were still 43% and 46% below 2019 levels, respectively. The current consensus is for a full recovery by 2024 at the earliest.

High oil prices make getting around more expensive, and so there is a risk that the recovery will be impacted by greater costs. But all the evidence is that people have bought many of the goods they wanted over the past two years because they could not consume services. They increased their savings and have the money to spend on travel. This higher demand is hitting limited supply. The result is that the price of airline tickets, hotel rooms and the costs of other aspects of travel, including hospitality and restaurants, have soared. Strong demand means that many companies have pricing power and are increasing prices to offset inflation and preserve margins.

Global hotel chains like Marriott, Hilton and Hyatt have all indicated that prices are going up. Rates are already up by 25% compared to 2019 and Keith Barr, the CEO of IHG Hotels & Resorts recently said that "there's still some pricing power in this business moving forward, and demand will continue to come through the summer".

Of course, we have to keep perspective. Eventually, prices will rise to levels that are not supported by demand and will moderate. People who are spending money they have saved on their first holiday in over two years will not be able to afford another one next year. This year's strong growth will be a hard comparison to beat so it will be followed by lower growth next year.

However, the strong recovery in tourism shows that the pandemic has changed little about people's desire to travel to new and existing places and to enjoy new experiences. This important fact is reassuring and supportive for many of the businesses we invest in.

LUXURY GOODS: STRONG RECOVERY BUT MORE TO COME FROM CHINA

Consumers love to shop when they travel, be it for a treat for themselves or as a gift for family and friends. That is why global travel retail (GTR) is an important driver of revenue for luxury, spirits and beauty companies. European cities like Paris, London, Rome and Milan are preferred places for buyers of luxury goods because prices are often lower than elsewhere reflecting high taxes and import duties levied by various countries outside Europe. In many cases, international travellers can make even greater savings by claiming the VAT back at airports and other points of departure.

GTR was hit hard by Covid-related travel restrictions, with sales down as much as 80-90% at the height of the pandemic. There has been a gradual recovery since the early days of phased re-opening but it only began to pick up speed in the spring of this year when most restrictions on Covid testing and quarantine were removed in Europe and the US. With American visitors to Europe returning in their droves, they are taking advantage of the strong US dollar against the weaker Euro and British pound. There are significant savings to be made. The same luxury item can cost 20-30% less in Europe than in the US. But it is not just Americans who shop till they drop. Visitors from the Middle East are flush from the wealth effect of high oil prices. Even more steady travel within Europe is on the increase as well as people all over Europe rush to enjoy their first holiday abroad in more than two years.

New Bond Street. Source: Author's own image

There is a bifurcation of low- and high-end consumers. Whilst low-income consumers have already felt the effect of the cost-of-living crisis and are reining in spending, luxury consumption is holding up despite inflation, the Russia/Ukraine conflict and volatile stock markets. One of our analysts recently visited avenue Montaigne, the main luxury shopping street in Paris, to check out the consumer appetite for luxury. The street was bustling with queues outside many of the luxury stores like Louis Vuitton. We witnessed similar scenes outside Chanel in London's New Bond Street. Luxury companies like LVMH, cosmetic giant L'Oreal, and spirits beverage leaders like Diageo and Pernod will certainly benefit from a renaissance of GTR.

However, despite the strong recovery in tourism from Western tourists, international travel from Asia is still relatively weak. While Southeast Asia is gradually easing Covid restrictions, China's zero-Covid policy continues to prevent people from travelling abroad for holidays. As China brings Covid under better control, we expect the government to take actions to reinvigorate the economy and consumer spending through stimulus and other incentives. Nothing has changed about Chinese consumers' demand for luxury goods. If and when China loosens travel restrictions, we expect a boom to rival what we have seen from the United States this year, and as travel from China recovers so will Chinese consumers' spending on luxury goods.

INDUSTRIALS: AEROSPACE ON THE RIGHT FLIGHTPATH

As travel activity recovers, the global aerospace industry is well placed to benefit. *Raytheon Technologies*, the world's largest Tier 1 aerospace supplier, is already seeing a significant pickup in activity. Its commercial aftermarket business within its Pratt & Whitney (aerospace engines) and Collins Aerospace (aerospace systems) divisions was up a combined 38% in the first quarter of the year. This is driven not only by the recovery in short-haul travel but increasingly by long-haul travel which is expected to reach 75% of the 2019 levels by year-end.

