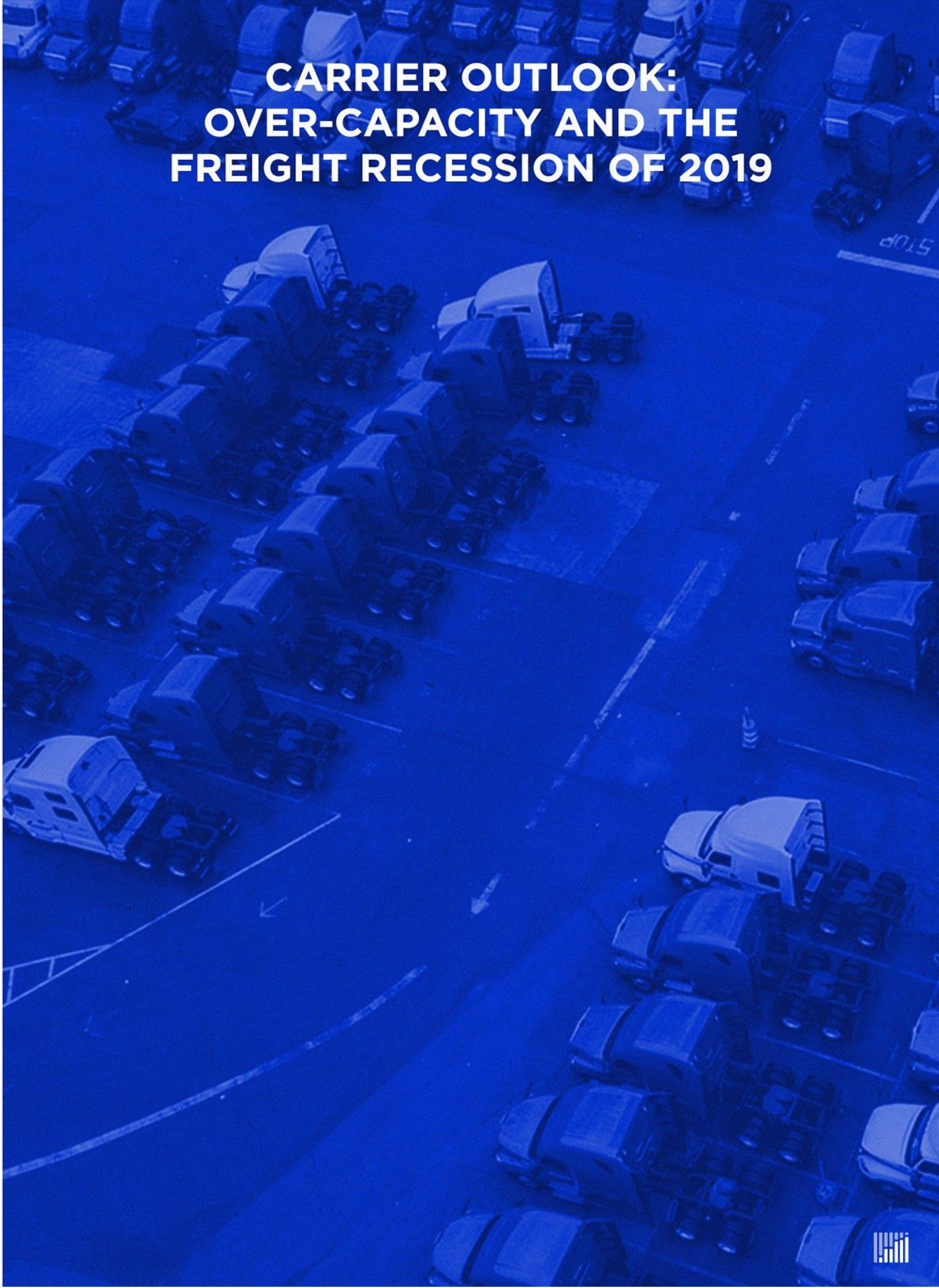
CARRIER OUTLOOK: OVER-CAPACITY AND THE FREIGHT RECESSION OF 2019



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Key Highlights

- Is there a formal definition for a freight recession? Not yet, but we believe any definition should include some combination of multi-quarter consecutive drops in tender load volumes, tender rejections, spot rates and market sentiment.

Metric	Q1 2019	Q2 2019
Tendered Load Volumes (OTVI.USA) y/y	-0.5%	-5.7%
Tender Rejections (OTRI.USA) y/y	-78.3%	-78.7%
DAT Spot Rates (DATVF.VNU) y/y	-22.4%	-27.5%
Carrier Sentiment for Load Volumes % Change	-22.0%	-5.0%
Carrier Sentiment for Line-Haul Rates % Change	-23.0%	-21.0%

*y/y is year-over-year
*Carrier Sentiment is % change from previous Quarter

Source: SONAR, Q3 2019 Carrier Outlook Survey

- Carrier sentiment for increases in loads and volumes has sunk by more than 50 percent since the fourth quarter of 2018.

- Positive carrier sentiment is now at 31 percent for load volumes and 20 percent for line-haul rates.

- National Outbound Tender Volumes (OTVI.USA) were down 45 basis points (bps) year-over-year in the first quarter of 2019 and sank lower in the second quarter, down 5.67 percent.

- National Outbound Rejections (OTRI.USA) were down 79 percent in both the first and second quarters of 2019 on a year-over-year basis.

- DAT's National Dry Van Spot Rates (DATVF.VNU) were down 22 percent in the first quarter and down 28 percent in the second quarter on a year-over-year basis.

- Even with carrier sentiment down in the doldrums, almost one-third of carriers plan to expand their fleets over the next 12 months. The most positive are fleets running 50 to 99 trucks; over 50 percent of them have expansion plans .

- To double-check carrier plans to expand in this market we surveyed insurance companies that specialize in trucking. The results confirm that one-third of fleets are expanding, based on policy renewals in the first half of 2019.

- Enough with all this bad news though, as the saying goes, “buy when there’s blood in the streets.” And we believe it is time now to get a bit more bullish… at least for freight volumes.

- Outbound tender volumes finished July 2019 2.77 percent higher year-over-year. And on an even higher note, the 60-day moving average finished over 2018 load volumes for the first time this year.

- Going forward, year-over-year comparables should become easier as the freight market began to weaken in the second half of 2018.

- A final warning though – line-haul rates and rejection tenders may lag far behind load volume year-over-year growth as capacity has not yet left the market. This will be a major headwind for carriers as diesel prices are likely to go higher due to IMO 2020.

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The Freight Recession of 2019

2018 was a tale of two markets. The first half was characterized as, not one of, but the best bull market many in the industry had witnessed since deregulation in the early 1980s. Trucking and logistics executives thought a new normal was emerging as trucking capacity trailed well behind a surge in load volumes.

This euphoria did not last long though. The perfect storm of dual hurricanes, electronic logging device (ELD) mandates, and an economic boost created by corporate tax cuts, created an increase in load volumes and a constraint on capacity that lasted less than a year. In a five-month span from June to October last year, tender rejection rates (OTRI.USA) halved from a high of 25.6 percent to 12.8 percent in early October. Rejection rates continued to fall following the holiday season and were under 6 percent at the end of June 2019.

While there is not a universally accepted definition for a freight recession, we believe any definition should include some combination of multi-quarter consecutive drops in tender load volumes, tender rejections, spot rates and market sentiment.

Figure 1 – The 2019 Freight Recession by the Numbers

Metric	Q1 2019	Q2 2019
Tendered Load Volumes (OTVI.USA) y/y	-0.5%	-5.7%
Tender Rejections (OTRI.USA) y/y	-78.3%	-78.7%
DAT Spot Rates (DATVF.VNU) y/y	-22.4%	-27.5%
Carrier Sentiment for Load Volumes % Change	-22.0%	-5.0%
Carrier Sentiment for Line-Haul Rates % Change	-23.0%	-21.0%

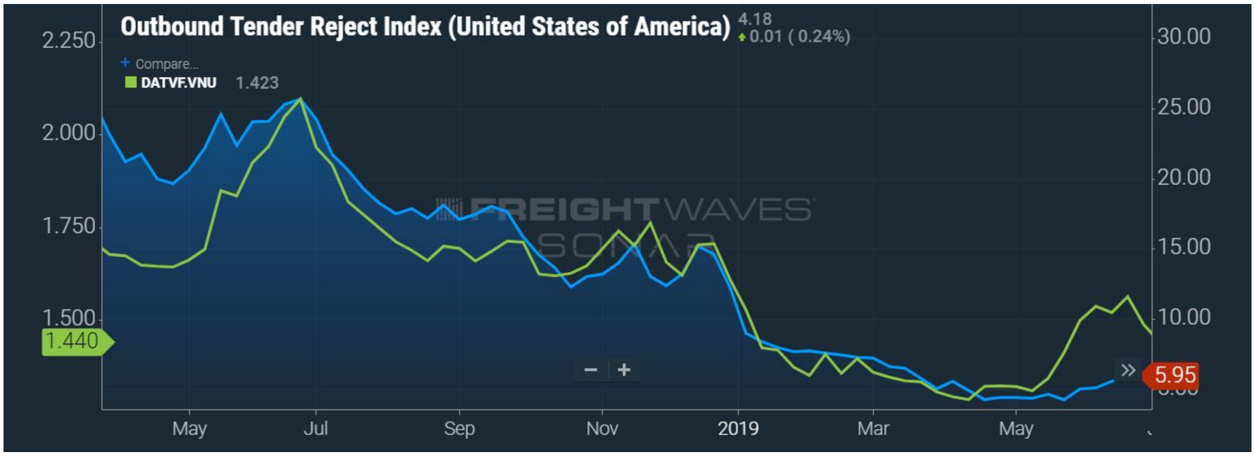
*y/y is year-over-year
*Carrier Sentiment is % change from previous Quarter

Source: SONAR, Q3 2019 Carrier Outlook Survey

Based on the declines described in Figure 1 above, it is clear the first half of 2019 the freight market has been in a freight recession.

