K | RATIO

Q4 RATE OUTLOOK

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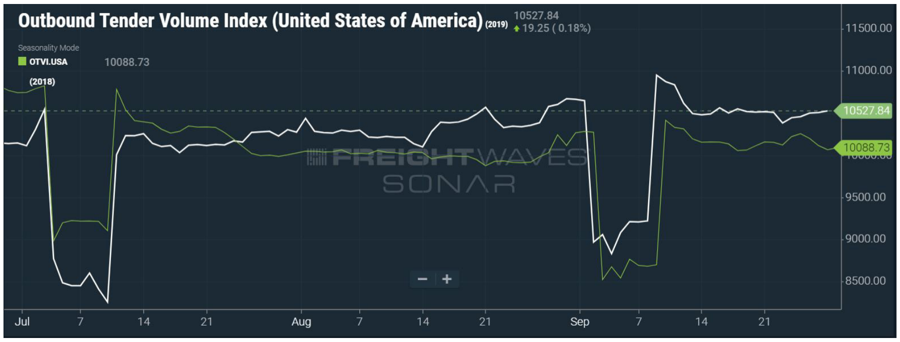
Trucking is a commodity and like any commodity, it's subject to the principles of supply and demand. From 2018 to 2019, the freight market has seen a fundamental economic idea play out; when it comes to commodities, the cure for high prices is, high prices. With rates at all-time highs due to a lack of supply in the name of truck capacity and excessive demand derived from the tariff pull-forward inside of a growing economy, Carriers ordered new trucks and expanded fleet counts at an over-corrective pace, tipping the equilibrium into Shippers' favor for 2019.

This remains our current landscape and one to such a degree that the term, "Freight Recession," has become commonplace and commonly accepted, despite the fact no official criteria for diagnosing this exists in the industry, which allows for interpretation and subjectivity, though the arguments against the idea are decidedly lower in number than those in favor. Regardless, all concerned with rates per mile acknowledge one undeniable and inescapable fact; prices for freight are drastically lower than a year prior.

SUPPLY



Given where rates currently sit, truck capacity is clearly abundant. Less obvious, however, is the latest estimates of truck fleet size[1] as they show the available pool is increasing, not decreasing. Despite strong volumes, rates have remained stagnant, leading most industry participates to believe that truck capacity would begin to shrink in size. Logically, this holds true as the average cost to run a truck is $1.69/mile[2] and national rates on average have held just above this mark for the better part of the year. Less efficient Carriers with tight cash flows and individual owner-operators of the same ilk or nearing retirement most likely fall off the grid in this environment. While the numbers do show the total count of trucks from new fleets decreasing in August for the first time this year, old fleets continue to add and do so at a greater pace. The longer rates remain depressed, the longer this LIFO type scenario should play out between old and new fleets. Well-funded and more efficient Carriers with established customers will, on average, outperform and therefore drive out new entrants with or without financial restrictions, as those without a solid customer base are subjected to spot loads sourced from brokers instead of higher paying contract loads. If seasonality holds true for the remainder of 2019, the duration of this scenario will not hasten as a bump in rates, even if temporarily, should allow Carriers to remain solvent and/or not idle trucks until 2020.

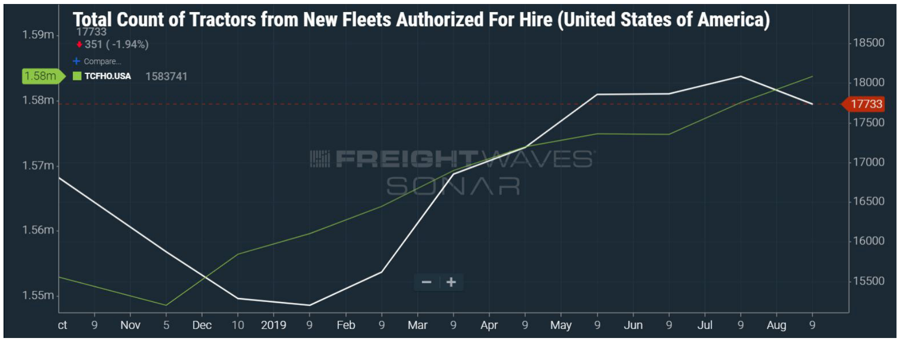
Perhaps not applicable for 2019 but on the radar for 2020 is the issue of driver recruitment and retainment. Prolonged low rates will make retaining current drivers the bigger issue of the two as independent drivers may suspend their driving activities and company driver pay will force many fleets into tough decisions when their margins compress to uncomfortable levels. As evidenced in a year-over-year comparison of capacity between 2018 and 2019, recruiting drivers can be easily done provided the pay is attractive. Keeping them around with current rates, however, is a different story.

