

**THE RELATIONSHIP BETWEEN OIL PRICE AND
AIRLINE STOCK PRICE**

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THE RELATIONSHIP BETWEEN OIL PRICE AND AIRLINE STOCK PRICE

By

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ABSTRACT

This study aims to examine the relationship between oil prices and airline stock prices. with the increase of threats of oil price fluctuations and rising energy price for airline companies, it is important to important to consider oil as a pricing factor in asset pricing models. Furthermore the study contributes to literature by demonstrating how the relationship between oil price and stock price vary among companies depending on their characteristics.

Two multiple regression models are executed to investigate the nature of the relationship between oil price and airline stock price. The models consider crud oil denominated by daily OPEC basket prices, and the data for 40 airline companies from 27 countries.

The findings suggest that there is a significant negative relationship between airline stock prices and both oil price and exchange rate. The findings also suggest that there is a significant positive relationship between firm size and profitability and the effect of oil prices, as well as there is a significant negative relationship between operating leverage and liquidity and the effect of oil price. Conversely, there is a negative relationship between financial leverage and the effect of oil price but not significant and as for the operating efficiency the finding show a positive relationship but not significant too.

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CHAPTER ONE

1.1. Introduction

The increasing role of stock markets in the economy over the past years has encouraged researchers to investigate the relationship between the stock markets and the economy. The studies conducted have shown that there is a strong relationship between stock prices and the macroeconomic variables. It is assumed that the information about the economy is considered by investors when they estimate the discount rate and expected cash flow from stocks (Mookerjee and Yu, 1997; Victor and Kuwornu, 2011; Singh, et al., 2011; Chen et al., 1986; Pearce and Roley, 1983; and Kim and Wu, 1987). In addition, an efficient capital market hypothesizes that stock prices adjusted to all new information released in the market. Fama (1970) documented that in semi strong market, stock prices should reflect all relevant information including publicly available information.

Since 1972, the price of oil price has shown to be an influential factor in the economy. An increase in oil prices can lead to a rise in production costs, as oil is a basic input in the production process. Thus putting pressure on the companies' profit margins and eventually will affect the stock prices of the companies. Any fluctuations in oil prices are reflected directly on the other sectors in the economy. The effect of oil price changes varies according to the amount of the dependence of the sector on oil (energy elements) as a key part of inputs (Maghyereh, 2007). The increase in oil prices has an indirect effect on the stock market. The change in oil price can lead to a transfer of income from oil consumers to oil producers, a rise in the price level and inflation, a change in

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changes. The high ratio might lead companies to bankruptcy. Thus, the potential investors will not be attracted to invest in stock with high leverage. This will lead to reduce the demand in such stocks which eventually reduces the price of the stock.

Finally, the findings show that operating leverage and liquidity have a negative relationship with oil price change. The company with high fixed cost in its cost structure is more sensitive to the change in oil prices. Since the cost of oil price is a part of the variable costs of airline companies, the increase in oil price leads to increase the portion of variable costs which will then decrease the operational leverage and the profit margin of the company.

5.3 Limitation

The study is limited to one sector which is the airline industry. Therefore, it is unable to generalize its findings for all stock market segments. The model used to test the relationship between oil prices and stock prices is ignoring the other macroeconomic factors which may have an effect on stock prices such as inflation and interest rate and financial factors like market return, term premium and other internal factors.

There is no complete list of all airline companies worldwide. Therefore, the study used the companies who are members of IATA as the target population. This makes the findings not generalizable from the sample to the population of interest (all airline companies worldwide). Nevertheless, 84% of the total air traffic are members of IATA and the diversification in the sampling seems to support the findings in general.

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