

Industrial Research

July 14, 2015

Does 2015's Transport Stock Weakness Foreshadow An End To The U.S. Recovery?

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Three Key Focal Points

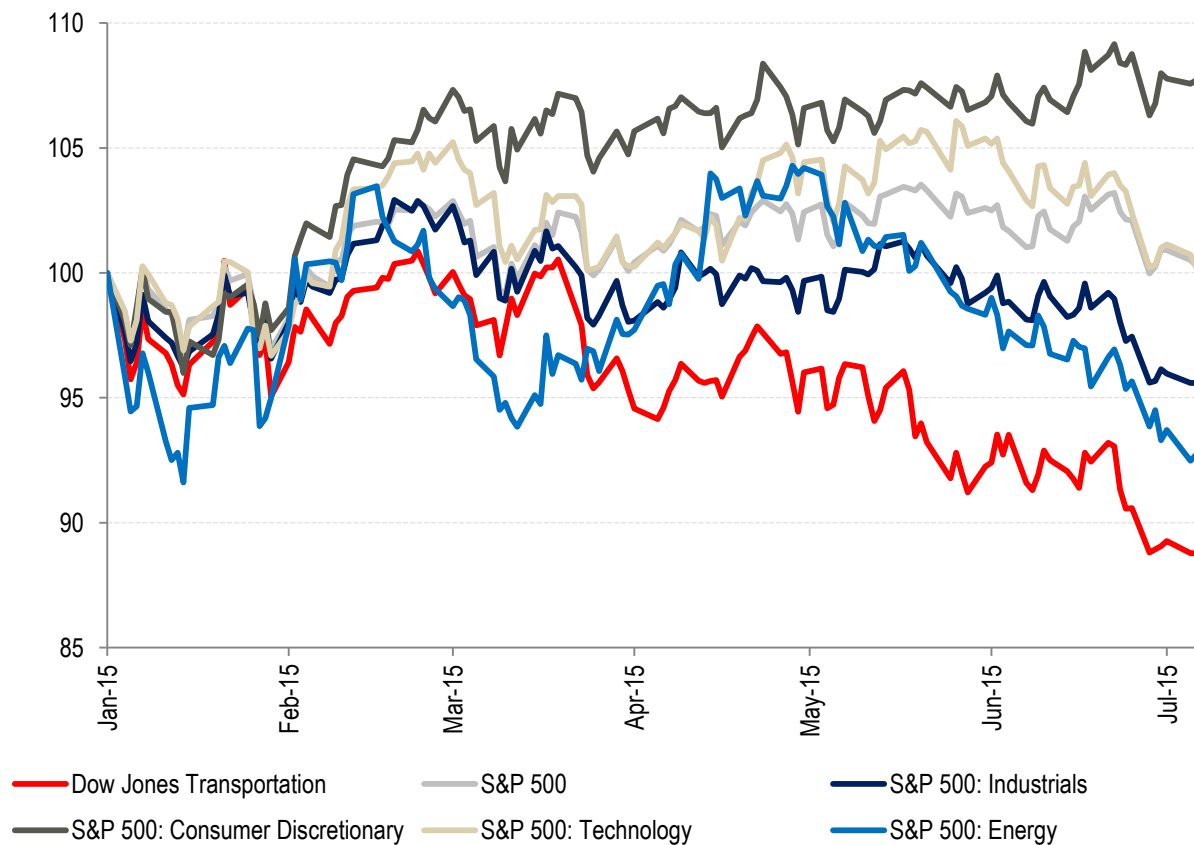


1. 2015: Meaningful transport stock weakness – what does it say about the US recovery?
2. Industry fundamentals normalizing in 2015 after 2014's tightness – the tightest truckload market in a decade. But prepare for 2016-17.
3. Trends affecting supply chain management this cycle
 - Regulations
 - Demographics
 - Technology

Transport Stock Performance Has Been Bad In 2015 – Does It Mean Anything?