While load volumes have remained steady and are showing signs of life in July 2019, line-haul rates and tender rejections are still struggling to find a floor to bounce off of.

Figure 2 – The Plunge in Load Tender Rejections and Spot Market Rates



SONAR: (OTRI.USA, DATVF.VNU)

Over-Capacity in the Trucking Industry

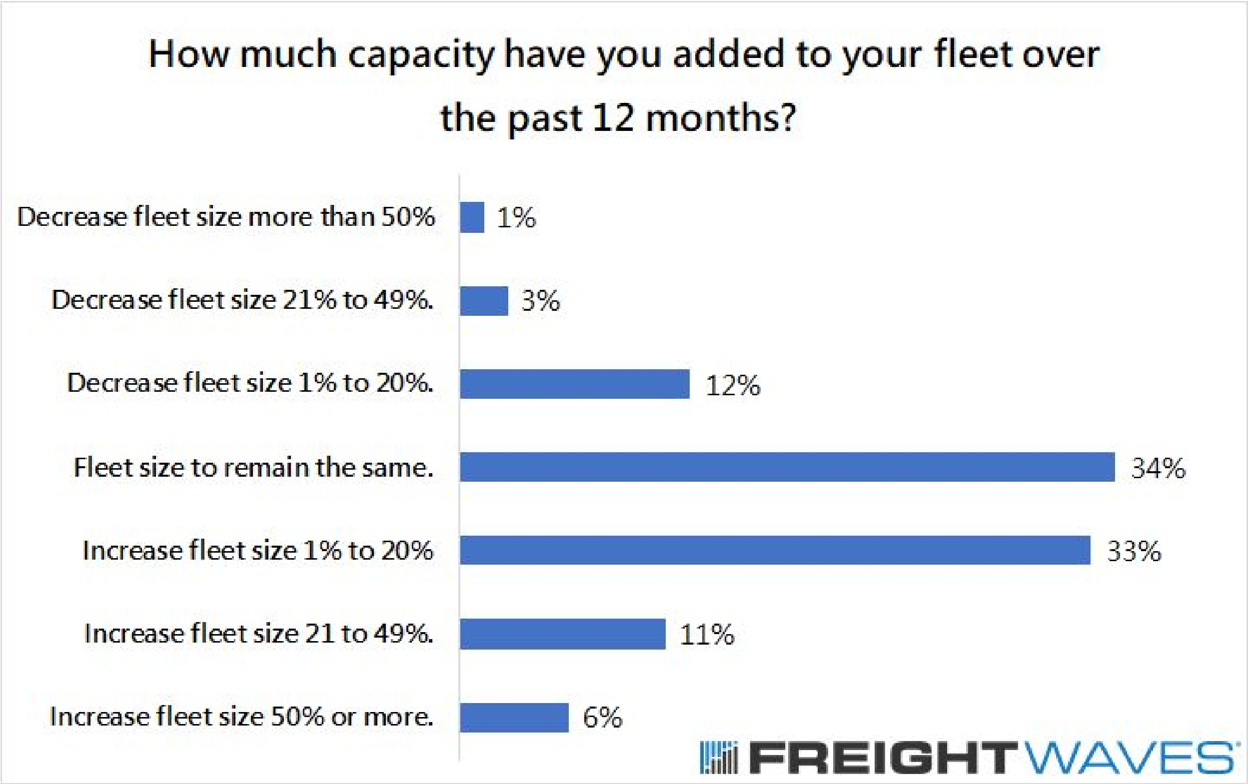
The slight decline in load volumes combined with the sharp loosening of capacity has led to the popular narrative of over-capacity in the market.

And for good reason too.

2018 was a record-breaking year for new truck orders as carriers rushed to increase capacity to capitalize on the unprecedented bull market. This led to over-capacity in the market that has continued to drag down rates through the first half of 2019.

In the second quarter 2019 survey we asked carriers how much capacity they had added in the preceding 12 months. Nearly 50 percent of respondents had added capacity, with most growing their fleets between 1 to 20 percent. Only 15 percent of fleets had reduced capacity during this same time period.

Figure 3 – Changes in Fleet Size From Q1 2018 to Q1 2019



Source: FreightWaves Second Quarter 2019 Carrier Outlook Survey

While many industry experts (including FreightWaves in the Second Quarter Carrier Outlook) predicted small-and medium-sized carriers would begin selling off unprofitable trucks, this has not happened yet.

Surprisingly, it does not look like carriers are planning to begin decreasing fleet sizes any time soon. Used truck values remain steady, even up 6 percent year-over-year in June according to ACT Research[1]. Added evidence to this trend was seen in our current carrier survey.

As seen in Figure 4 below, even in a freight recession, carriers still plan to add capacity over the next 12 months. Forty-seven percent plan to remain the same size, while 37 percent plan to increase their fleet size over the next year.

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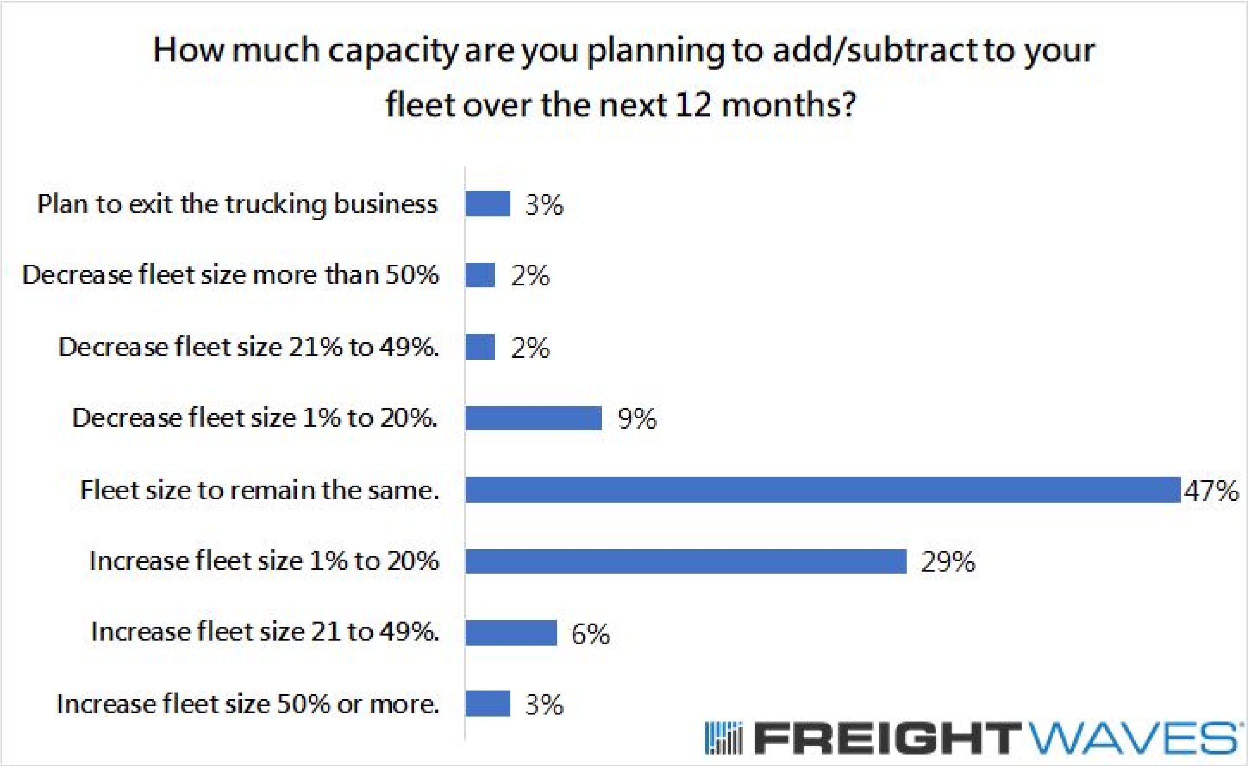
[1] FreightWaves, June used Class 8 truck prices are up 6 percent from previous year, July 27, 2019