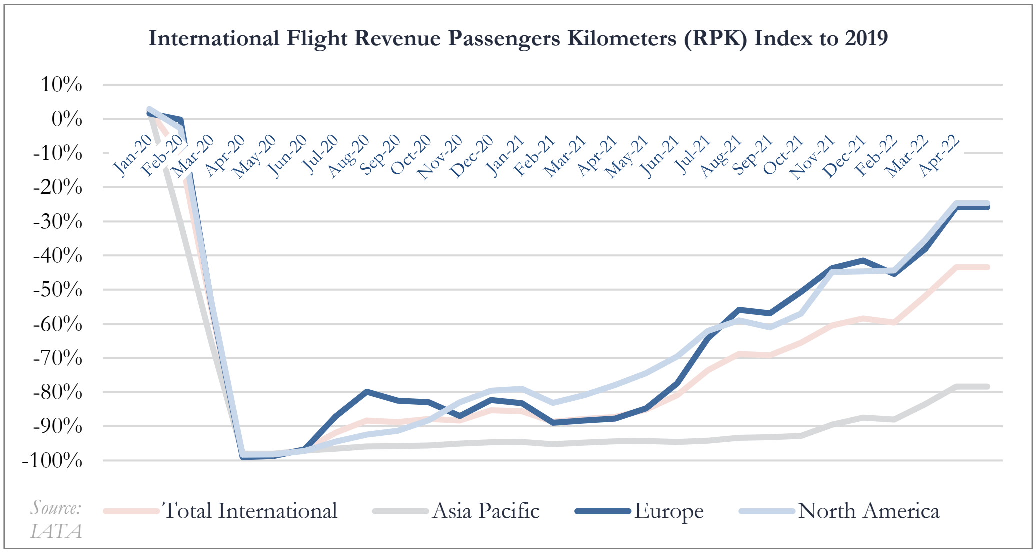
Importantly as the businesses recover, their profitability improves disproportionately as the effects of the accelerated cost optimisation programmes implemented over the past year translate into significant margin expansion. Similarly, *Honeywell*, a global leader in aviation and air connectivity systems, saw a 28% recovery in aftermarket activity within the same period. Its later cycle original equipment business is set to follow as the demand recovery sets in.

The current elevated energy price environment has increased the urgency for airlines to renew their fleets with new planes that have greater fuel efficiency and improved economics of new planes. Although the main airframe providers, Airbus and Boeing, expect a significant increase in deliveries they remain 30-50% below 2018/19 levels, leading to sustained demand for the companies' civil aviation businesses. At the same time, Russia's invasion of Ukraine has highlighted the need for increased investment in defence capabilities in the United States and especially in Europe, providing significant multi-year opportunities for the companies' defence businesses. Improving earnings and lower valuations mean that these companies have great prospects for value generation.

DIGITAL: CARD NETWORKS TAP IN ON INCREASED SPENDING

The return of global travel is important for the card networks. The networks generate a higher fee from cross-border transactions given the greater risk of fraud and the additional complexity of making the transaction. Additionally, people no longer exchange their money for wads of foreign currency or order travellers' cheques before travelling because they assume that cards will be accepted. Payment infrastructure has improved. For example, many transit networks around the world now offer contactless payment, which furthers the adoption of cards for regular small ticket items. The pandemic has had a profound impact with many businesses in the US and Europe moving away from cash payments altogether. Payment operators like Square and others have enabled small merchants, coffee shops, market vendors, cab drivers and others to accept cards as easily as the biggest stores, hotels or restaurants. Payments are becoming more ubiquitous around the world, deepening card penetration and removing cash from the system.

We recently met with Visa's management. They highlighted that there is still significant pent-up demand for travel and that where travel corridors have opened up, there has been strong demand. In their last earnings report, Visa's management said that in many of those travel corridors, travel-related spending is back at 90% of pre-pandemic 2019 levels or higher. Overall, global travel-related spending is back at 82% of 2019 levels. Some of the important corridors have not yet recovered to the same extent. Inbound to the US is only at 70% of 2019 levels and Asia is also significantly lower at just under 40% of 2019 levels. Lower Asian spending is due to the ongoing Covid-related restrictions imposed by China but also by Japan and Korea and China as can be seen in the IATA flight data below.



Visa's management was confident that the recent travel disruptions and negative macro-economic headlines would have the effect of delaying and prolonging travel plans, not cancelling or abandoning them. They said that they expected people to take more time to travel but would still go on holidays, visit family and travel for work. They thought that travel in Asia would recover strongly if and when restrictions are eased. They also predicted that business travel would rebound globally although more in value than volume as the widespread use of video conferencing software meant that business travel would be less about short meetings that could be held online and more about longer trips, more value-added projects and efforts to build relationships.

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