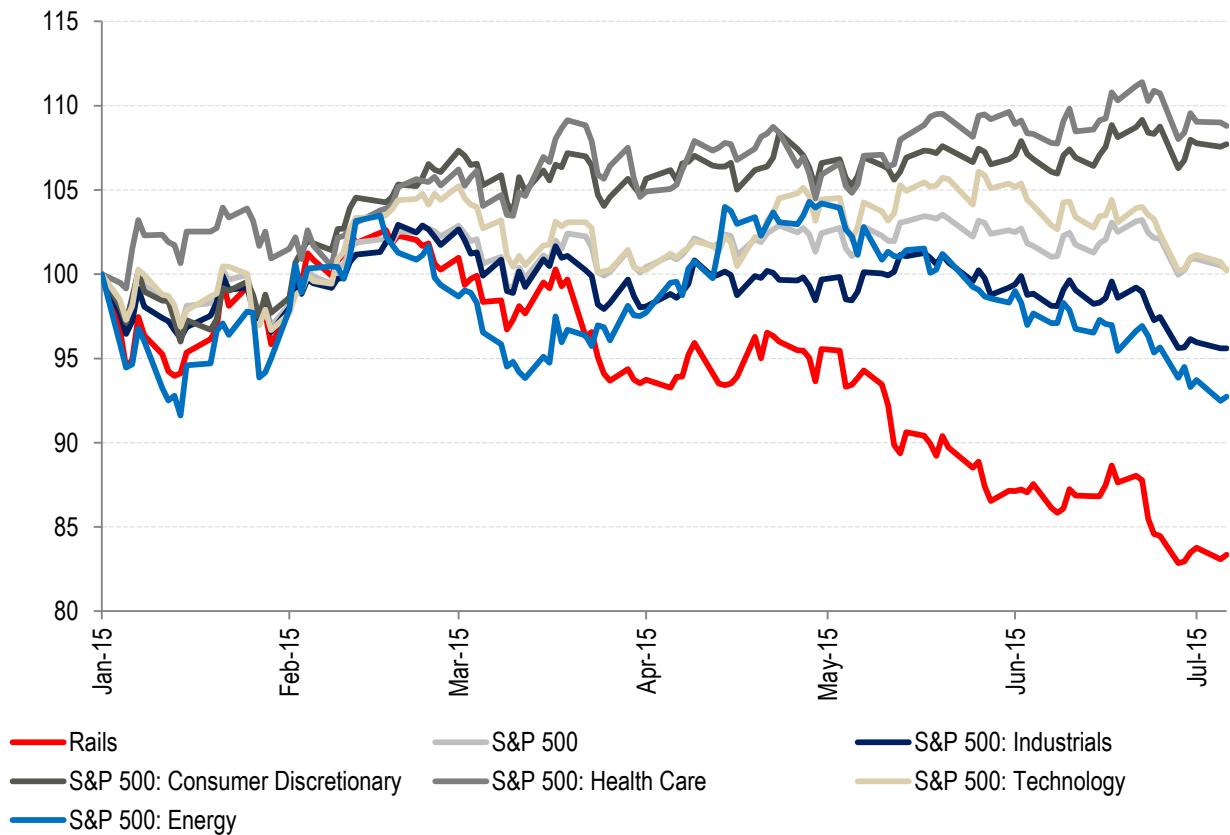
2015 year-to-date, transports have meaningfully underperformed the market.



Transport Stock Performance Has Been Bad In 2015 – Does It Mean Anything?



