The State of Freight

August 2023

Over the last couple of years, it has been commonplace to see earnings call transcripts littered with CEOs and CFOs discussing how supply chain issues impacted their respective companies. Recently, however, analysts and investors are hearing less and less about bottlenecks in the supply chain and more about a faster path to normalization.

During the early months of COVID until the end of 2021, the Dow Transportation Index outperformed the S&P 500 by roughly 30%.[1] This outperformance can be attributed to extreme supply chain congestion, which caused an extreme shift in demand that led to large price increases and companies overearning the last couple of years. However, from the end of 2021 until the end of May 2023, the Dow Jones Transportation index has underperformed the S&P 500 by almost 700 bps.[2] Although the Transports subsector makes up less than one percent of the S&P 500, the transportation sector has a significant reach and impact on other sectors (e.g. retail/E-Commerce, energy, manufacturing, and infrastructure) of the economy. With the freight recession upon us, the big question remains whether we are at a trough, will the trough arrive in the second half of the year, or is it early next year? These are topics that we are going to explore in this piece.

Trucking

The trucking sub-sector has been a beneficiary of supply chain issues over the past couple of years as it typically outperforms when there is disorder in the market. Trucking companies fall into a few categories: Truckload (TL), Less-than-Truckload (LTL), and Intermodal. Truckload carriers transport goods for one shipper and are designated for one delivery point on a direct route. The TL segment accounts for almost 50 percent of all freight.[3] The largest TL carrier in the U.S. is Knight Swift.

Less-than-Truckload carriers transport small orders of freight from several shippers in one trailer. While smaller by volume, the cost savings from sharing truckloads with other shippers can be offset by surcharges and fees. Old Dominion is the largest LTL trucking company in the U.S.

Lastly, intermodal involves multiple modes of transportation (combination of rail, truck, ship, and plane) to move goods. While trucking remains the most dominant mode of shipping products domestically, intermodal freight tends to be less costly and generally produces fewer emissions when transporting goods over longer distances. J.B. Hunt (JBHT) is largest intermodal company in this segment.

Two items that are focal points of the trucking industry are spot and contract rates. Spot rates are offered on the spot to move a one-time shipment from place to place and are often considered to be more volatile and can change rapidly. Contract rates cover moving multiple freight loads for a customer within a particular lane under defined conditions for a set amount of time. Contract rates are generally more stable for both the shipper and the carrier, which can make it easier for carriers to budget for expenses. Typically lasting one year, contract rates tend to protect both the shipper and the carrier from fluctuating market conditions, which can vary over a year.

As of June 23rd, spot rates for dry van, flatbed, and reefers are down -13%, -24%, -12% year-over-year, respectively, and down -58%, -37%, and -68% from their respective peaks over the past couple of years.[4] According to Scott Group of Wolfe Research, the spread between spot and contract rates are near historically high levels which can be detrimental to margins. The good news is company executives' mentions of "inventory destocking" on earnings calls has significantly decreased between the first and second quarters, so this could be the growth driver for the freight industry should inventory re-stocking materialize in the coming months.

