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INSIGHT

VIEWPOINT

The Truck Stops Here – May 2018

JOEL C. SHPALL | MAY 17, 2018

If manufacturing is the heart of an economy, freight traffic is its lifeblood. Evidence of a surge in manufacturing can be seen not only in the stats on capital investment and in the purchasing manager's surveys, but also in the freight indices.

To that end, the Dow Jones Transportation Average (TRAN) is a closely watched stock market reading for the transports and a traditional leading economic indicator. The TRAN index performed well in the second half of '17, outpacing the S&P 500 Index over the period, and in particular from 9/1/17 to the end of the year (when it nearly doubled the broader market). The TRAN also gained 26% from a dip that occurred last August through mid-January.

Dow Jones Transportation Average (TRAN) versus S&P 500 Index – Last 12 Months

Source: Dow Jones

However, since the highs reached in January, the TRAN index has essentially traded sideways. So, is the strength seen in the second half of '17 and early '18 a signal of economic health, or is the more recent performance signaling that some risks lie ahead? If we take a deeper look at the underlying currents in the transportation market, we can observe some demand-related tailwinds as well as some noteworthy bottlenecks that have emerged.

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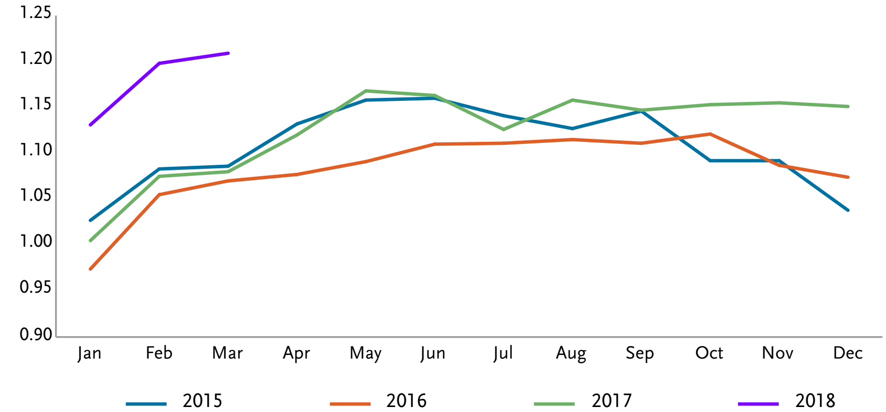
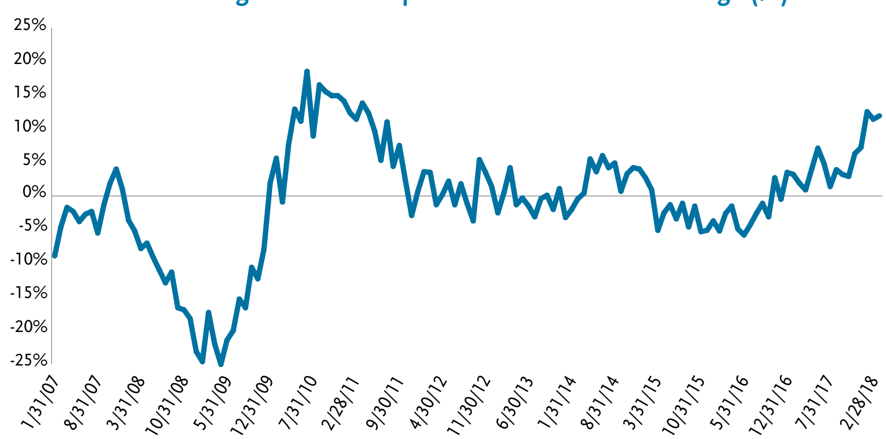
Mr. Shpall is a Credit Analyst in the Fixed Income group and is responsible for the transportation, autos, and chemicals sectors. Mr. Shpall joined TCW in 2010 with the acquisition of Metropolitan West Asset Management LLC (MetWest). He conducts credit research in the consumer cyclical and transportation sectors. He has garnered considerable expertise in the auto and airline industries. Prior to joining MetWest in 1998, he was a trading officer with Wilshire Associates, responsible for processing all international and fixed income trades. Mr. Shpall holds a bachelor's degree in Economics from the University of California, Los Angeles (UCLA).

The trucking market began strengthening in the second half of '17 against an economic backdrop that was largely supportive. Consumer confidence remained resilient and shipments of goods gained velocity. The strong '17 holiday sales season and the proliferation of e-commerce also contributed to rising transportation demand. As can be seen from the following graph of the Cass Freight Index, freight volumes were firm in '17, particularly in the second half of the year, avoiding the seasonal fall-off that typically occurs toward year-end. This continued in the first quarter of '18, where shipments hit the highest levels since the Great Recession a decade ago.



Source: Cass Information Systems, Bloomberg

The amplitude of year-over-year gains in freight traffic earlier this year has been especially noteworthy, as increases of this level are typically only seen when coming off a down year (i.e. in the footsteps of a recession, such as in '10/'11).

