

October 30, 2006

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Travel Industry Analyst

Dear Client:

Planning for 2007 is now a priority. We see a year of slow but stable growth for most all sectors of our industry.

Economic projections for the year ahead are positive, but with the anticipation of slower GDP growth than this year. Consensus estimates for 2007 gains in GDP generally fall in the 2.5-3.0 percent range, down from the 3.4 percent level expected for 2006. Consumer spending will also fall somewhat. The declines will be largely traceable to a continued softening in the housing market and spending related to it – home improvement, appliances, furnishings, etc. Travel should therefore really not be impacted significantly by the weaker economic numbers.

Travel industry projections based on historical travel to GDP relationships are a starting point in most forecasts. For 2005 and 2006, this relationship has been 0.75:1.00, i.e., for each percentage point growth in GDP (1.00) travel trip volume grows by 0.75 percent. A straight line 2007 projection on this basis would result in travel growth of 2.0 percent (i.e., $0.75 \times 2.75\% \text{ GDP} = 2.0\%$). Assuming travel prices rise in proportion to the expected 2007 national inflation rate (+2.8%), travel spending would grow by 4.8 percent ($2.0\% + 2.8\%$).

Travel pricing developments will be important to watch in the year ahead. After the robust increases in most all travel sector prices this year, logic would say that this is unlikely to continue, with price increases falling more in line with the rise in the CPI. In 2006, domestic travel prices, as reflected in our composite index, rose at 2 ½ times the national inflation rate. A key issue for 2007 therefore will be how much of the industry's revenue growth will come from increased demand, how much from pricing, and/or what combination of both.

Business travel in 2007 should again be a lot stronger than in the leisure sector. All of the business travel economic fundamentals that we track are positive. Corporate third-quarter profits are again meeting Wall Street analyst expectations. This will be the 13th consecutive quarter of double-digit profit gains for S&P 500 companies. And companies continue to be in a growth and expansion mode, with increased capital spending commitments. This all bodes well for business travel in the year ahead.

T&E spending restraints also seem to be loosening. With the business travel rebound now past its second year, there's a natural tendency over time for spending restrictions to be relaxed by companies. And as travel hassle increases for their travelers, many companies seem to be compensating for this by allowing more convenience and comfort upgrades. The strength of the luxury and upscale hotel segments may reflect these trends. Marriott RevPAR in the third quarter was 9.4 percent above year ago.

Leisure travel prospects now look a lot better than they did a few months ago. As reported in our last newsletter, trip volume over the peak summer vacation travel months showed a disappointing 0.5 percent year-over-year gain. We believe this was a function of household budgets being tightly squeezed in the first half of the year – particularly among middle- and lower-income families. But as summer came to an end, there were two positive developments: gas prices have fallen dramatically and, along with this, above-normal inflation rates that had been eroding incomes has also fallen.

Retail gasoline prices that hit a summer high of \$3.08/gallon were down to \$2.23/gallon in mid October. For each 10¢ movement in prices, up or down, consumer spending on other goods and services can fall or rise by \$1 billion/month. The 85¢ peak-to-trough decline in gas prices therefore freed up \$8.5 billion monthly for other types of consumer spending (i.e., $85¢ \div 10¢ = 8.5 \times \$1 \text{ billion} = \$8.5 \text{ billion}$). Had summer gas prices been at this month's lows, the consumer would have had these extra dollars for vacation spending.

Lower rates of inflation, that are now evident, result not only from lower gasoline prices, but also from lower prices on other goods and services. From June-July of this year, the overall CPI was 3.7 percent above year ago. For August/September, it's down to 2.9 percent. With this decline, consumer income gains are now outpacing the inflation rate, not lagging behind it.

Consumer retail sales are reflecting the improvement in the economic well-being of the average household. The Goldman Sachs September retail sales index was 3.4 percent above last year. Other good news is that the housing slump does not appear to be hurting households as many anticipated. While new home purchase and resale transactions are down, house prices nationally have fallen less than 2 percent this year, based on data from the National Association of Realtors. There's therefore been little negative "wealth effect" on homeowners. And to offset this for many other households, the Dow Jones Industrial average has passed the 12,000 mark.

