K RATIO

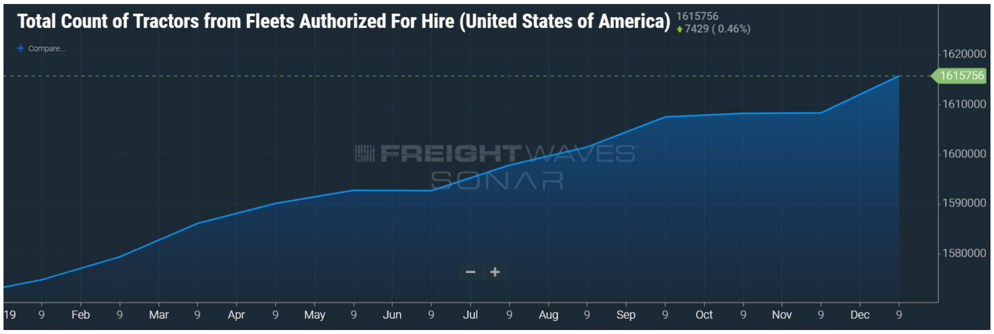
2020 RATE OUTLOOK

Q4 RATE OUTLOOK

Trucking is a commodity, and like any commodity, its price is volatile and unpredictable. Many claim predictive modeling is an effective means to deduce timelines and rates for the industry based on cost inputs, seasonality, and the cyclical nature of freight. True, it is an extremely cyclical commodity with routine seasonality and mandatory inputs, but few would argue any more so than corn or soybeans, which quite literally have rigid seasons, fixed inputs, and unrivaled cyclical patterns. All of this to say, if you could predict time and price so accurately that you would publicly state these opinions, why not put your money where your mouth is?

Rather than pretending to have all of the answers, what follows below is our analytical approach to outline the factors that will determine price and its timeliness for 2020. Recommendations do not come with dates for price shifts and their respective magnitudes. Instead, a guide to help navigate the unknown territory in an attempt to protect balance sheet risks.

SUPPLY



This is it, right? This is the year all of the trucks finally disappear, and rates jump higher. The "Trucking Bloodbath" has finally taken out enough trucks to lift the lid on prices. This report notwithstanding, don't believe everything you read. Recent numbers suggest we now have more trucks for hire than ever before. In fact, after flatlining for three straight months, December actually showed an increase in the amount of trucks for hire registered with the FMCSA. Contrary to popular belief, trucking companies do exit the marketplace via closure or bankruptcy, but the trucks they owned never quite go away with them. They might come off the grid for a short period of time, but assets are gobbled up by other companies operating on better financial footing and thrown right back into the pool of available capacity. Even an abrupt closure as large as Celadon does not influence price for any notable length. Loads are reallocated to other providers, likely at the same rates, possibly at an initial premium, but also equally possible the newly awarded business goes to a more efficient and/or cost-effective provider offering lower rates. Just because one company couldn't run their business at certain rates per mile does not mean all companies cannot run their businesses at those same rates per mile.

If 2019 rates were so problematic that truly well-run organizations were forced to shut their doors, the industry would have imploded. Instead, the herd was thinned out. We simply witnessed an unfortunate fact of business; during leaner times, natural selection rewards only those companies better equipped or with larger cash reserves. The possibility for this trend to continue into 2020 still lingers. Insurance premiums will rise, debt financing could become an issue as flat revenues derived from depressed rates per mile might outweigh low interest rates, and driver retainment issues amid these low prices persists. Those companies still remaining are in position to reap the rewards once rates do move higher, but even if the floor in rates is set, just because we're finished moving lower doesn't mean we have to start heading higher. Efficient Carriers can grow their profitability by simply increasing their market share acquired from bankrupt businesses while maintaining current margins. The trend of truck company failures alone and by itself does not warrant a rally in price.