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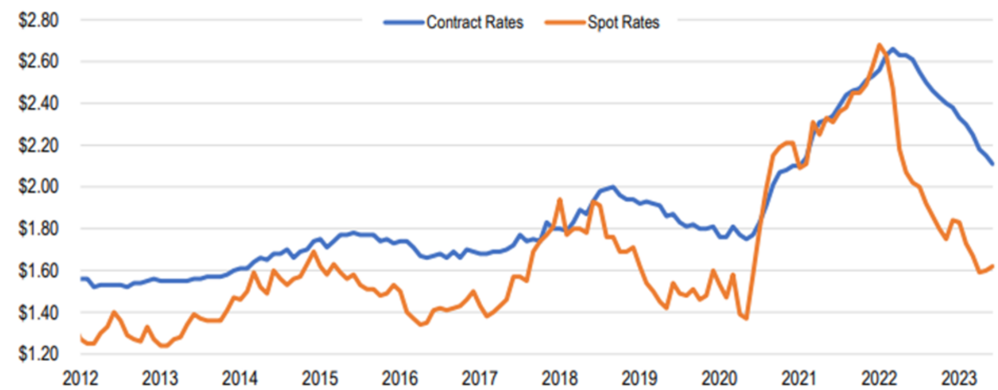
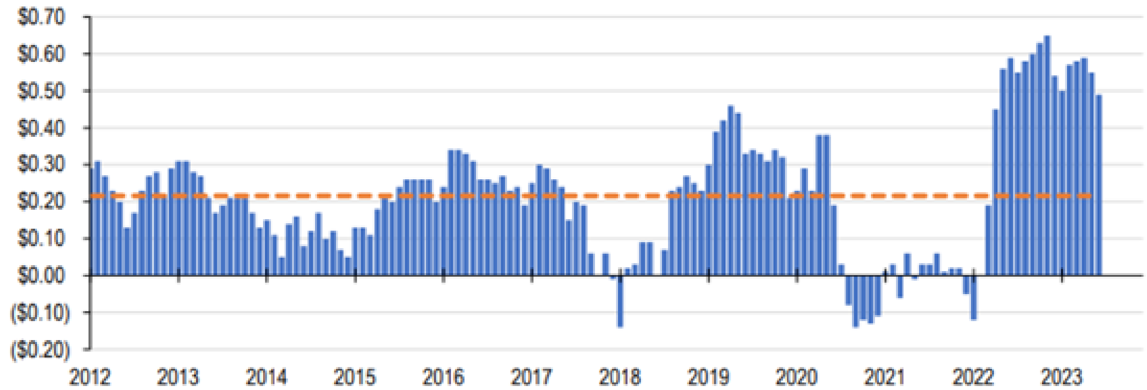
Historically High Level between Contract and Spot Rates[5]