Leisure destinations hopefully will now do better in 2007 than they did this year. Data for January-August show visitor counts at Las Vegas only a modest 0.6 percent above year ago; Hawaii, +0.1 percent; Orlando, down 4.0 percent, based on STR hotel room nite data. Fortunately for each destination, the softness in visitors was made up by 10 percent plus increases in hotel room rates.

U.S. coastal and island resort destinations fortunately have had a hurricane-free season. Though the season does not end until November 30, of five hurricanes to date, all have missed the U.S. coastline. Predictions had called for an above-average storm season. Had this occurred, these could have been a longer-term negative for hurricane-prone destinations in shortening their late summer/early fall season.

Air travel data is now available for the first nine months of the year, and shows domestic enplanements 2.3 percent below year ago; international up 5.3 percent. Domestic enplanements have fallen below the prior year in seven of the last nine months. The declines are worrisome to us. They have largely resulted from the internal restructuring that is going on within the airline sector. This starts with domestic service

reductions by the legacy carriers, as they see more opportunities internationally than domestically. Continental now has 47 percent of its capacity on international routes; American, United and Northwest each with more than 35 percent.

Airline travel hassle is also a negative factor affecting traffic. Short-haul air travel appears to be impacted most, as other intercity modes can be used instead. Southwest Airlines, which was a pioneer in moving travelers from automobile to air travel, is now seeing this reverse itself, and it is impacting the airline's traffic. Southwest's routes are primarily short-haul

Airfare increases may be another negative depressing travel. Year-to-date domestic fares are up 10.8 percent and may be reducing travel among the more price-sensitive leisure travelers.

Airline financial performance is much improved in spite of these traffic negatives, and by year-end at least half the carriers will be showing quarterly profits. These profits will clearly not be traffic-dependent, but from pricing, lower jet fuel costs and the effects that are now beginning to show from their cost reduction efforts.

International travel is showing a mixed picture. On a worldwide basis, IATA reports year-to-date international traffic up 6.1 percent. This strength is tied to strong worldwide economic growth this year that will average 3.7 percent. Asia/Pacific GDP is particularly strong, at 5.0 percent. While these levels of growth will likely moderate in 2007, they will still be quite respectable and above the expected gains in the U.S. economy.

U.S. international travel, both inbound and outbound on a nine-month basis, is 5.3 percent above year ago. While meaningful breakouts between inbound and outbound are not yet available, early data show the outbound market a lot stronger than inbound. U.S.-Europe traffic, through June, was running 4.4 percent above year ago. In contrast, inbound traffic from Europe is down 4.5 percent; total overseas arrivals, down 1.3 percent.

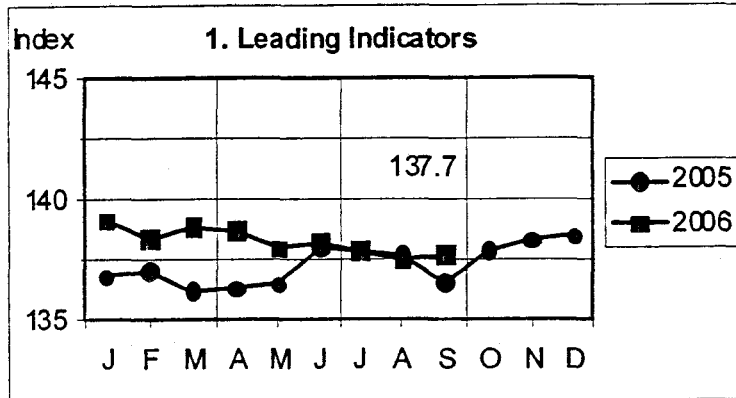
Inbound foreign arrivals continue to be disappointing, and appear to be more leisure than business travel oriented. For May/June/July, the first months of the leisure travel season, total arrivals from overseas were 3.0 percent below year ago. Arrivals from Europe were down more sharply, at 4.8 percent. If the early trends hold by year-end 2006, overseas arrivals will still be 15 percent below those of the peak year 2000. If growth had been normal, at a mere 3 percent annually, 2006 arrivals would be 20 percent above those of the year 2000.