DEMAND

Volumes remain firm overall with positive current YoY comparisons[3] but this exists with the silver lining of the extreme 2018 H2 counter-seasonality due to the anomalous tariff pull-forward. National volumes in 2018 H2 were somewhat subdued outside of the overheated LA market, causing pockets of depressed rates contrasted with the exorbitant rates seen for outbound LA. With holiday retail sales forecasts predicting a strong season[4] and a significant amount of goods already domestically warehoused in and around West Coast ports, some predictability in the supply chain can be expected this year versus last year's scramble. This predictability coupled with the reality that anything short of last year's high volumes should place a firm ceiling on top and apply general downward pressure on rates.

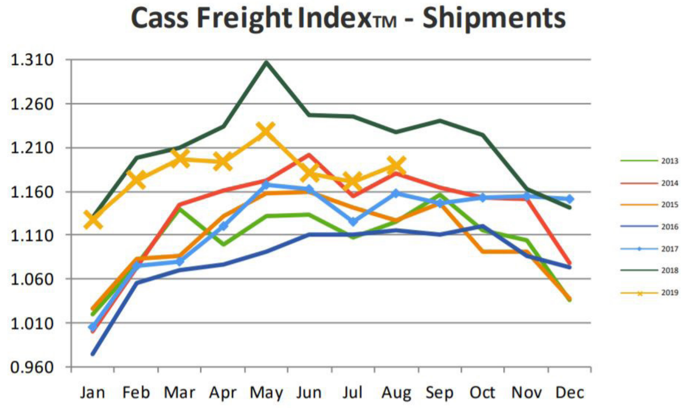
[1] FreightWaves' SONAR, 08/09/19
[2] American Transportation Research Institute, Oct. 2018
[3] FreightWaves' SONAR, 09/2019
[4] Deloitte, 09/17/2019; AlixPartners, 09/17/2019

An interesting scenario to watch as we move to this part of the calendar will be how the potential increase in load volume is handled by Shippers and their providers. Anecdotal reports of shipments that would typically be categorized as spot running through the traditional routing guide instead (this belief is corroborated by the ultra-low Tender Rejection Indices), indicate an overwhelming level of acceptance from Brokers and Carriers to maintain relationships despite adverse price risks. This presents a problem from a provider standpoint only if rates do indeed rise, but one that would compound any issues during Q4 as the current equilibrium is based on an environment void of any tangible spot business. Alone, this is not enough to spark a rally in price since much of 2019's added capacity lives in Carriers that only run broker loads (individual owner-ops or small fleets), making the delineation between spot and contract loads one that is never seen through their eyes. True spot business in Q4 will require at least a re-pricing of lanes but without a surge above historical volumes, the demand side of the fulcrum will not be enough to tip the balance away from our oversupplied condition, leaving upward price movement relatively contained.



US ECONOMY

Without jumping into the economic recession debate, we can universally agree conditions have eased from the rapid expansion pace seen through 2018 as major economic reports display mixed signals. The Institute for Supply Management Purchasing Managers Index remains down in all comparisons, but Industrial Production and Retail Sales remain firm. The Cass Freight Index, which displays the general strength of shipments of merchandise for the consumer and industrial sectors but not bulk commodities and across all modes of transportation, shows significantly weaker YoY numbers[5] . There are less goods traveling through all networks inside of the United States. Be it tariffs, economic policy, or purely cyclical, the end result matters more than the reason(s) why.