Source: DAT.com; Wolfe Research

Contract vs. Spot Spread



Source: DAT.com; Wolfe Research

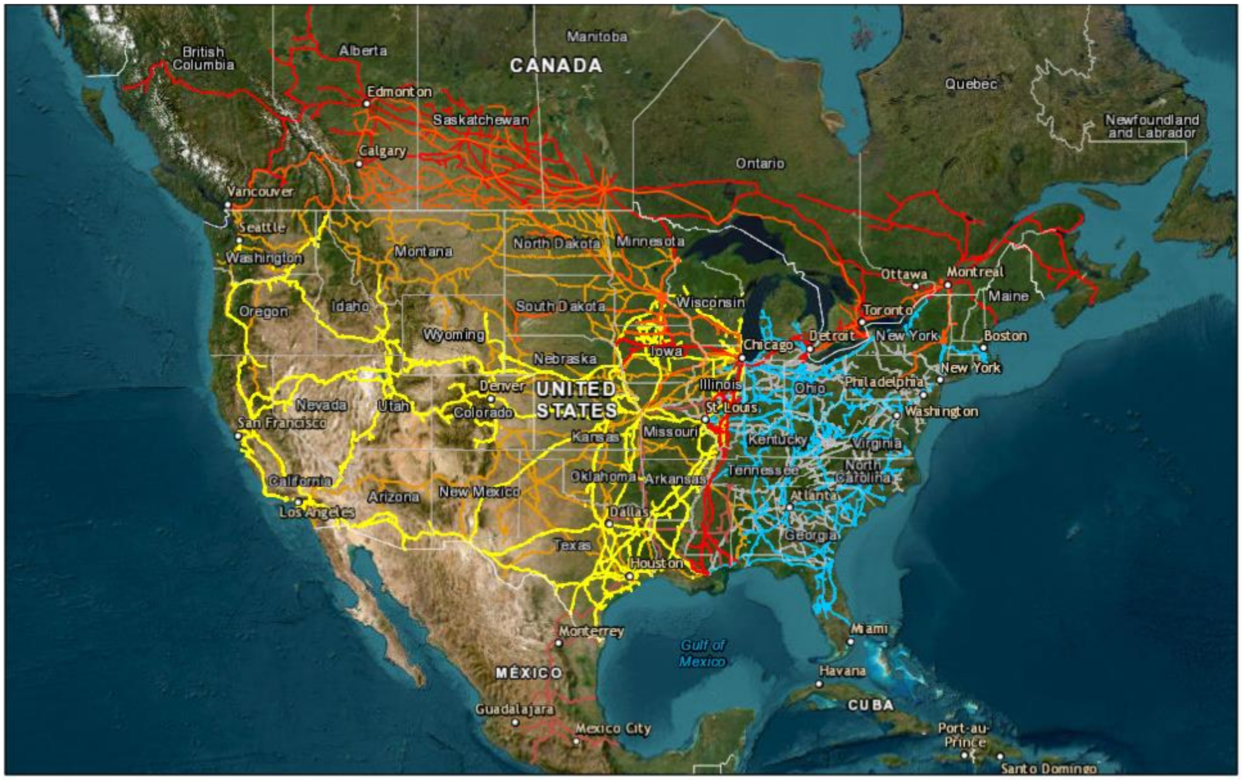
Rails

The rail industry is the one sub-sector within transportation that most analysts would argue did not over-earn during the pandemic, unlike other areas of transportation (e.g., Less-than-Truckload). With the recent merger of Canadian Pacific Railway and Kansas City Southern (CP), there are now six Class I freight railroad companies. The other five companies are Burlington Northern Sante Fe (BNSF-Berkshire Hathaway Company), Union Pacific (UNP), CSX Transportation (CSX), Norfolk Southern (NSC), and Canadian National (CNI).

When compared to shipping goods by truck, rail is often more cost-effective when it comes to shipping large quantities of goods over long distances. Moreover, rails can carry much larger volume of freight compared to trucks. A freight train can haul 100-150 cars, and they can carry 200-300 containers if they are double stacked. Assuming that the average gross container weighs about 33,000 lbs., this means that a freight train can move close to 10,000,000 lbs. in a single trip, whereas a truck can carry no more than 80,000 lbs.

Additionally, transporting goods by rails is more fuel-efficient than trucks, especially when transporting heavier loads over long distances. Freight trains can carry one ton of freight nearly 500 miles while only using 1 gallon of diesel fuel. Compared with over the road trucks, moving freight by rail reduces greenhouse gas emissions by an average of 75% while also reducing road congestion and roadway wear and tear.[6]

Should we continue to see less congestion, this could benefit the rail companies. However, there is potential regulatory risks from the recent Norfolk Southern derailment in East Palestine, Ohio. This event brought on the Rail Safety Bill which is set to be voted on by the Senate in the coming months. In the bill there is a mandate for a two-person crew. In an already difficult backdrop of higher headcount and lower volumes, the two-person mandate could be a large cost headwind for the already underperforming rail companies. We remain hopeful that we are approaching an inflection point as volumes, train speeds, dwell times, and cars on line metrics have all improved for both US rails and to a lesser extent Canadian rails.



Map Illustration as of 4/28/2019

Rail Company	Revenue as of 2022*	Total Rail Length	Regions Served
Burlington National Sante Fe	$25 Billion	32,500 miles	West of the Mississippi River
Union Pacific	$24 Billion	32,000 miles	Western US
CSX	$15 Billion	20,000 miles	US Canada
Canadian National	$13 Billion	20,000 miles	Canada, Gulf of Mexico
Norfolk Southern	$12 Billion	21,500 miles	Eastern US
Canadian Pacific* Kansas City Southern	$10 Billion	20,000 miles	Canada, US, and Mexico

*CP and KCS merged

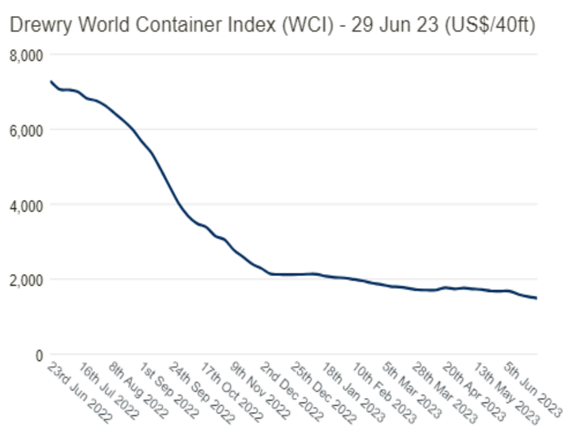
Source: https://soundingmaps.com/the-largest-railroads-in-us/
https://www.acwr.com/economic-development/rail-maps/class-i-freight-carriers , FactSet Market Data*