Figure 4 – Carrier Plans for Expanding or Contracting Fleets Over the Next 12 Months



Source: FreightWaves Third Quarter 2019 Carrier Outlook Survey

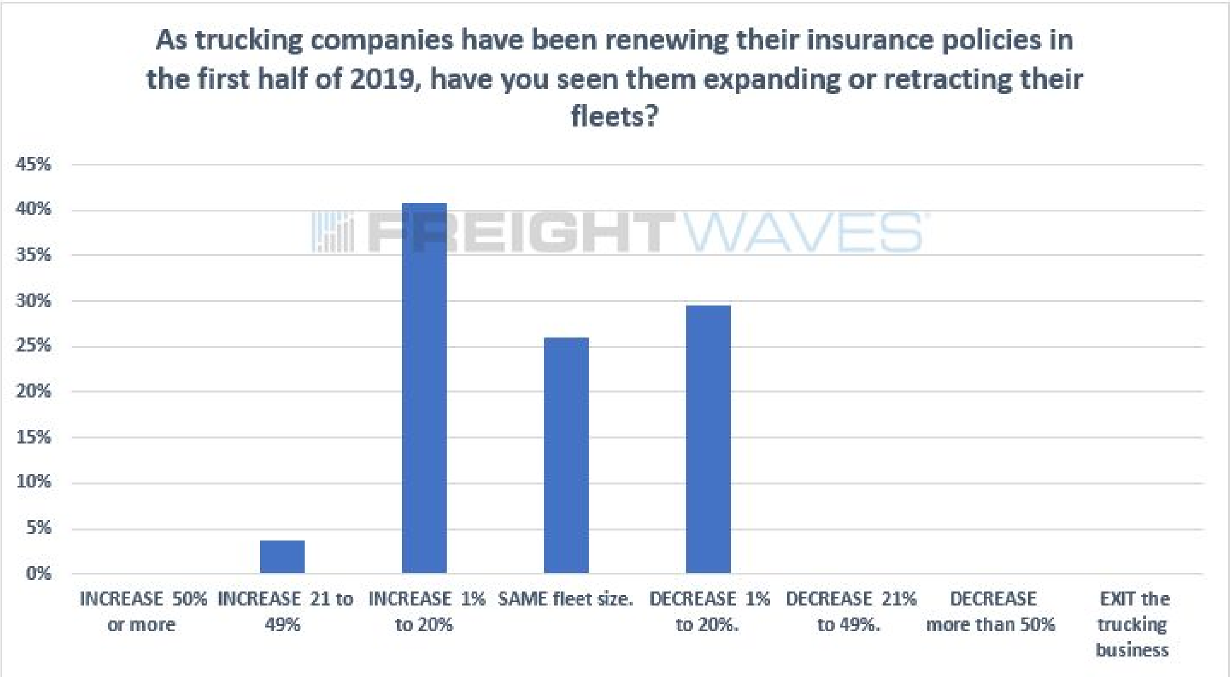
Fleets running between 50 to 99 trucks[2] were the most optimistic segment of the carriers we surveyed. Plans to expand were more than double any other fleet segment.

For a trucking market drowning in capacity it seems odd that carriers still plan to add capacity. So, to add more depth to these results we decided to survey insurance companies that specialize in underwriting insurance policies for trucking fleets.

The insurance survey is very similar to the Carrier Outlook Survey. Forty percent of policy renewals year-to-date have seen expanding fleets. With this said, it also indicates about twice as many fleets are contracting than what is seen in the Carrier Outlook Survey.

[2] Figure 11 on page 16 has results broken out by fleet size.

Figure 5 – Fleet Insurance Renewal Rates Year-to-Date in 2019



Source: FreightWaves July 2019 Insurance Survey

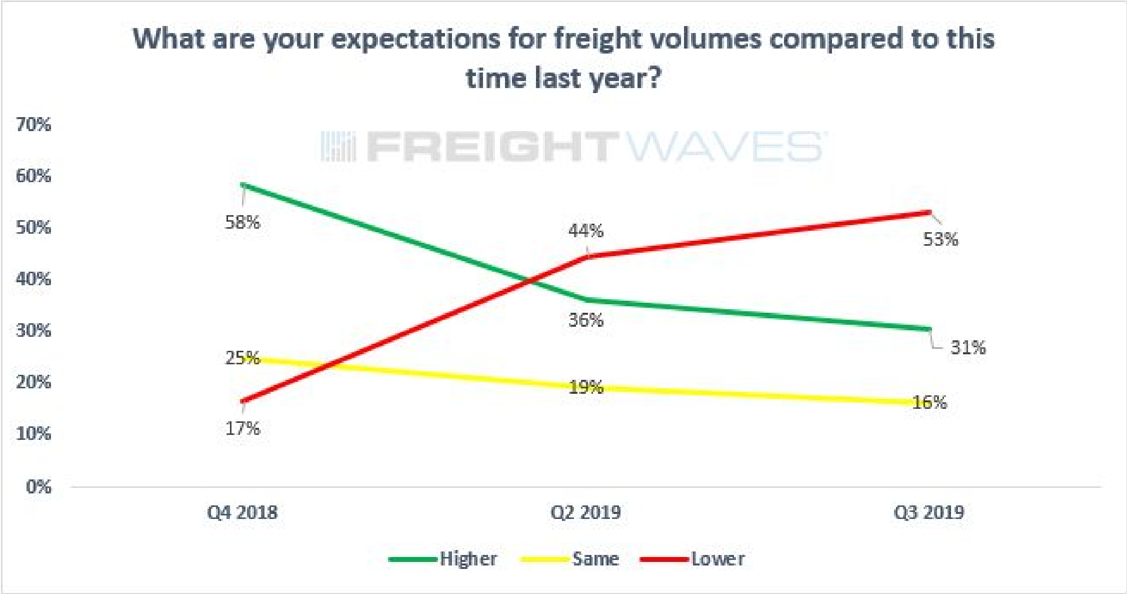
Has Carrier Sentiment Reached a Bottom?

Expanding fleet sizes in an environment of stagnant load volumes and over-capacity seems counterintuitive. One would think carriers are highly optimistic about the second half of 2019 compared to 2018. Or at least a tiny bit optimistic.

Comparing carrier optimism from September 2018 until July 2019 indicates expectations for the second half of 2019 can be characterized as anything but positive.

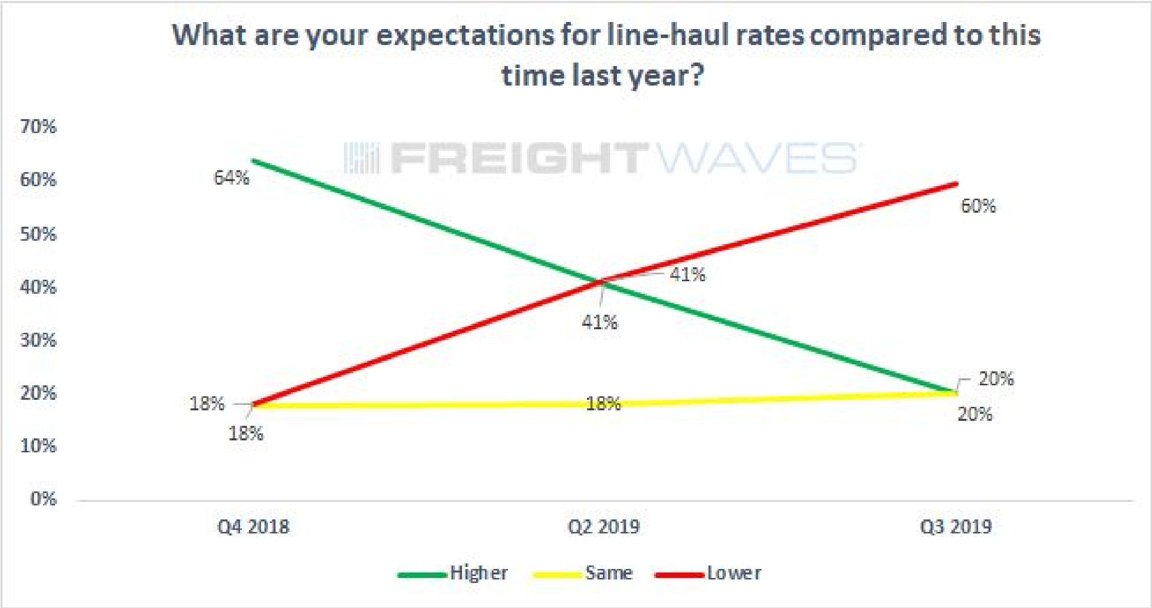
Expectations for freight volumes are half of what they were last year. For line-haul rates it is even worse, dropping by almost 70 percent since the second half of 2018.