Negative perceptions of the U.S. overseas have got to be a major factor in the inbound softness. The overseas consumer economies and purchasing power of their currencies have been strong, so it's not economics that is contributing to the weakness.

Updated indicators follow. Nine-month data is now available for most all of the indicators.

Our year-end publication schedule, as in the past, calls for a combined annual forecast issue, mailed and posted on our Web site in mid December.

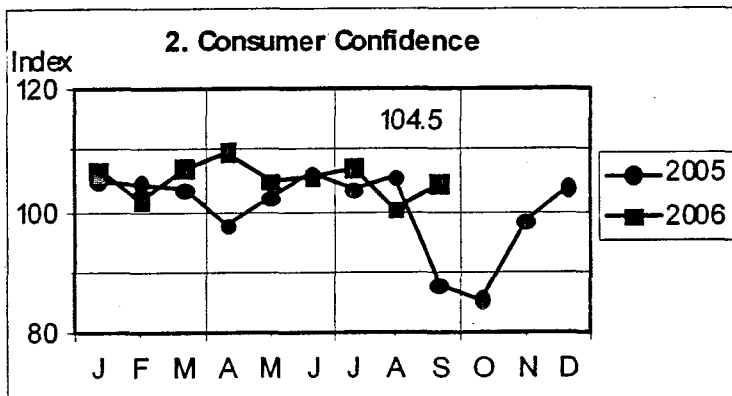
Letter #274
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September 2006

% Change:	
Prior Period:	+0.1%
Prior Year:	+0.6
Year-to-Date:	+ 0.9

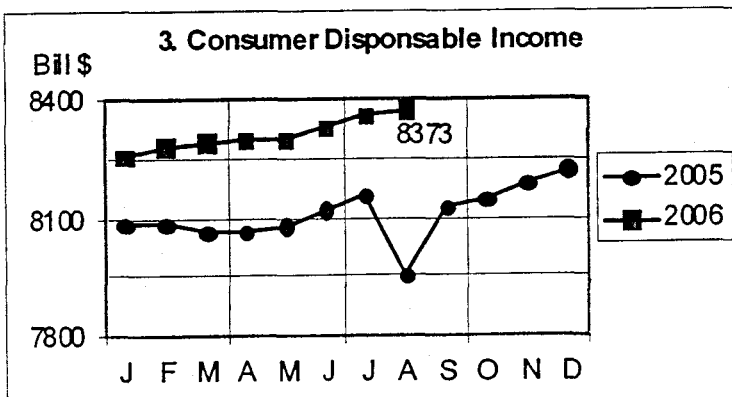
Though this index is down from its early-year highs, its stability in the most recent months suggests that any declines in the economy will be modest ones.



September 2006

% Change:	
Prior Period:	+ 4.3%
Prior Year:	+19.4
Year-to-Date:	+ 3.5

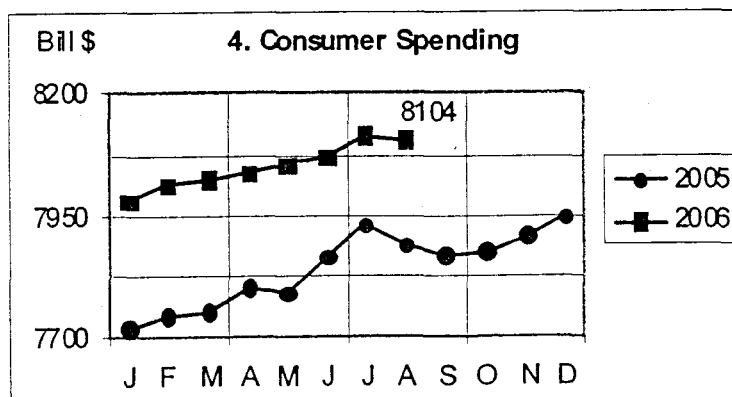
The sharp decline in gasoline prices triggered a rebound in this index in September, and will provide support for improved confidence levels in the months ahead.