[1] FreightWaves' SONAR, 12/19

DEMAND

The other side of the price equilibrium as it pertains to 2020 is much more straightforward, and therefore easier to put into perspective. All freight shipments as recorded by the Cass Freight Index show 2019 volumes with continually negative YoY comparisons and consecutive monthly declines as well[2]. It can be argued that 2018 was an extremely strong year for freight volumes so any YoY comparisons within reasonable negative values should still be considered strong. Point taken, and this is seen in FreightWaves' Outbound Tender Volume Index[3]. The volume strength of 2018 was the impetus for the capacity growth of 2019 that remains to this day and provides our current low rates environment. Looking ahead to 2020, if all of Wall Street is debating the prospect of a US economic recession, does an increase of freight volumes seem at all possible, much less likely? If anything, flat 2020 levels would be the more reasonable optimistic view, and if that is the case, we are now back to asking supply to serve as the driver of higher rates.

Any falloff in freight volumes simply adds more downward pressure on rates. A rebound from greater truck capacity bleed off would ultimately occur if the volume decrease were a prolonged scenario, but therein lays the catch, it would need to be prolonged, thus further pushing out the time horizon for a price increase and still steering the conversation back to the faulty belief in truck exits. True capacity shrinkage can only arise from greater macro-level changes to the industry, such as a long, drawn-out decrease in freight demand as witnessed in severe economic recessions, where prices will face deflationary pressures far stronger than internal dynamics.

INTERNAL FACTORS

Freight is changing. The previous sentence might be the most obvious statement in this entire report and it's undoubtedly the most understated. Things are changing and they are changing fast. Ever-growing digitization and automation are making freight a better-utilized and optimized industry. Redundancies, waste, and ineffectiveness are exchanged for accuracy, efficacy, and efficiency, giving proper businesses the ability to operate successfully under tighter margins. The unintended result of this modernization of freight is lower rates per mile. If you can run your business smarter, cheaper, and leaner, you can offer your customers a cheaper product or service while increasing profitability. This is what allows well-positioned Carriers to absorb the assets of fallen truck companies. This is what will separate 3PLs in 2020. Stale and stagnant freight brokerages will find their fate all too similar to that of travel agents. Ever wonder why so many "digital freight brokerages" flush with investment capital are around these days? See Hotwire, Orbitz, or Expedia. Just wait until 2025 when we'll have our own Kayak and Booking.com.
How can aggregators exist inside freight? Price transparency. The seed has been planted with the advent of the Freight Futures market and it will grow like a weed. Why? An industry this large and important to the entire economy cannot operate in opaque waters, regulators and bankers will not allow it. How does this relate to price? Competition has a funny way of driving prices down.

While the industry is not yet ready for something like freight aggregators, the rise of the DFBs has not been ignored. Darlings of the media, Uber Freight and Convoy grab the lion's share of coverage, but those companies less-mentioned still bring the same effect. The attention of the incumbent 3PLs is acutely tuned to these upstarts as well, and it is this aspect that has our curiosity piqued. The traditional bid season for freight is currently underway and while the digital guys have made their message heard loud and clear, we have yet to see how the old guard would respond. That is, until now. Agree or disagree, long-held ranges of acceptable margin have been challenged by the new players in the space. The possibility for a reaction in price from the established companies would come in Q1 and in the form of drastically lowered Contract rates.

[3] FreightWaves' SONAR, 12/2019
[2] Cass Information Systems, 11/2019.

EXTERNAL FACTORS

By far, the single most dominant external factor on freight rates is the health of the US economy. Briefly mentioned earlier, the risk here is recessionary. Capital markets do not directly influence freight rates (indirectly, yes for publicly-traded companies) but the psyche of the US consumer is often primed by the performance of equity markets and 401k accumulations. Shaky as economic conditions might be, equity markets can and will operate in a completely dichotomous manner, especially given where interest rates currently sit. Still, it appears extremely unlikely for the US consumer to facilitate greater freight demand by way of increased personal consumption. Domestic production might not hold the key for growth either as US railcar volumes signal lower industrial demand with YoY carloads down 4.8% YTD[4]. This fact brings with it more than just a sign that rail traffic is down, it's also a direct competitor to truckload volumes. Diminished demand from the industrial sector opens the door to greater capacity for shipments typically routed over the road.