Figure 6 – Quarter-to-Quarter Changes in Carrier Expectations for Freight Volumes



Sources: FreightWavesCarrier Outlook Surveys Q4 2018, Q2 2019, Q3 2019

Figure 7 – Quarter-to-Quarter Changes in Carrier Expectations for Line-Haul Rates



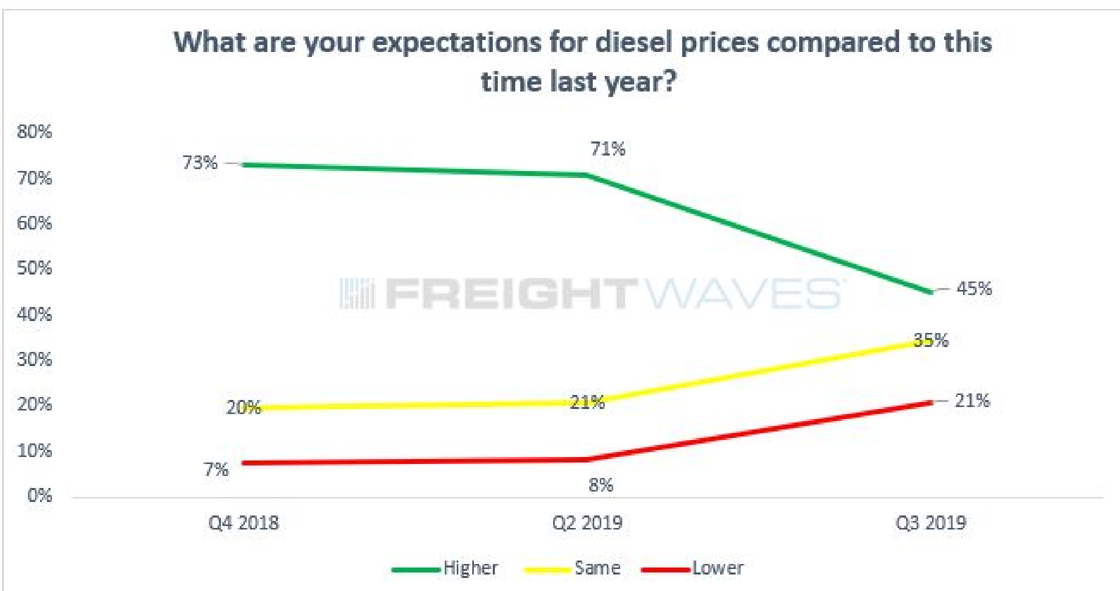
Sources: FreightWavesCarrier Outlook Surveys Q4 2018, Q2 2019, Q3 2019

Carrier expectations for diesel prices has moderated over the past nine months. Only 45 percent anticipate higher diesel prices for the remainder of the year compared to 2018.

This optimism might be misplaced. IMO 2020, the United Nations mandate that ocean vessels begin using very low sulfur fuel oil, is right around the corner. The official start date is January 1, 2020, though the changeover should begin in the fourth quarter of 2019.

This mandate will increase demand for the same distillates that are used for diesel fuel. With refinery capacity limited and an estimated 7 percent increase in demand for diesel, prices are likely to move higher soon. FreightWaves forecasts this will increase diesel costs by $0.25 to $0.50 per gallon (based on stable crude oil prices)[3]. There is also more on IMO 2020 in Trend 2 – Diesel Prices Are Set to Squeeze Margins on page 21.

Figure 8 – Quarter-to-Quarter Changes in Carrier Expectations for Diesel Prices



Sources: FreightWavesCarrier Outlook Surveys Q4 2018, Q2 2019, Q3 2019

[3] Freight Intel Group:IMO 2020: A new normal for diesel prices?, provides an in-depth analysis of how IMO 2020 is expected to impact diesel prices. It is live in SONAR.

These conditions are dangerous for carriers. A combination of depressed line-haul rates and sharp increases in diesel prices are the most statistically significant predictors for trucking company failures[4].

"Buy when there's blood in the streets"

Enough with all this bad news though. As the saying goes, "buy when there's blood in the streets." There are enough positives in the freight markets now that it could be signalling better days ahead. Or at least defining a bottom of the recessionary trough.

Most notably, outbound tender volumes finished July 2.24 percent higher year-over-year. July load volumes look even stronger using a 60-day moving average to compare year-over-year results.

Year-over-year load volume comparables will only get easier to achieve for the rest of 2019 and the first half of 2020. Assuming, of course, the economy keeps humming along at its current pace. If it does then it should be good news for trucking and logistics companies that have been up against some of the toughest year-over-year comparables for revenue and earnings that they have ever seen.

For all carriers and freight brokers it should signal at least set a slightly higher floor for contract prices in the next round of negotiations. Based on several data points and industry insiders, shippers are aggressively clawing back the contract rate concessions they made over the past 12 months.

Carrier sentiment is also so low right now that it can be viewed as a positive. It can always sink lower, but with an uptick in load volumes and any good news at all for contract rates, sentiment should slowly climb over the next few months.

For spot rates though, it is likely to get a bit bloodier before it gets better. It is likely that rates and rejections lag far behind any recovery in load volumes as the freight market is still flooded with capacity.

Until the supply of trucks shrinks to meet load volumes, rates will stay flat at levels far below 2018. Based on our survey data and the values in the retail Class 8 truck markets this not happened yet, and may not happen quickly enough for most carriers.

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[4] Freight Intel Group: Why Trucking Failures Could Increase in 2019, uses regression testing to predict failures based on a number of market conditions. It is live in SONAR.

Third Quarter Carrier Outlook Survey Results By Fleet Size

In April 2019 FreightWaves surveyed 252 trucking fleets to gauge their current sentiment on a number of market conditions compared to those experienced in 2018. A similar survey was conducted in September 2018 that highlights carriers' changing attitudes over the past six months.

Figure 9 – Survey Respondents by Fleet Size

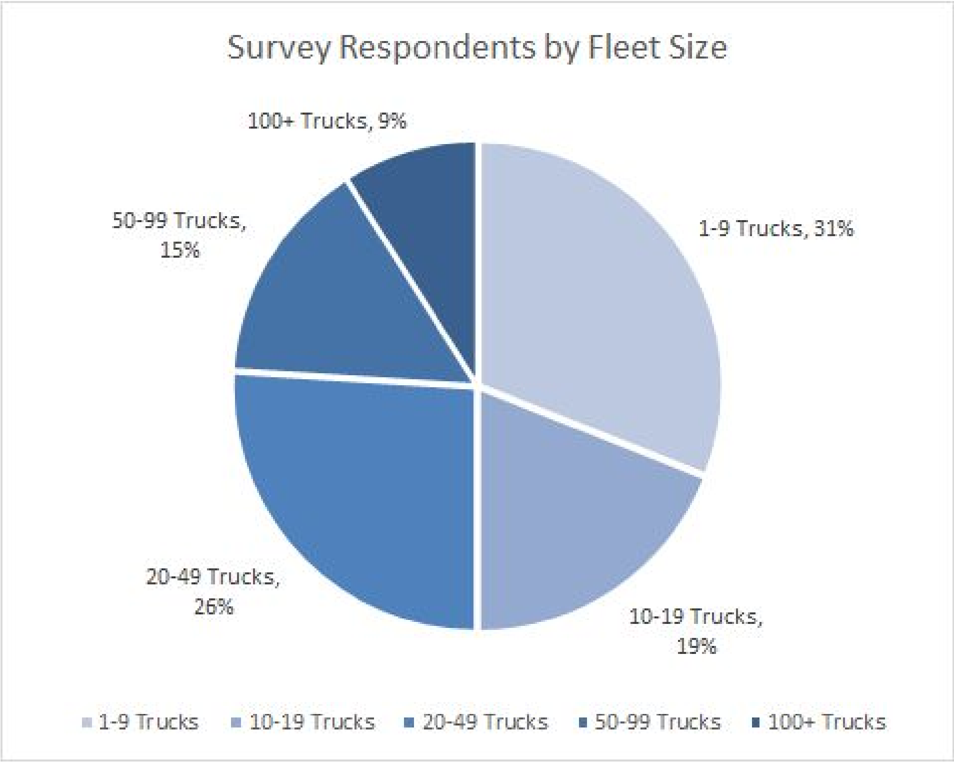
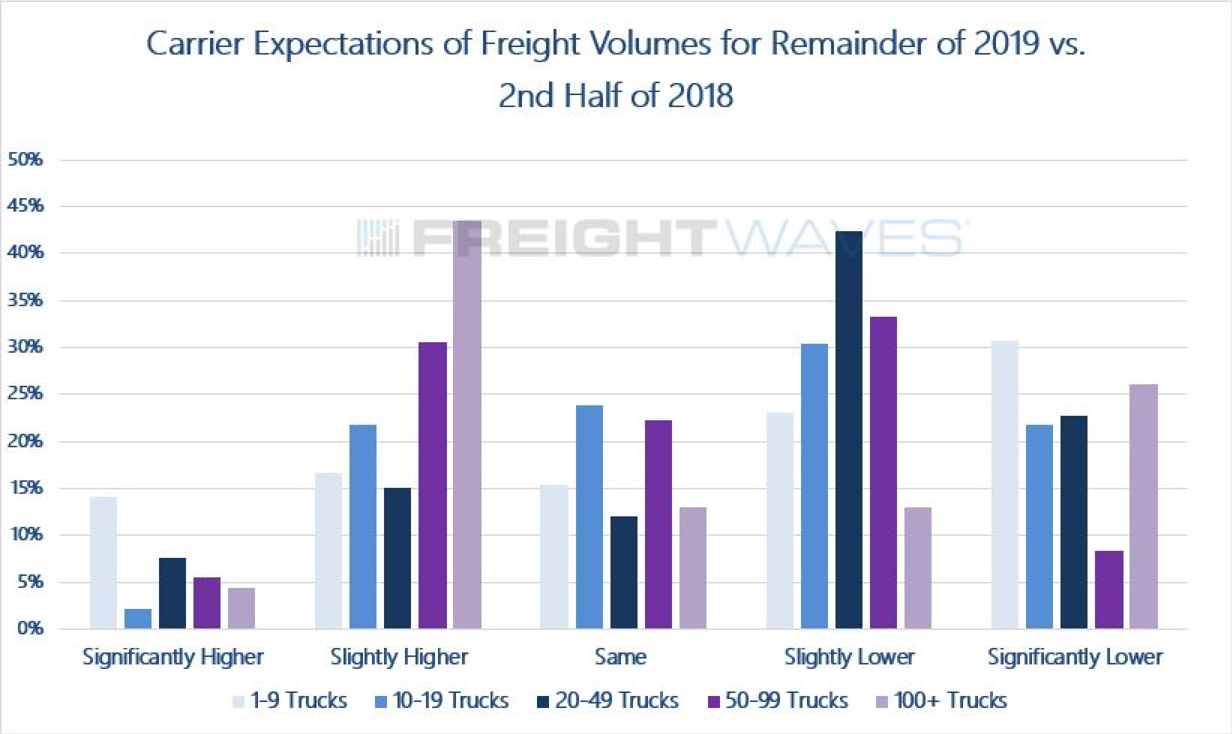