August 2006

% Change:	
Prior Period:	+0.2%
Prior Year:	+3.1
Year-to-Date:	+3.0

Real income gains are now beginning to accelerate as the inflation rate falls as a result of lower energy prices.

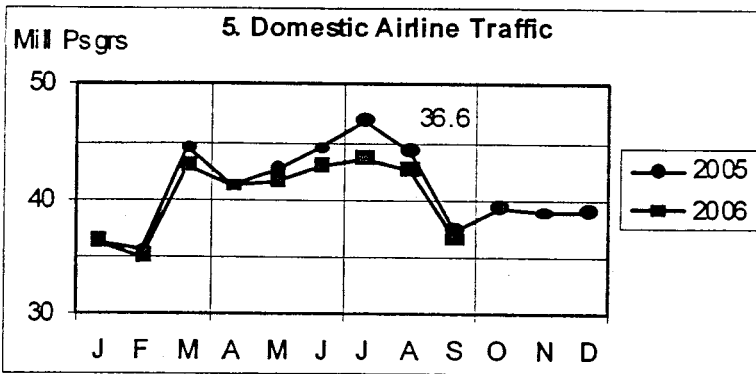


August 2006

% Change:	
Prior Period:	- 0.1%
Prior Year:	+2.7
Year-to-Date:	+3.0

Though many had anticipated consumer spending cutbacks in the final months of the year, the income gains that are now occurring are enough to sustain respectable levels of spending.

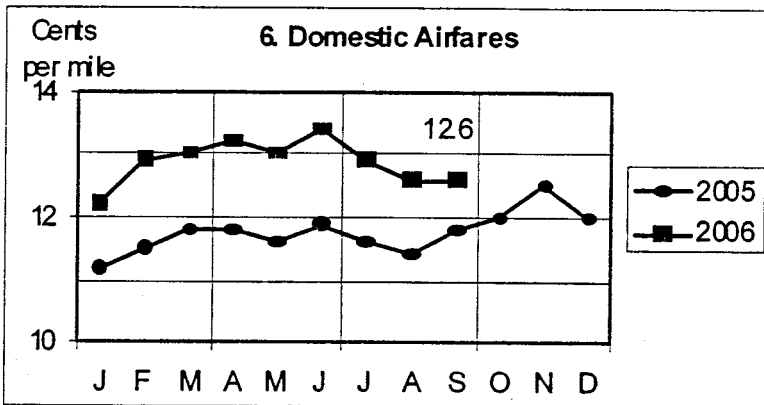
September 2006



% Change:
Prior Period: -14.3%
Prior Year: - 1.9
Year-to-Date: - 2.3

Domestic enplanement levels continue to remain below year-ago levels. The sharp September decline is, however, a normal seasonal occurrence.

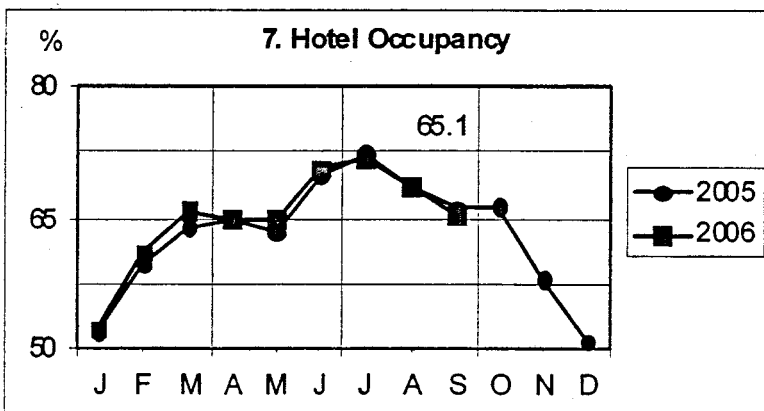
September 2006



% Change:
Prior Period: - 1.1%
Prior Year: + 7.3
Year-to-Date: +10.8

Airline fares continue to be well above last year, and are what's boosting the financial fortunes of the airlines.