Circling back to the intersection of interest rates and equity markets, there does exist an interesting possible scenario for 2020. Should equity markets retreat from recent highs while access to capital remains cheap, investors looking to allocate resources outside of traditional avenues could further the recent trend of investment in logistics, particularly freight tech. This potentially carries its own downward pressure on freight rates as new entrants to the space in the form of 3PLs or freight matching platforms would be willing to run on negative margins in order to acquire market share. Investments in the freight tech arena could lead to further efficiencies by way of automation, also creating the ability for companies to run profitably on lower margins. This scenario does bring a wrinkle of risk with it, however, as any tightening in lending or steepening of the yield curve would pull investment capital out of the industry and do so in a hurry. The vacuum of capital left in the wake would immediately prop up freight rates, although the conditions typically seen in such situations stem from recessionary environments; again, negative to freight rates.

The global economic risks as they pertain to freight mainly come in the form of trade policy and trade wars, both of which are currently handled domestically in 140 characters or less. The fallout from escalating US-China tensions has already altered domestic freight patterns and the rates associated with them. Shifting import flows from countries like Vietnam and Mexico have destinations on the US East Coast, away from the dominant ports of LA/Long Beach. Some of this phenomenon was seen in December 2019 and sent Outbound Atlanta and NJ/PA rates higher while Outbound LA suffered. A few days extra in ocean transit can now be easily made up with shorter truckload runs on the more densely populated half of the country, in addition to a vastly superior web of rail line offerings. Should this method continue, truckload rates will face continued headwinds as trucks will have a shorter length of haul, bringing with it the opportunity to run more loads, more often.

VARIABLES

Weather tops the list of risks beyond control. Forecasts will not be referenced here as they are not worth the paper they are printed on (even if it's digital). Specific to freight, a weak or mild winter could provide a slow start to the year for freight rates. Void of any supply-chain altering storms, the status quo won't give any bump in rates and could also yield smaller crop harvests come produce season due to suboptimal precipitation. The decrease in volumes associated with smaller harvests would obviously be negative to rates.

Government regulation in the form of Hours of Service changes could be on the horizon for 2020. The changes would provide additional flexibility to drivers in how their allowable hours are used, and when viewed as total potential capacity, more elasticity in available driving hours is another negative influence on rates per mile. California's AB5 holds serious potential to shake up the industry but that measure will likely work its way through every level of the courts before a final ruling ultimately hits the industry. If enacted, it will immediately place a greater financial burden on truck companies which would translate into higher prices.

IMO 2020 is finally here. Over-hyped by the media and largely ignored by the masses, new fuel emission standards for marine cargo vessels has the potential to disrupt diesel fuel stockpiles used by trucks. The industry was given ample time to prepare for this change, and futures markets for crude oil and its distillates gave an avenue to displace any true price risk. Smaller Carriers and individual owner-operators could potentially feel some discomfort at the pump in retail fuel purchases, but these participants individually do not posses the ability to dictate linehaul rates based on weakened fuel surcharges. The bigger risk to prices at the pump will not come from IMO 2020 but rather from heightened tensions and conflicts in the Middle East.

[4] Association of American Railroads, 12/2019.

SUMMATION

Tough sledding. The path to higher rates per mile is a rough one, however, the easiest, and perhaps most likely, is one clearly laid out for all to see. Contract rates will come down, that much is certain, the degree to which they decrease is the only uncertain. The spread between Contract and Spot could narrow to a historically low level and one so tight that any moderate increase in Spot rates would ignite chaos. Many have called for continued Carrier closures in the first half translating into higher second half rates, but that logic doesn't hold true for reasons stated above regarding capacity remaining inside the industry and the fact that just because rates stopped moving lower doesn't mean they have to start heading higher. The tightened spread between Spot and Contract rates will act like kindling wood but we still need something, likely an event, to spark the fire.

Remember when you first started ordering goods online from your dial-up internet connection? Shipping was a mess, with inconsistent times, abhorrent charges, and returns were a process not wished upon enemies. What's it like now? Free, fast, and easy. Why? Progress. Logistics is finally undergoing a great transformation and joining every other industry in the digital age. Full ELD compliance is here, GPS tracking is the norm, some loads are even quoted and booked automatically.

Stockbrokers used to charge clients tens and sometimes hundreds of dollars in commission for stock purchases. Online brokerages now offer commission-free trades. If you think freight brokerages will continue to operate with historical margins in the mid-teens for simply connecting shippers with truck capacity, now is the time to wake up.

2018 was an anomaly. 2019 was the response to that. 2020 will be…