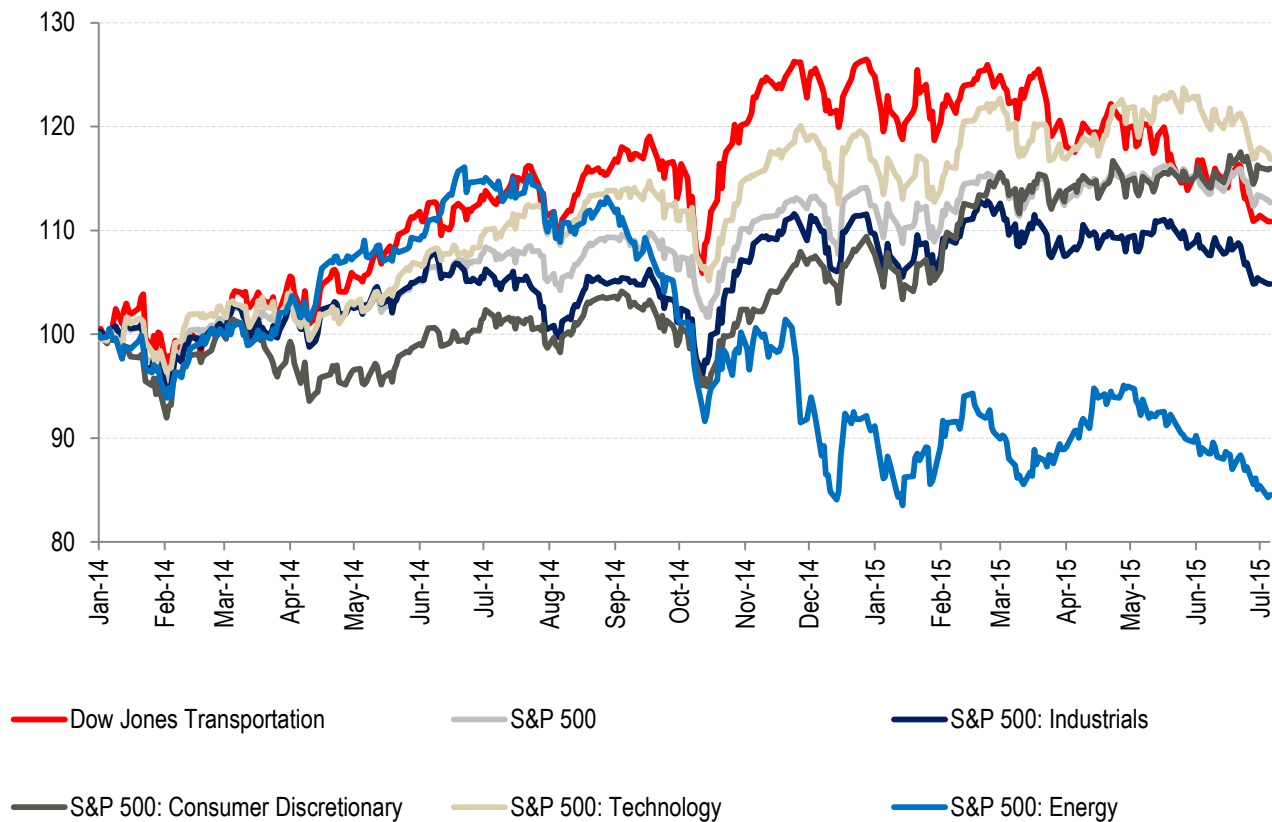
YTD, rails have similarly underperformed the market.



Transport Stock Performance Has Been Bad In 2015 – Does It Mean Anything?



Some of the giveback was expected after 2014's strength.