Figure 10 – Carrier Expectations for Freight Volumes by Fleet Size



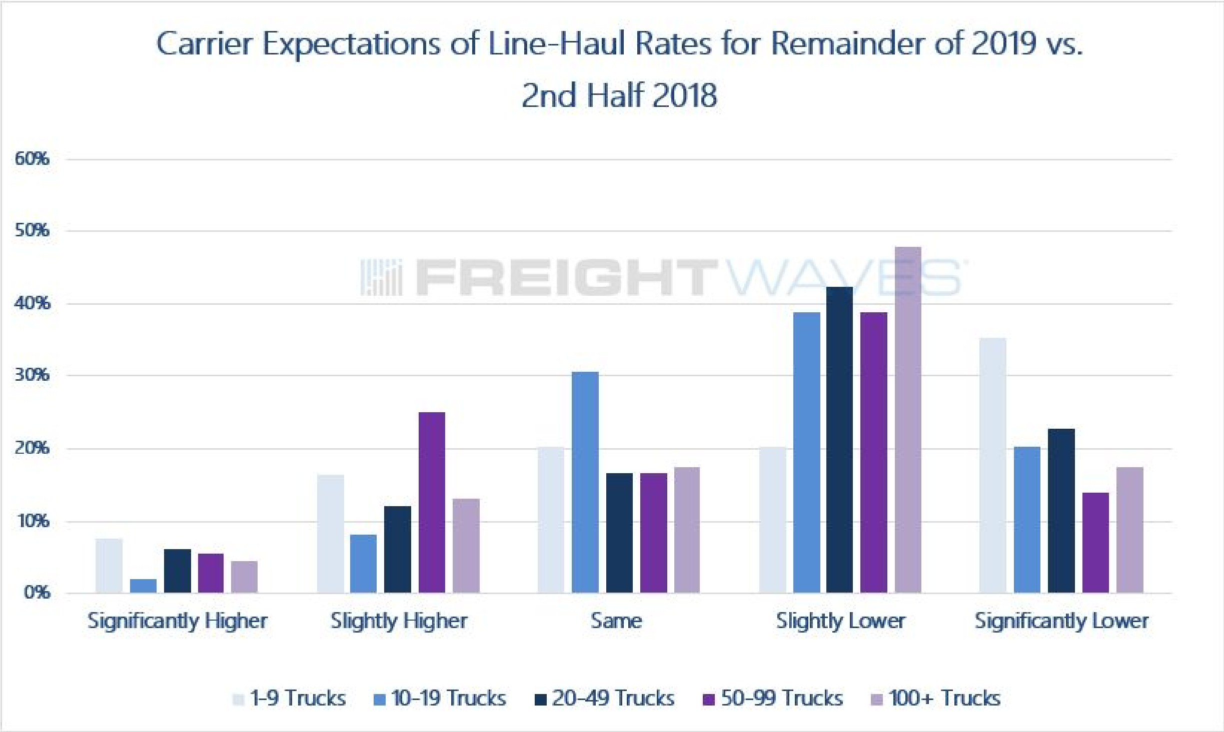
Source: FreightWaves Third Quarter 2019 Carrier Outlook Survey

- The most optimistic or positive carriers are those with the largest fleets – nearly 50 percent of the largest carrier grouping believe volumes will be slightly or significantly higher for the remainder of the year than the second half of 2018.

- The most pessimistic survey participants are those with the smallest fleets – more than 50 percent of both 1-9 Trucks and 10-19 Trucks groupings indicated negative sentiment regarding volume for the remainder of the year compared to the second half of 2018.

- In contradiction to small carrier pessimism, the 1-9 Truck grouping voiced the strongest belief (15 percent) that volumes would be significantly higher for the remainder of the year when compared to the second half of 2018.

Figure 11 – Carrier Expectations for Line-Haul Rates by Fleet Size



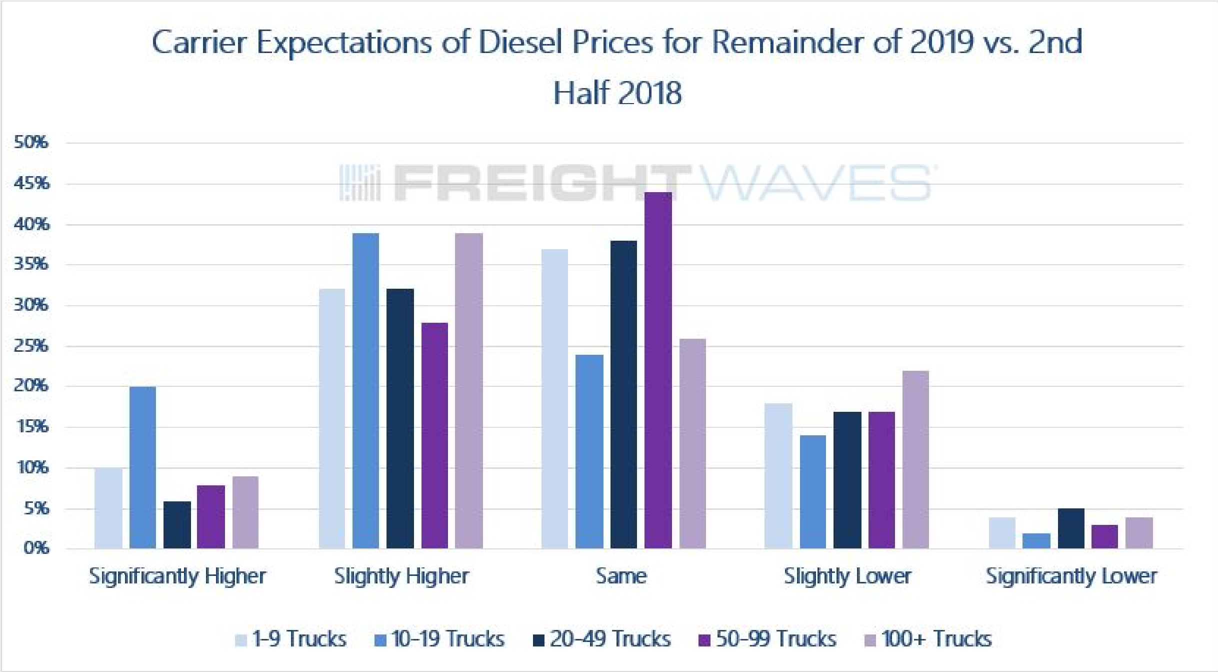
Source: FreightWaves Third Quarter 2019 Carrier Outlook Survey

- Nearly 60 percent of all respondents expect lower rates for the remainder of the year compared to the second half of 2018 (34 percent 'Slightly Lower' and 25 percent 'Significantly Lower').