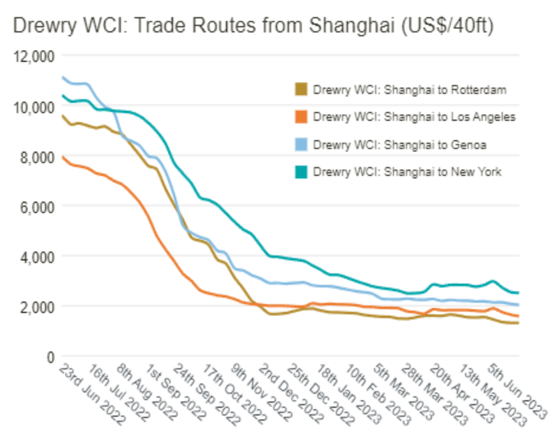
Ocean Freight

Not that long ago, it was nothing out of the ordinary to have a crowd of container ships waiting to dock and unload goods along the West and East Coasts. At one point in the first quarter of 2022, the West Coast backup reached over 100 cargo ships waiting to dock. However, since the highs of '22, the West Coast has remained at zero ships waiting to dock/unload for 30 consecutive weeks as of late June.[7]

Since the peak of the Drewry WCI composite index (which measures the average cost of shipping containers on major global trade routes) at $10,377 per 40-foot container that was reached in September 2021, the index has dropped 85% from the peak to $1,592 per 40-foot container.[8] However, the 10-year average for the Drewry WCI index is $2,688, suggesting a return to normal prices on the horizon.[9]

In addition to the Drewry WCI composite index, the Baltic Exchange Dry Index (BDI) measures the overall cost of shipping raw materials and commodities by sea. At the end of June, the BDI was at 1138, which is down almost fifty percent in the past year, but higher than the all-time lows of 530 seen earlier this year in February.[10] According to Wolfe Research, since ocean freight shippers are continuing to experience a weak pricing environment, some shippers they interviewed in June revealed that certain carriers were offering fixed pricing for two-month periods at current spot rates ($1500/container), but now, as the market remains soft, these carriers are extending the option to fix these rates for the full year. Supply chain congestion at ports has eased significantly, and ocean container rates have followed suit. Since shipping rates have declined back to their pre-Covid levels, we think freight will continue to shift from air to sea.





Source: Drewry World Container Index

	Week Ending:					
	7-Jun	14-Jun	21-Jun	28-Jun	1Q:23 Avg.	Recent Trends
Ocean Data:						
Containters Dwelling for 9+ Days at L.A. and LB	3,074	1,191	2,566	3,237	4,050	
Weekly Container Volumes - Port of L.A. (y/y)	(25%)	(13%)	(13%)	22%	(37%)	
Hong Kong-L.A. Drewry Ocean Rates (y/y)	(76%)	(79%)	(80%)	(82%)	(86%)	
SCFI - Comprehensive Index (y/y)	(75%)	(77%)	(78%)	(78%)	(80%)	
Baltic Exchange Dry Index (Weekly Avg y/y)	(61%)	(54%)	(56%)	(46%)	(51%)	

Source: Port of LA, Port of LB, Marine Exchange of Southern California, Drewry, Baltic Exchange, DIIO, Surface Transportation Board, Intek, Bloomberg, Wolfe Research