A Look Back at an Eventful 2014

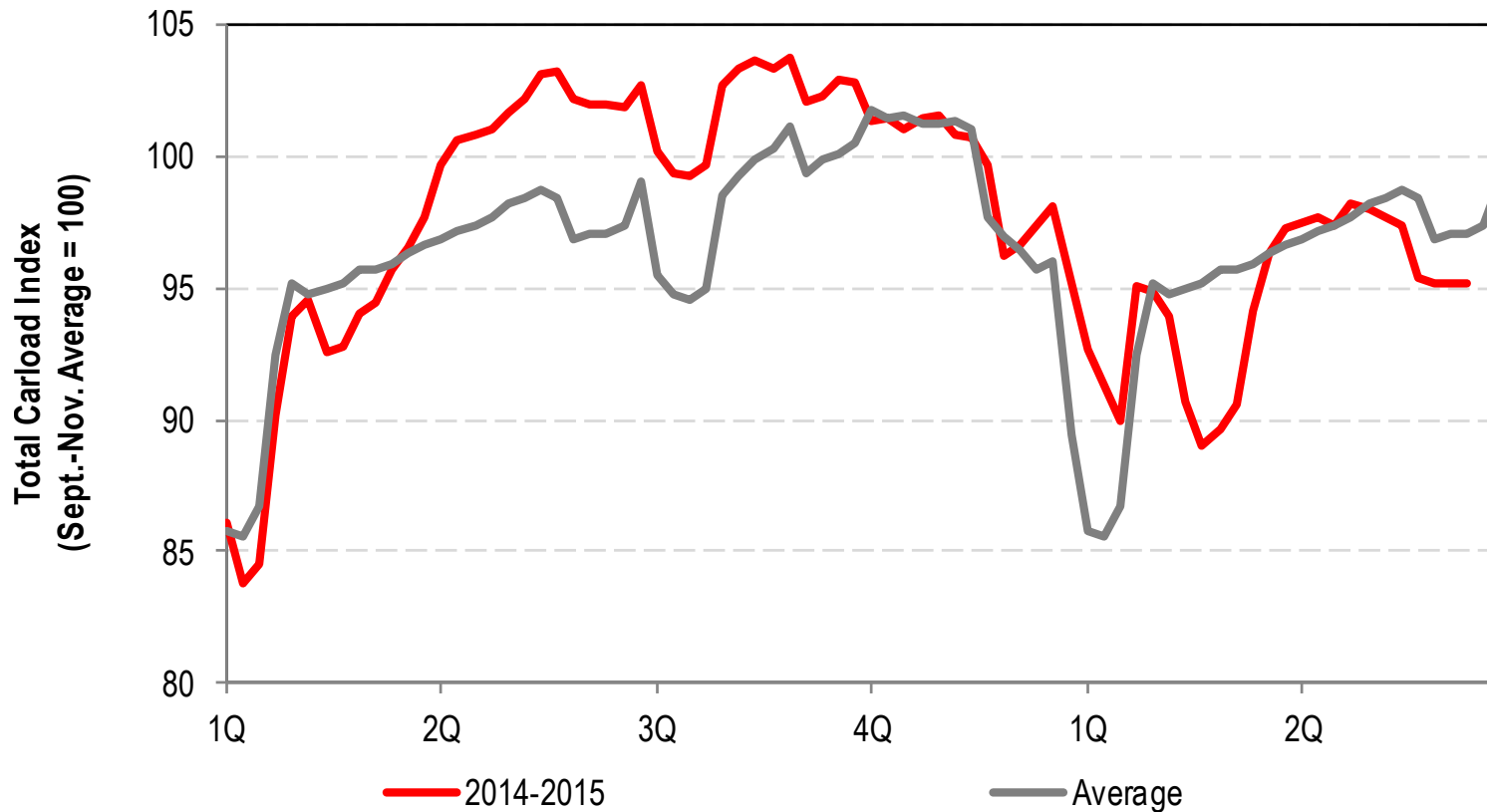
The tightest truckload market in a decade, triggered by:

1. The July 2013 drivers' hours-of-service modifications (**regulations**)
2. B2C's development and the 2013 peak season
3. Numerous winter weather events
4. Sharp recovery in demand beginning late 1Q14
5. Worsening driver shortage (**demographics**)
6. Rail service erosion (caused by factors 3 and 4)
7. US West Coast port labor dispute