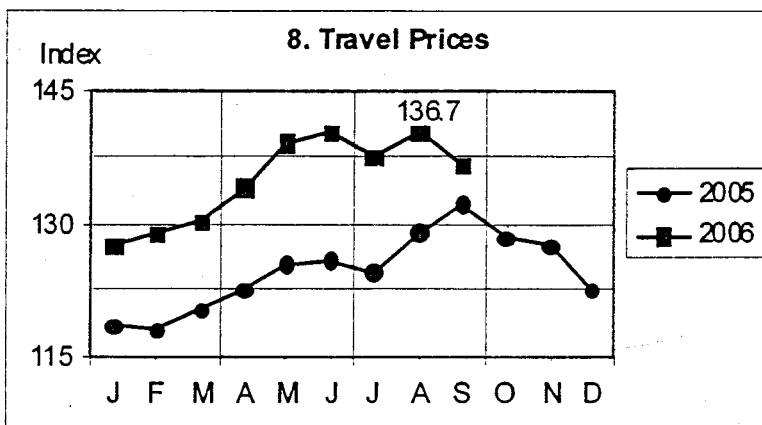
September 2006



% Change:
Prior Period: - 5.2%
Prior Year: -1.3
Year-to-Date: +1.0

With room demand remaining soft (+0.2%), occupancy fell below year-ago.

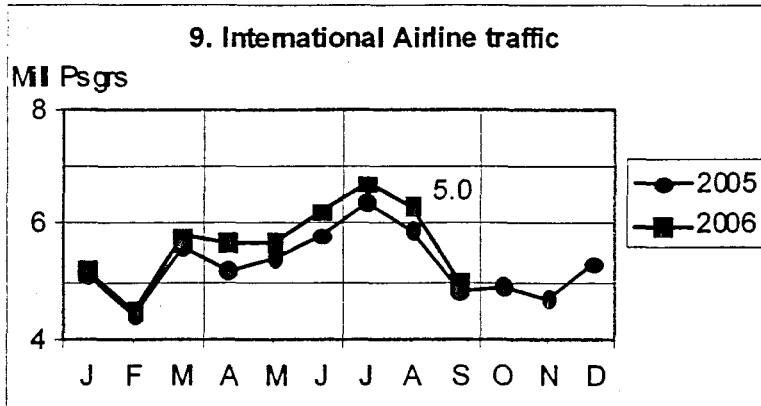
September 2006



% Change:
Prior Period: -2.6%
Prior Year: +3.4
Year-to-Date: + 8.8

Though drive gasoline costs represent only a small portion of our composite index, its sharp declines in September worked to lower the overall index.

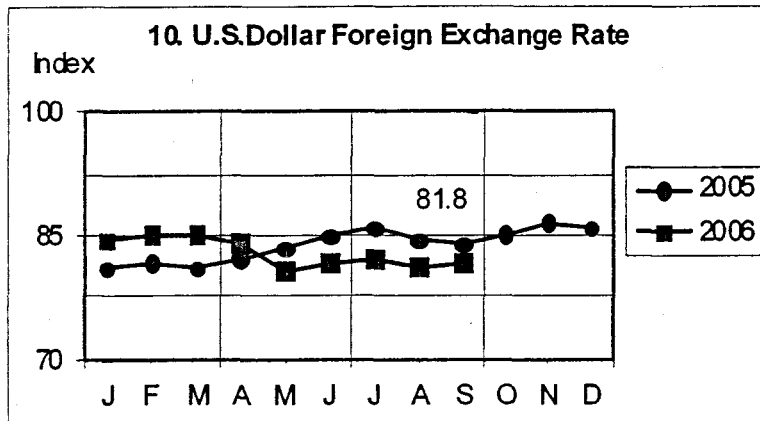
International Travel Indicators



September 2006

% Change:	
Prior Period:	-19.3%
Prior Year:	+ 4.2
Year-to-Date:	+ 5.3

September traffic reflected the normal seasonal fall-off in international travel.