Air Freight

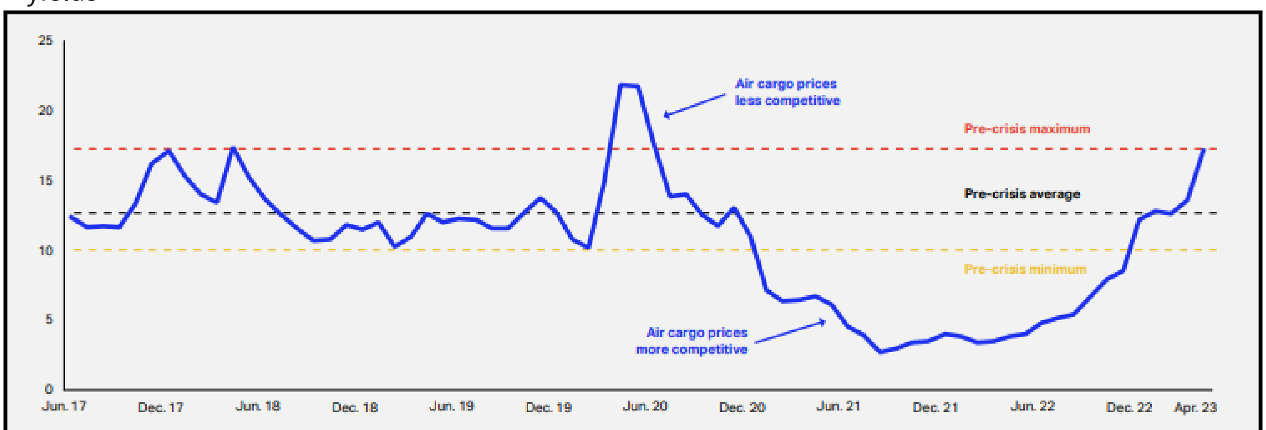
Air cargo performed remarkably well in 2021, however, industry-wide air cargo weakened in 2022, and this underperformance has carried over into 2023. Industry wide cargo tonne-kilometers (CTKs) declined by almost 7 percent year-over-year for April and has seen 13 months of consecutive year-on-year declines since March 2022.[11] Rates for air freight out of Shanghai and Hong Kong are down considerably over the last twelve months due to weakening demand of Chinese exports from the U.S. and European Union.

	Week Ending:					
	7-Jun	14-Jun	21-Jun	28-Jun	1Q:23 Avg.	Recent Trends
Airfreight Data:						
Hong Kong Outbound Airfreight Index (y/y)	(44%)	(41%)	(42%)	(39%)	(35%)	
Shanghai Outbound Airfreight Index (y/y)	(56%)	(54%)	(52%)	(52%)	(39%)	
U.S.-China Daily Passenger Flights (Weekly Avg #)	10	10	10	10	6	

Source: Wolfe Research

Between December 2020 and April 2022, yields of maritime cargo saw triple-digit annual increases, while air cargo yields rose by less though a still hefty 24% in 2021 and 7% in 2022.[12] Since May 2022, however, ocean shipping prices have declined significantly faster than air cargo prices. By March 2023, container yields were only 8% above their 2019 levels, while air cargo yields remained 45% higher than in 2019.[13] As a result, air cargo has lost its recent relative price advantage over ocean shipping due to a decline in shipping container freight rates.

The relative price of shipping by air versus maritime cargo, ratio of air cargo yield to maritime cargo yields[14]



Sources: Boeing, IATA CargoIS, Freightos Baltic Index

Fed Funds Rate Impacts on Transports

At the time of this writing, the Fed had just increased the Fed Funds Rate to the range of 525-550bps.[15] Although Jay Powell did hint at the possibility of one more rate hike before year-end should the data warrant an additional hike, most economists believe the Fed will pause for the remainder of the year. Using this as a base case, we thought it would be helpful to examine the performance of each sub-sector within the transportation sector in rising, falling, and steady interest rate environments, comparing each sub-sector to the entire industrials sector and the overall S&P 500.

Sector Performance in Relation to Fed Funds Rate

Fed Funds rate rising at a slower pace									
3 mo.	LTL 8.2%	Brokers 6.4%	Intermodal 6.0%	Rails 5.9%	Truckers 5.7%	Logistics 3.5%	Parcels 3.1%	Industrials 3.0%	S&P 500 2.4%
6 mo.	Rails 13.5%	LTL 13.3%	Intermodal 12.9%	Brokers 11.5%	Logistics 9.5%	Industrials 7.5%	S&P 500 5.2%	Truckers 4.9%	Parcels 4.7%
9 mo.	Rails 19.9%	LTL 17.1%	Brokers 17.0%	Intermodal 15.7%	Logistics 13.5%	Industrials 8.1%	Truckers 8.0%	S&P 500 6.5%	Parcels 5.3%
12 mo.	Rails 32.8%	Intermodal 26.2%	Brokers 24.8%	LTL 23.9%	Logistics 16.8%	Truckers 10.8%	Industrials 10.8%	S&P 500 10.1%	Parcels 6.7%