Severe Winter Weather Hampered 1Q14, But Volumes Snapped Back in 2Q



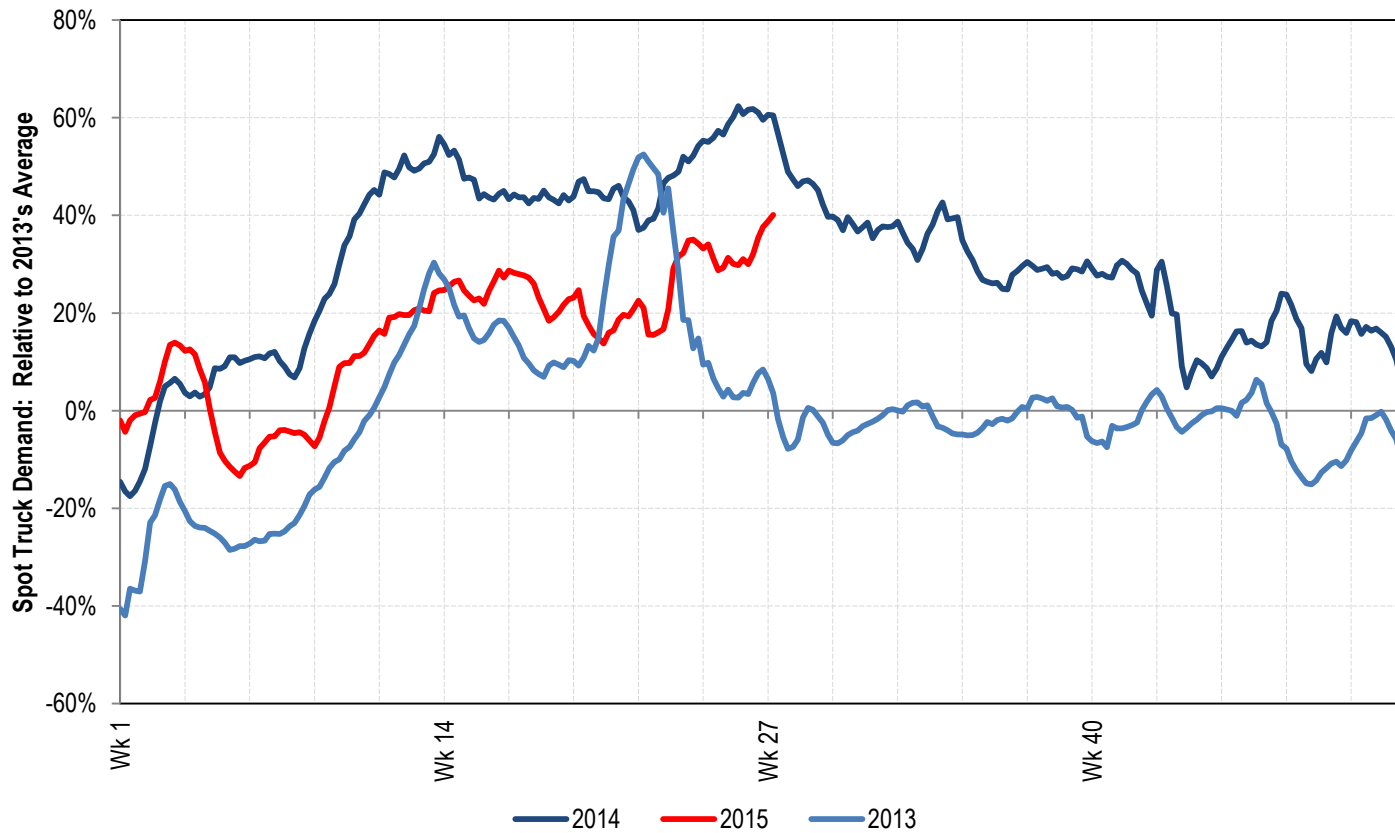
Notice the return to “normal” seasonal patterns in 2H14 and into 2015