Confined to the remainder of 2019, additional escalations (maybe even de-escalations?) in the ongoing US-China trade war will not have much of an effect, if any, on rates. 90 days is not a long enough runway to adjust entire supply chains based on policy via Twitter, so anything beyond a production and import push will be a 2020 issue, and current port logistics seem capable to handle more of what's become the norm as far as increased container volumes.

Further down the line, freight market implications from external financial factors like deflationary equity markets, a tightened lending environment, or significant currency exchange shifts all exist but live beyond the scope of influence for 2019.

VARIABLES

The primary factor in rates for this quarter will obviously be the holiday retail season. The most significant risk to rates lives inside a diminished sales period. Should consumers delay purchases or resist the temptations of early promotions, October pre-build inventories could last longer than typical and reduce, if not eliminate, any December expedited movements, thus further depressing the chance of the normal December spike in rates. Early Q4 activity or lack thereof has the potential to make the back half of the quarter unusually light in business, and subsequently, rates.

[5] Cass Freight Index, 08/2019
[6] Broughton Capital, 09/2019

Weather becomes a feature at this point of the year and despite mankind's sincere efforts, it remains as unpredictable as ever. Rather than speculate or give credence to any prognostication, we prefer to highlight where the risk lives. Given current rates and their trough position in the cycle, at first glance it would seem that a brutal winter season poses the gravest danger. Heavy snowfall precipitation during a time of increased volumes will certainly upset transportation patterns, and therefore bring higher rates, but we are in the belief that a mild winter season carries the ultimate peril. With many Carriers and Providers quite literally dying[6] for any sort of sustained rise in rates, a ho-hum winter removes the risk premium already built into prices and allows for maximum capacity participation and utilization. Sprinkle in even the slightest downtick in retail sales and we have a virtual certainty of flat rates throughout the entire quarter.

Since ample capacity presently holds the key to rates, the impending AOBRD deadline of December 17 does have the capability to push the needle higher but its spot on the calendar makes this situation one to monitor for 2020. Speaking of 2020, the big, bad bogeyman named IMO 2020 is lurking around the corner. Lurking, however, is the only threat this will produce for trucking rates. Though more of a marine fuel issue, some have argued that decreased supply of ultra-low sulfur diesel by way of increased marine vessel consumption will affect the trucking market as both machineries will compete for the same fuel source. Frankly, the trucking industry has been given a long enough runway to prepare for any change to diesel prices coming in January. Taking a strictly objective approach, the futures markets for both crude oil and its distillates remain firmly in backwardation, which indicate nothing structurally is priced in. Additionally, large to mid-size fleets are generally not susceptible to sticker shock at the pump due to fuel hedges or fuel surcharges as a pass-through cost, rendering IMO 2020 a potential problem for only the smaller fleets if diesel prices do spike. Lastly, trucking routes along coastal ports presumed to carry additional basis risk for cash diesel prices will have this added cost baked into linehaul rates, eliminating spot loads from consideration.

APPLICATIONS

Commercial hedgers with short exposure should look to increase protection, especially on the more macro-level regional and national averages. While upside price risk remains depressed, the severity of a rally in price, though likely short-lived, could be drastic due to the prolonged period of time spent near the "Idling Put". Carriers and short providers can still find some risk premium priced into the forward curve, but the window of opportunity is closing as the market has discounted much of it already with December National Futures off $.20 since July 1. Shorts should still be placed primarily in Dec with some Nov, but little Oct, as Oct National Futures listlessly drift 2 cents lower than Sep.

Those seeking long coverage should look to the lane specific contracts as some of the riskier O/D pairings offer decent value. The Outbound LA quarterly strips all hover around $2/mile and represent the biggest upside from any decent supply chain disruptions. Speculative money may find some value in backhaul Philadelphia to Chicago sub-$1, an interesting play in the belief that East Coast import volumes will continue to exhibit strong growth and become a more preferred destination.