- In line with volume sentiment, the smallest fleets are again the least optimistic – 55 percent of fleets with 1-9 Trucks and 58 percent of fleets running 10 to 19 Trucks believe rates will be lower for the remainder of 2019 than the second half of 2018.

- Nearly 40 percent of all fleets running 10 or more trucks believe rates will be slightly lower for the remainder of 2019 compared to the same period last year.

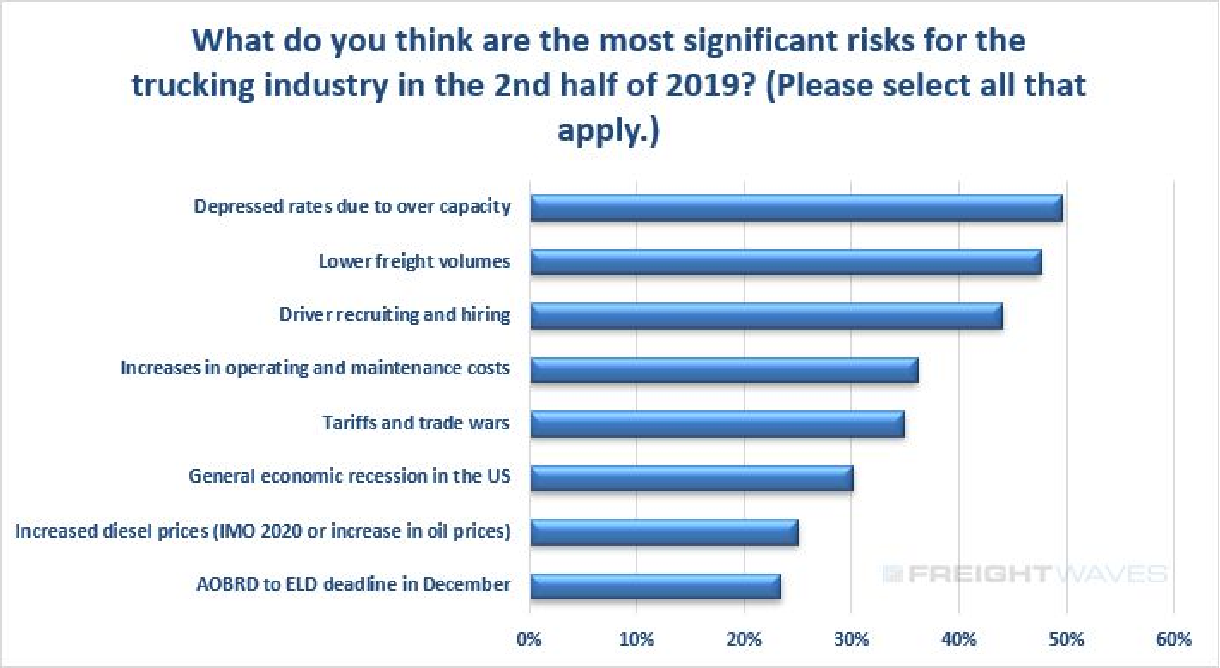
Figure 12 – Carrier Expectations for Diesel Prices by Fleet Size



Source: FreightWaves Third Quarter 2019 Carrier Outlook Survey

- Two-thirds of all respondents believe diesel prices will be the same or slightly higher for the remainder of 2019 compared to the second half of 2018.
- The 10 to 19 Truck grouping has the most negative view of diesel prices for the next six months – 60 percent expect 'slightly' or 'significantly' higher diesel prices for the remainder of the year.
- In a survey conducted by FreightWaves in July 2019, it was discovered that 70 percent of owner-operators had either never heard of IMO 2020 or had not paid any attention to it. This sentiment is echoed by this survey in which more than half of all respondents believe diesel prices will be the same or less than 2018 levels.
- While IMO 2020 isn't to be implemented until January 1, 2020, the markets may be impacted as early as September.

Figure 13 – Risks for Second Half of 2019



Source: FreightWaves Third Quarter 2019 Carrier Outlook Survey

- Concerns of over-capacity depressing rates ranked the number one risk for three of the five fleet groups (1 to 9 trucks, 10 to 19 trucks and 50 to 99 trucks).
- Larger fleet groups expressed heightened concern over driver recruiting than did smaller fleets.

Four Freight Market Trends for the Second Half 2019

In the second quarter survey we identified trends to look out for during the remainder of 2019. In the following sections these trends get a fresh look.

Trend 1 – Shippers are clawing back rates

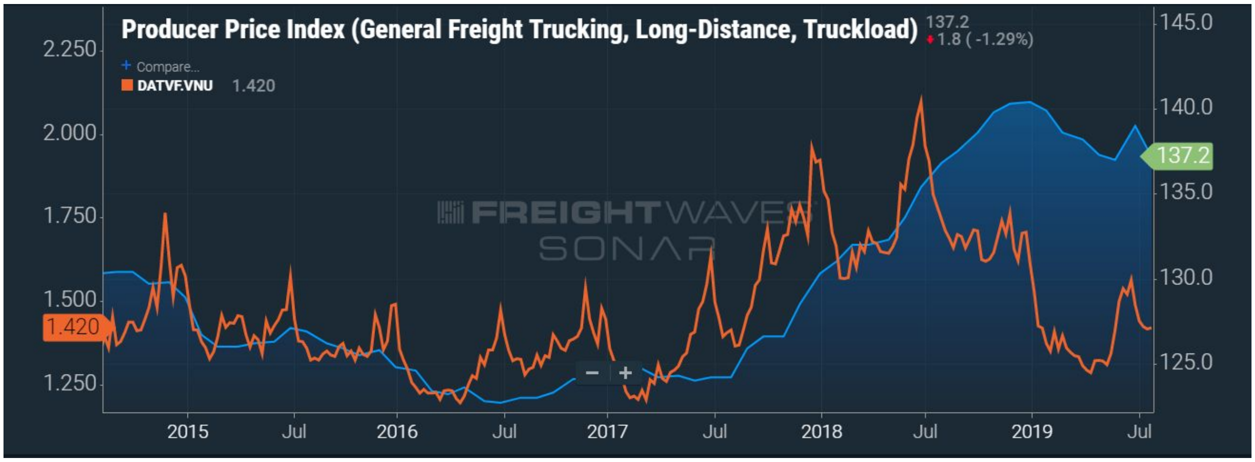
Equity analysts from UBS kicked off the downgrades for the trucking sector based on less than stellar earnings expectations for the second quarter of 2019. This was quickly followed by KeyBanc, Morgan Stanley and other equity analysts before earnings season began.

One of the main themes from all equity analysts has been the outlook for contract rate increases going forward. This was the first trend we identified in our second quarter survey.

From freight brokers and carriers we have spoken with in July 2019 this trend remains firmly in place.

The producer price index (PPI) for long-distance truckload rates is one of the best proxies contracted trucking rates. According to SONAR, PPI.LDTL peaked in the fourth quarter of 2018 and has followed DAT spot prices down and has trended down hill until June.

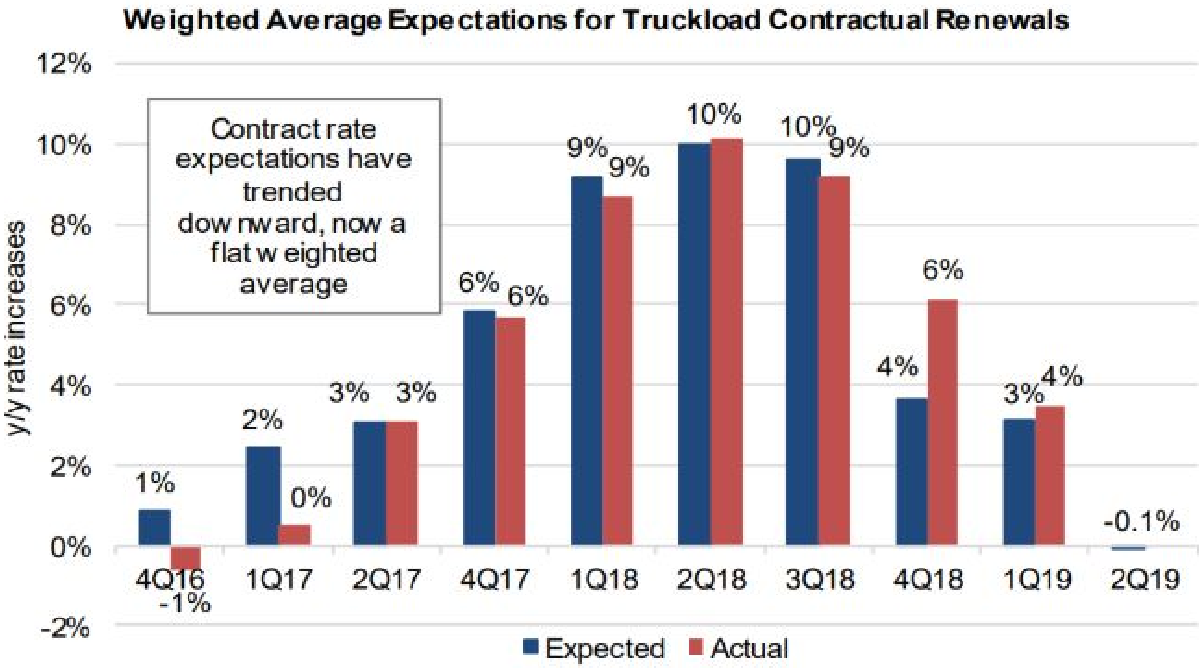
Figure 14 – Contract Pricing Line-Haul Rates vs. Spot Rates