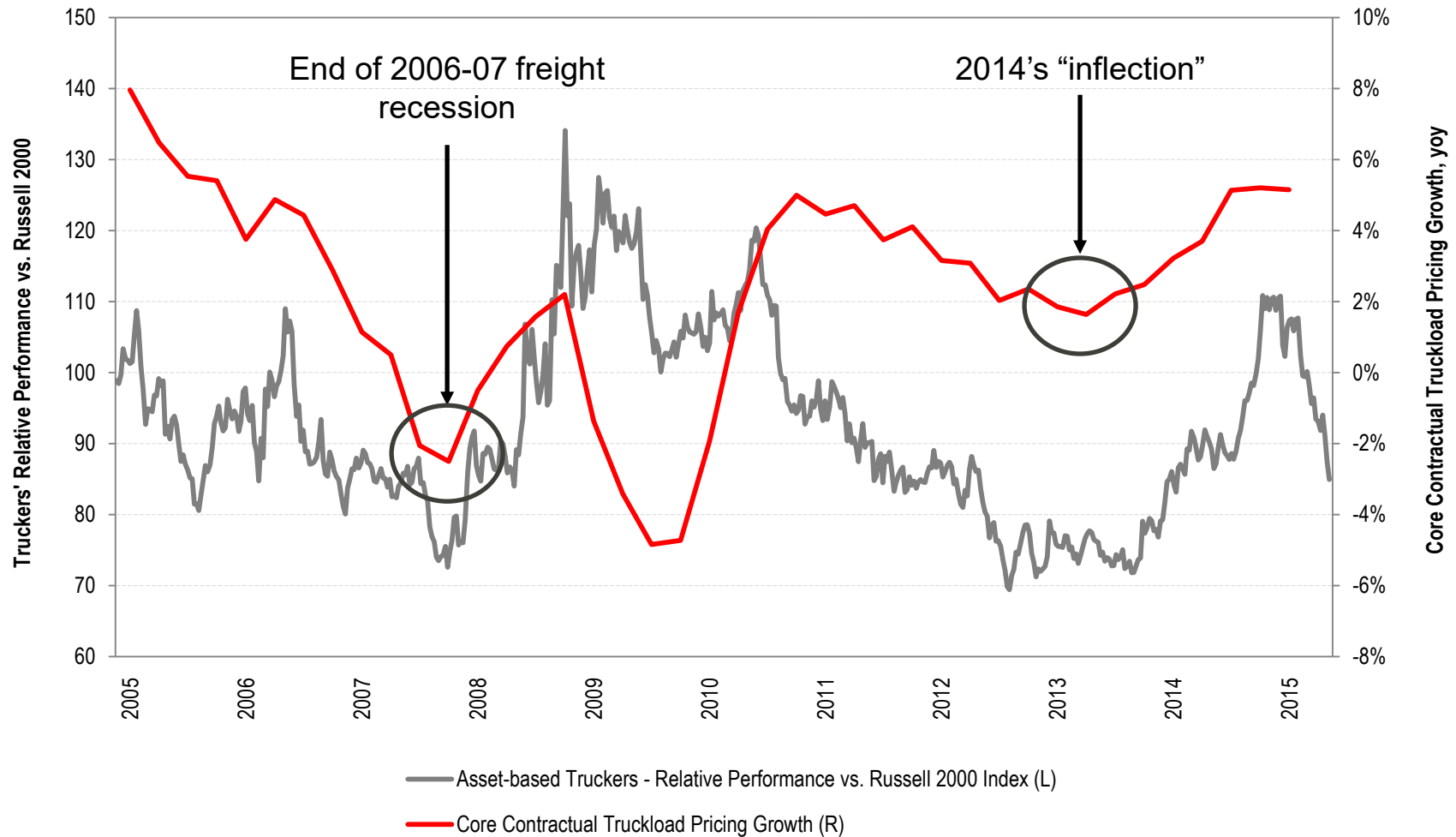
The Net Result: Truckload Tightness Throughout 2014...



2014 spot demand was 30% higher than 2013 levels – but notice the normalization during 2H14 (which has continued into 2015).