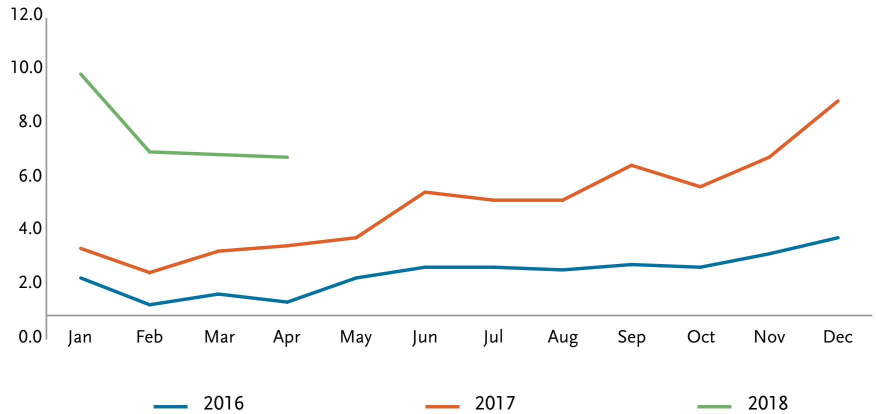


Source: Cass Information Systems, Bloomberg

However, coincident with the strength in freight volumes has been a truck driver shortage that can be traced to a tightening overall labor pool and blue-collar labor migration to rebounding sectors such as new construction and energy. This has helped keep a ceiling on the level of incremental trucking supply that has come to market. In addition to this labor shortage, there has been a regulatory change with the implementation of ELDs (Electronic Logging Devices), which now electronically monitor the hourly logs of trucks and their respective drivers, limiting any ability to 'stretch' driver hours. These ELDs needed to be installed on trucks by December '17 (although some compliance leeway was granted). This regulatory change may squeeze some incremental trucking capacity out of the market, particularly from smaller trucking companies.

These constraints on adding trucking capacity in the near-term, coupled with continued momentum on the demand side, can be seen in the following Market Demand Index. This Index tracks the van load-to-truck ratio in the marketplace—the ratio of goods ready to be shipped versus the number of trucks available to ship them.

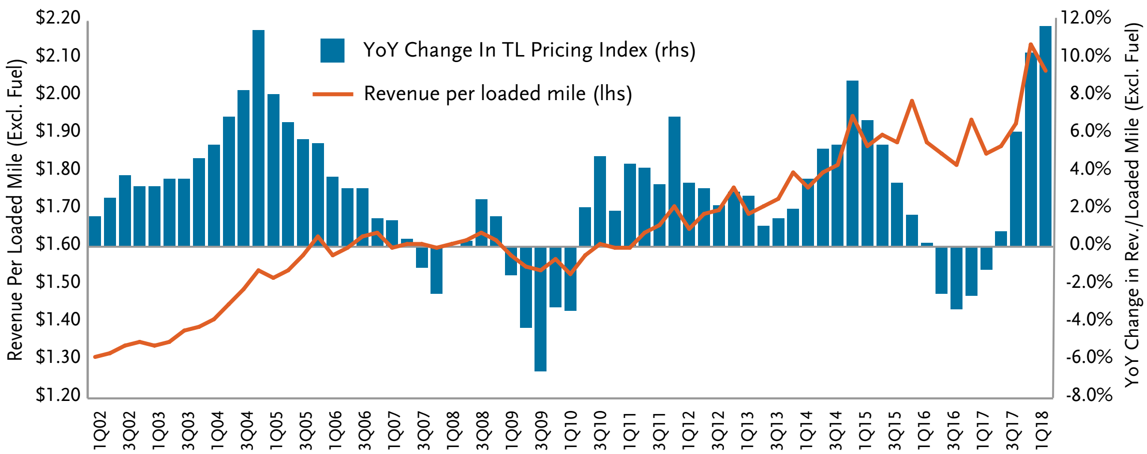
Market Demand Index—Van Load-to-Truck Ratio



Source: DAT

These factors taken together have resulted in upward pressure on freight prices, particularly in the trucking sector (the highest since '04). The following graph illustrates that trucking prices began generating significant momentum in mid-'17, with truckload revenue hitting a cyclical high of $2.10/mile in January.

Truckload Pricing Trends



Source: UBS

While tightening supply-demand conditions have been beneficial to the broad trucking industry (and rails to a lesser degree), downstream sectors have felt cost pressures that affected profit margins. From distributors to manufacturers and from retailers to consumer products companies, several sectors of the economy have commented on the inflationary pain within transportation. Gross margins for some of these companies have been impacted by 50-150 basis points, and have had a consequent impact on corporate earnings:

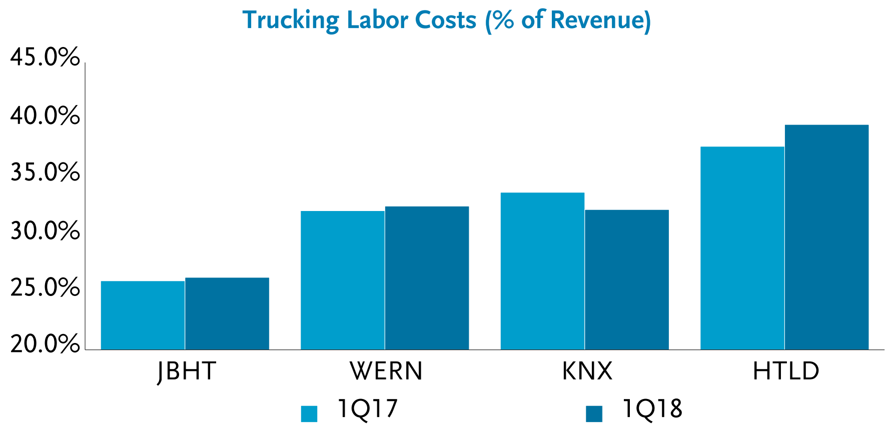
“We have budgeted higher freight costs and diesel costs than a year ago. Our outlook currently includes a headwind of approximately $68 million, or $0.22 in earnings per share related to these costs.”

- Dollar Tree, corporate earnings call

“Across the business, we are absorbing freight inflation… So we’re looking at an aggregate about $15 million of [incremental] freight [expense].”

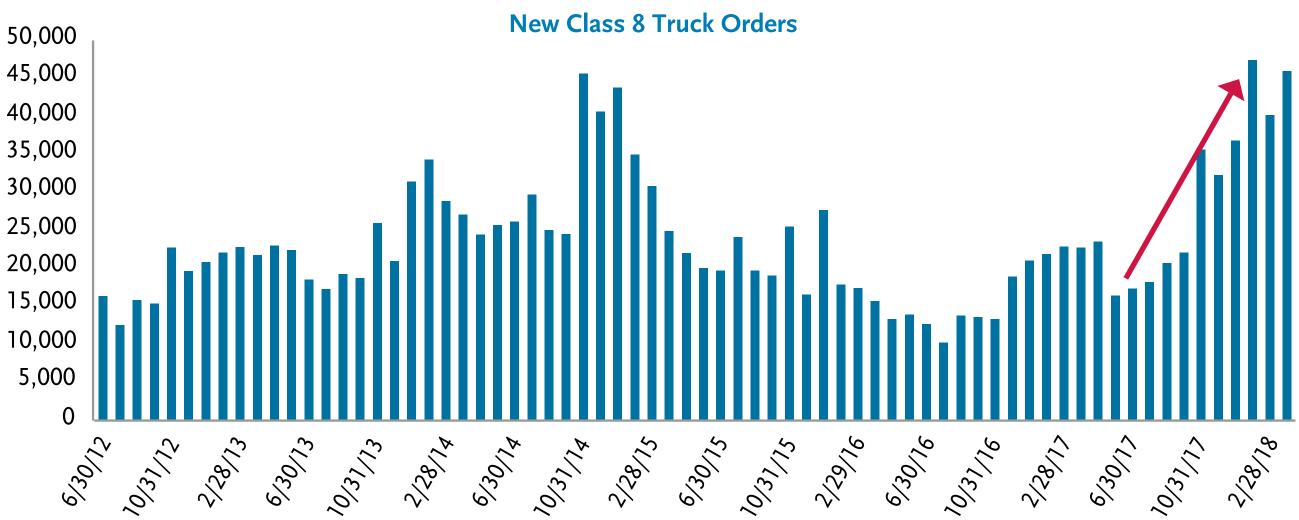
- Post Holdings, corporate earnings call

Unfortunately for the freight providers themselves, inflationary pressures are also emerging. While rising fuel costs can typically be passed-through to customers, rising labor costs are not as easily offset. This is particularly true for the trucking industry, where labor costs are a larger burden. Werner Enterprises (a truckload freight company) noted in its 1Q’18 earnings that truck driver pay is increasing +9% year-on-year. Knight-Swift, another truckload freight carrier, recently noted that driver wages have been trending up 7-9% over the last two quarters.



Source: Company Financials

As freight demand has increased and pushed transportation costs higher, new orders for Class 8 trucks have responded in kind, as trucking companies look to bolster their fleets. According to ACT Research, preliminary truck orders for March were 47k, up 102% year-on-year and 16% sequentially. This capped off the highest quarterly order volume since the 4Q of '14. However, new capacity will take several months to enter the market in any meaningful way.



Source: ACT Research, UBS

All in all, the trucking sector has enjoyed a favorable backdrop since last summer. Demand trends have been strong and capacity growth limited. Yet some of these capacity trends may be the very reason why the Dow Jones Transportation index has lost some of its luster in recent months. While freight volumes have seen an uptick, driver shortages and trucking capacity in general have created bottlenecks that pose a challenge for higher levels of growth. In addition, the market has come to better understand that transport companies too are experiencing inflationary pressures (labor) and passing some, but not all, of the higher costs to downstream industries. The same TRAN index that pointed to strong economic prosperity in the second half of last year seems to be signaling recently that some constraints may be emerging on our highways. ■

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