Source: SONAR: PPI.LDTL, DATVF.VNU

June's spike in contract and spot rates is most likely a seasonal spike. The following channel surveys of shippers from KeyBanc and Morgan Stanley paint a grimmer picture for contract rates for the second half of 2019.

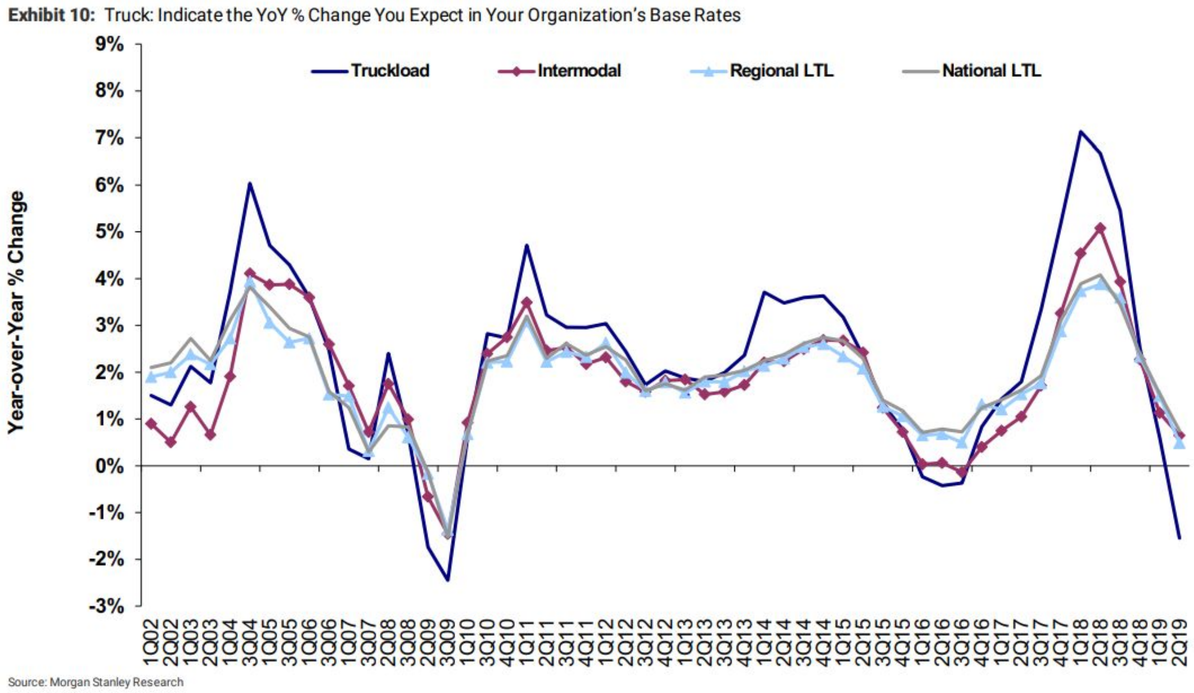
Figure 15 – KeyBanc Shipper Survey of Expected Contract Rates



Data Source: KeyBanc *TL Update: Lowering Estimates, Fundamentals Potentially Beginning to Bottom, June 18, 2019*

Morgan Stanley's latest shipper survey is even more bearish. Shippers are expecting all transportation modes to see a reduction in year-over-year contract rates over the coming months.

Figure 16 – Morgan Stanley's Shipper Rate Expectations Survey Results



Data Source: *Morgan Stanley:54th Shipper Survey July 22, 2019*

It is clear from multiple shipper and carrier surveys that the entire logistics industry is bracing for reduced contract rates for the next few quarters.

Trend 2 – Diesel Prices Are Set to Squeeze Margins

What would happen if one million over the road semi-trucks switched from diesel to gasoline on January 1, 2020?

The best odds for a bet is this new demand would send gasoline prices sharply higher, most likely leading to angry consumers across the U.S. A similar scenario is likely to play out in the diesel markets in the next few months.

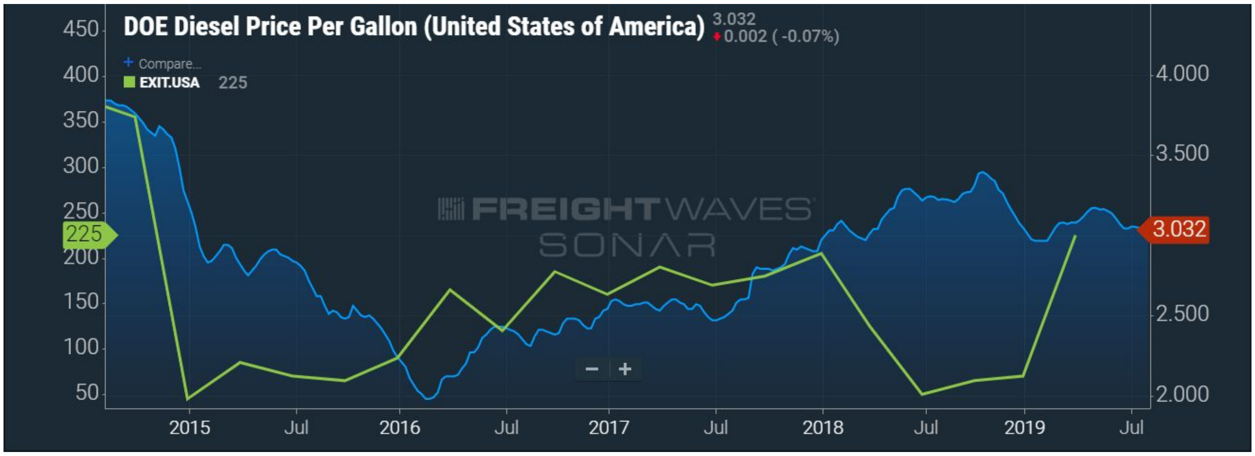
If the term IMO 2020 doesn't ring a bell yet, then it will soon enough. It is a United Nations (UN) mandate that forces ocean vessels to switch from using high sulphur fuel oil (HSFO) to very low sulphur fuel oils (VLSFO). This will affect trucking directly as the feedstock for the new low sulfur marine fuels is made from middle distillates… the same feedstock used for diesel and jet fuel[5].

Like with the gasoline example above, this new demand by maritime vessels for diesel products should drive prices higher, at least in the short-term. Though forecasts for a long-term new normal for diesel prices can readily be found among energy analysts.

FreightWaves research forecasts diesel prices should rise $0.25 in the first half of 2020 due to IMO 2020 demand. This is assuming underlying oil prices remain steady.

This will likely lead to an increase in trucking failures based on Freight Intel research. Our previous research based on 20+ years of trucking company failures indicates the two most significant predictors are increases in diesel prices with flat or declining rates.

Figure 17 – How Diesel Prices Affect Trucking Company Failures



Source: SONAR (DOE.USA, EXIT.USA)

Putting a further squeeze on carrier margins are the 2018 increases in driver pay and operational costs that are not going away any time soon.

FreightWaves Market Expert Zach Strickland detailed this to perfection with his article, [Trucking rates have fallen back to 2017 levels, but costs have not](). Figure 18 illustrates falling spot rates in orange, rising maintenance costs in green, and earnings in the flat blue line.