Fed Funds rate held at a steady pace									
3 mo.	LTL 6.2%	Intermodal 5.6%	Rails 4.7%	Parcels 3.7%	Brokers 3.6%	Truckers 3.3%	Logistics 3.4%	Industrials 3.1%	S&P 500 2.6%
6 mo.	LTL 13.3%	Intermodal 11.4%	Rails 9.6%	Brokers 7.2%	Logistics 7.0%	Parcels 6.5%	Truckers 6.2%	Industrials 6.1%	S&P 500 5.1%
9 mo.	LTL 20.4%	Intermodal 18.5%	Rails 15.1%	Brokers 10.9%	Logistics 10.6%	Parcels 9.6%	Industrials 9.6%	Truckers 8.9%	S&P 500 8.0%
12 mo.	LTL 28.2%	Intermodal 25.7%	Rails 19.8%	Brokers 14.3%	Logistics 13.5%	Industrials 12.2%	Truckers 11.9%	Parcels 11.6%	S&P 500 10.6%

Fed Funds rate falling at a faster pace									
3 mo.	Intermodal 11.1%	Truckers 7.7%	LTL 6.9%	Rails 4.3%	Brokers 3.7%	Logistics 3.0%	S&P 500 -0.4%	Industrials -0.5%	Parcels -1.1%
6 mo.	Intermodal 21.3%	LTL 14.1%	Truckers 13.4%	Rails 9.7%	Brokers 8.3%	Logistics 4.8%	Parcels 3.0%	S&P 500 -0.1%	Industrials -1.4%
9 mo.	Intermodal 26.1%	LTL 19.8%	Truckers 19.3%	Brokers 11.1%	Rails 9.5%	Logistics 8.2%	Parcels 7.5%	S&P 500 -1.6%	Industrials -4.7%
12 mo.	Intermodal 32.9%	LTL 25.9%	Truckers 22.5%	Parcels 17.1%	Brokers 16.4%	Logistics 14.0%	Rails 10.6%	S&P 500 -1.4%	Industrials -3.2%

Source: JP Morgan-Brian Ossebeck, Bloomberg Finance L.P. Note: The data looks at January 2010 until June 2023 and found 29 instances for Fed Funds rate rising at a slower pace, 180 instances of Fed Funds remaining steady and 22 instances for Fed Funds rate falling at a faster pace. Average total return by group shown above.

As you can see in the chart above, Brian Ossenbeck of J.P. Morgan points out that the largest sample size in the analysis is observed when interest rates remain steady because the Fed is typically not actively raising or lowering rate during such periods. As a result, this tends to benefit the sectors that have historically outperformed since 2000, such as railroads, LTLs, and intermodal. These sectors have experienced a market share gain that corresponds with the same timeframe. The data additionally indicates that when interest rate cuts start to have an impact, intermodal demonstrates strong performance, followed closely by LTL and truckload sectors. These stocks are considered early-cycle and have a higher level of involvement consumer-driven freight activity, which is more responsive to a spur from lower rates. Furthermore, their valuations tend to decrease before other sectors which helps aid the recovery.[16]

Conclusion

If we are nearing the end of the freight recession, a couple of things need to happen within the rail and trucking industries to be considered a point of inflection. With the rail industry operating with a higher headcount and heftier cost structures when measured against prior down cycles, volume growth is vital. Service metrics have been improving, and comps are getting much easier in the second half for rail companies, this could be a favorable backdrop for an industry that has underperformed year-to-date. In the trucking industry, if there is no big jump in demand then we will need to see some capacity leave the market. With the recent news of Yellow going bankrupt, the third largest carrier in the country, this could be the seminal event that helps stabilize certain segments of the trucking industry.

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