September 2006

% Change:	
Prior Period:	+0.5%
Prior Year:	- 2.6
Year-to-Date:	- 0.2

Recent months have shown stability in the dollar, and it remains modestly below year ago.

TRENDS & PROJECTIONS

PERCENT ANNUAL CHANGE

	ECONOMIC						TRAVEL				
	GDP	Businesses Investment	Profits	Consumers Income	Spending	CPI	Domestic Hotel Demand	Air Psgs	Air Psgs	International Overseas Outbound	Inbound
2001	0.8	(4.2)	(6.2)	1.9	2.5	2.8	(3.4)	(7.3)	(6.3)	(6.0)	(15.9)
2002	1.6	(9.2)	15.5	3.1	2.7	1.6	0.8	(5.1)	(0.2)	(6.0)	(12.4)
2003	2.5	1.0	12.1	2.2	2.8	2.3	1.6	(2.8)	(1.8)	2.8	(5.7)
2004	3.9	5.9	19.1	3.6	3.9	2.7	4.6	4.8	13.9	11.9	12.7
2005	3.2	6.8	12.5	1.2	3.5	3.4	3.3	1.6	9.4	5.0	6.7
2006 (proj)	3.4	8.5	15.0	2.6	3.2	3.5	2.8	(0.2)	4.2	4.0	3.8

Economic Data: Department of Commerce, Bureau of Economic Analysis. Changes in inflation-adjusted dollars. CPI, Bureau of Labor Statistics. 2006 projections, Travel Industry Indicators.

Travel Data: Air Transport Association, psgr enplanements; Smith Travel Research, hotel room demand; Commerce Department/Tourism Industries, outbound departures/inbound overseas arrivals; 2006 projections; Travel Industry Indicators.

LESS PRICE COMPETITION FAVORABLE FOR INDUSTRY

One of the developments most evident in 2006 has been the lessening of travel industry price competition. Travel supplier prices have risen sharply rather than fallen, and we no longer see inventories being dumped and sold en masse through discount intermediaries. This is a positive development, and reverses a trend in which too many travel products were rapidly becoming commodities, with price becoming the sole criteria for brand selection by the consumer.

The danger of becoming a commodity is well understood by most marketers. If you're a commodity, you lose the ability to create brand preference and brand loyalty. There's no real need for the customer to choose your brand, nor stay with you. There's also the loss of any pricing power. In the absence of points-of-difference, it's then the lowest price that counts, putting downward pressure on margins. Commodity marketers are also highly vulnerable to new entrants -- whose only requirement for competing may be lower costs and the lower prices they might offer customers. And, finally, commodity marketing is usually inefficient, with advertising dollars largely wasted. A dollar spent today will have little lasting value tomorrow in holding onto the customer. As most marketers know, it's less costly to keep a customer than to create new ones over and over again. If you're a commodity, this is what you have to do. Jack Welch, formerly the very successful head of GE, saw undifferentiated brands as being "commodity hell," a place you don't want to be.

How does one protect against "commoditization" of its brands? The antidote to "commoditization" is brand-building. It is taking steps that will set one's product apart from the competition, with differences that are either real, perceived or a combination of both. Brand-building is an art pioneered in the consumer packaged goods industry by Proctor & Gamble. It has 21 different and successful brands, each with sales of over \$1 billion annually. It employs a strategy that calls for adding small but meaningful innovations to mature products to keep them contemporary and distinctive. The innovations are then heavily advertised and promoted. Over time, successive innovations work to enhance the brand's overall image with consumers. The process is a continuing one that constantly challenges the company's executives.

The Starwood's introduction of the Heavenly Bed five years ago employed such a strategy. Today its CEO is a Coca-Cola trained executive, marketers of America's best-known brand. Starwood's goal is to build a distinctive image for each of its nine hotel brands. Other hotel chains appear to be following its lead, with innovations such as celebrity chef restaurants, new gym and spa facilities.

In planning ahead for 2007, every travel marketer should think about ways that its brand-building efforts can be accelerated and its discounting efforts lessened.