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[5] An in-depth look on how IMO 2020 may affect the trucking industry is live in SONAR. The white paper is, *IMO 2020: A new normal for diesel prices?*

Figure 18 – Maintenance Costs on the Rise, While Spot Rates Remain Steady

Source: SONAR (Average hourly wages – Transportation and Warehousing, Maintenance cost per mile, DAT Van Freight Rate Index – National (SONAR: EARN.TPWH, MAINT.VCF, DATVF.VNU)

Dan Cushman, CEO of P.A.M. Transport, summed up the margin pressures for carriers quite nicely during the company's second quarter earnings call with investors:

"Many shippers have expressed intentions of returning rates to levels seen prior to the 2018 increases. However, these increases were, in large part, passed through by many carriers, including us, to drivers and owner-operators in an effort to increase the competitiveness of the truck driving profession with other career opportunities and to increase the pool of available driver capacity. This increase combined with increases in other operating costs means that rate decreases can only be granted through giving up margin,".[6]

Trend 3 – Used Tractor Prices in the Second Half of 2019

After our second quarter outlook, the growth of small fleets over the past 12 to 18 months signaled over-capacity in the market. This led us to believe that at some point in 2019 fleets would begin to sell off unproductive assets. Based on the third quarter survey results and the average values for used trucks this is not happening yet.

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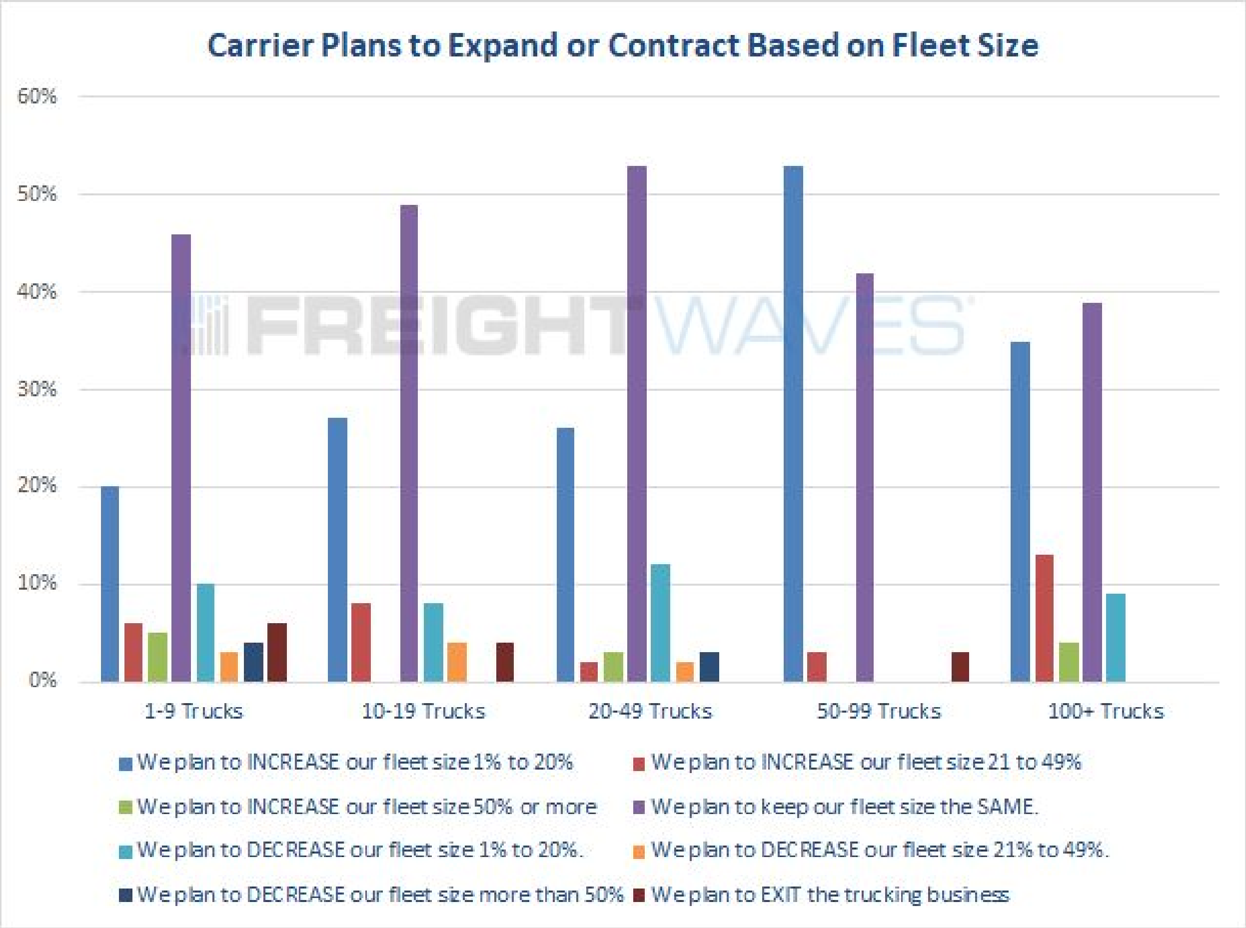
[6] FreightWaves article, P.A.M. beats expectations, warns pricing concerns and rising costs may challenge future margins, July 16, 2019.

Based on the most recent survey results it does not look like small-and medium sized carriers are ready to throw in the towel. Twenty-eight percent are planning to expand their fleets by up to 20 percent over the next 12 months.

Figure 19 – Carrier Expectations for Expanding and Contracting Fleet Sizes



Source: FrieghtWaves Third Quarter 2019 Carrier Outlook Survey

Carriers that plan to increase their fleet sizes up to 20 percent are represented in the darker blue bars. The most optimistic fleets are those operating between 50 and 99 trucks, where over half are expecting to expand. The most cautious are fleets running less than 10 trucks, though 20 percent of this group still have plans to add trucks.

The appetite for reducing capacity is not apparent in the survey results. Only 16 percent of all fleets expect to reduce capacity or exit trucking altogether.

Based on low expectations for load volumes and rates this is hard to believe.

New orders for Class 8 trucks (in the orange mountain data set) have fallen off a cliff since setting a record in 2018, while used truck values for all ages – three-year, four-year and five-year – remained steady for most of the first half of 2019, before popping up by 5 percent in May.

Figure 20 – New Truck Orders and Used Truck Pricing in the First Half of 2019

Source: SONAR (ORDER.CL8 (Orange Mountain), UT3.USA (Green), UT5.USA (Orange line))

Based on these two data points it looks like carriers are still planning to expand capacity. Why is anyone's guess, as carriers have become more pessimistic about both volumes and rates over the remainder of 2019.

Trend 4 – Tariffs and Trade Agreements

The trade war with China is gathering steam again in 2019. The U.S. imports $540 billion from China. As of June 1, 2019 there were 25 percent tariffs on $250 billion of the $540 billion, leaving $300 billion untariffed. As of a July tweet, President Trump has announced that beginning September 1, 2019 the U.S. will begin 10 percent tariffs on the remaining $300 billion of Chinese imports. China has retaliated by halting all U.S. agricultural imports, as the trade war continues to escalate. We would not be surprised if 25 percent tariffs were on the table by our fourth quarter Carrier Outlook edition.

Figure 21 – Decision Tree for Possible Short-Term Scenarios for Tariffs

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		Sep 1, 2019	30 to 90 Day Extension?	Result
	Trade Agreement Reached (i.e. 0% on $300 Billion)	Yes	No	No pull-forward; inventory drawdown normal and imports back to pre-Trade War conditions
Bargaining Chip	0-10% on $300 Billion	Yes	Threat of increase to 25% if no deal	Pull-forward demand; inventories build higher
	25% on $300 Billion	Possible	No	No pull-forward; significant drawdown of existing inventories and decrease in new orders in hopes of trade agreement in future

Adding to the drama (which now seems like ancient history) was the week-long threat of 5 percent tariffs on Mexican imports In early June. This was coupled by threats of new tariffs on India, and recent threats on imports from Vietnam.

Our expectations for another round of front loading imports ahead of any possible tariffs did not materialize after the latest round of 25 percent tariffs. This is clearly seen in Figure 22. The blue mountain line is the Freightos Baltic Index rate prices from China to the U.S. West Coast.

The run-up in ocean rates during the fourth quarter of 2018 illustrates the demand that was pulled forward. With ocean rates in 2019 remaining around the normal seasonal levels the demand anticipated by many, including by the Freight Intel Group has not materialized.

Figure 22 – Ocean Rates and Pull Forward Demand in 2019

Source: SONAR (FBX.CNAW, AIRUSD.HGKNOA)

This could change after the latest tariff deadline of September 1, 2019. Inventories from the original pull-forward in the fourth quarter of 2018 have likely been worked down by now. Added to this scenario is the U.S. is in its traditional gear-up for the holidays. Most retailers and consumer product companies begin importing holiday merchandise in the early third quarter to have it ready and on the shelves by November.

If pull-forward demand does happen it will most likely pull-forward the traditional seasonal patterns once again in 2019. If so, this should be a tailwind for trucking in third quarter, and a headwind in the fourth quarter.