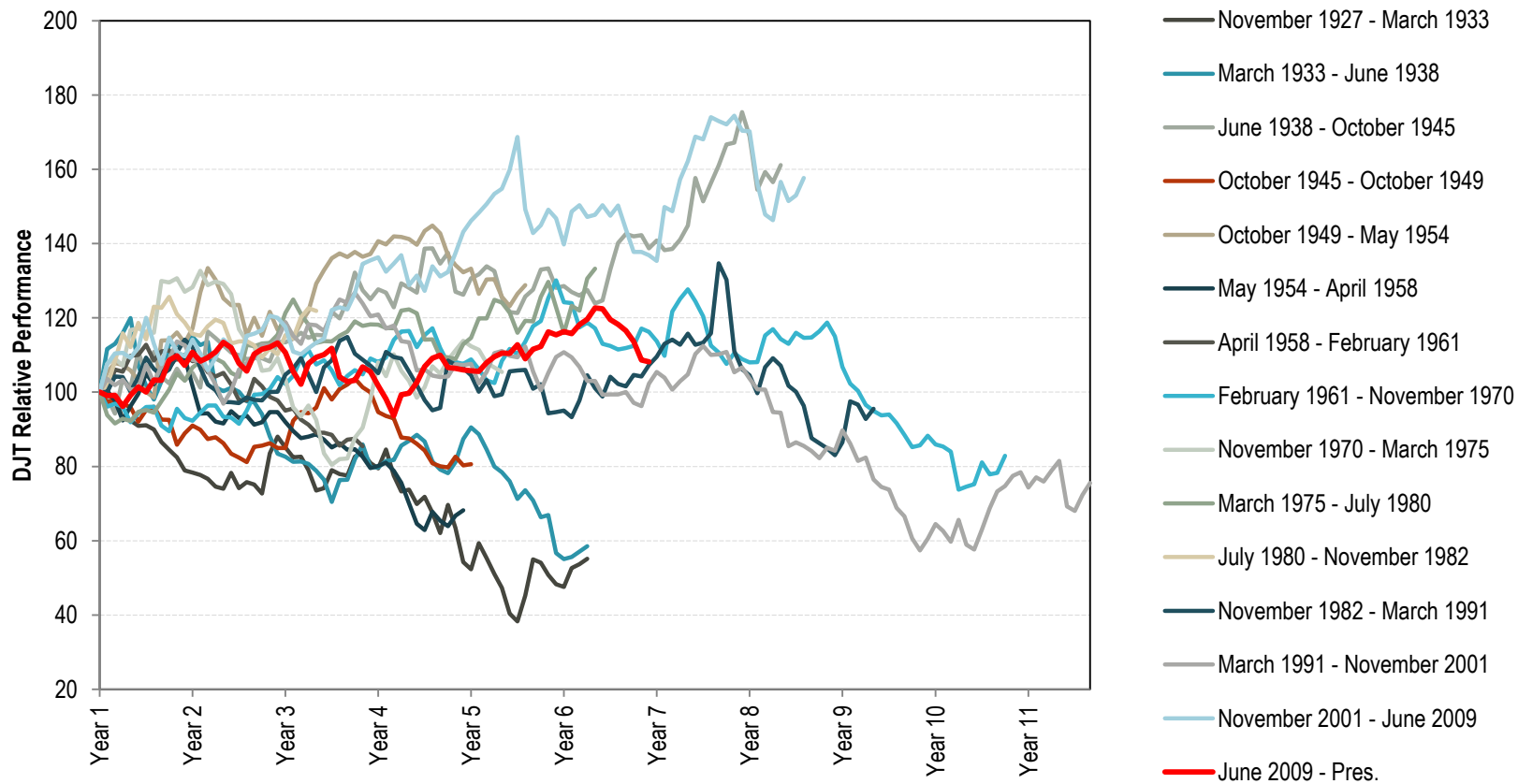
The Net Result: ...And a Pricing Growth “Inflection”



Transport Stock Performance Has Been Bad In 2015 – Does It Mean Anything?



Historically speaking, not really.

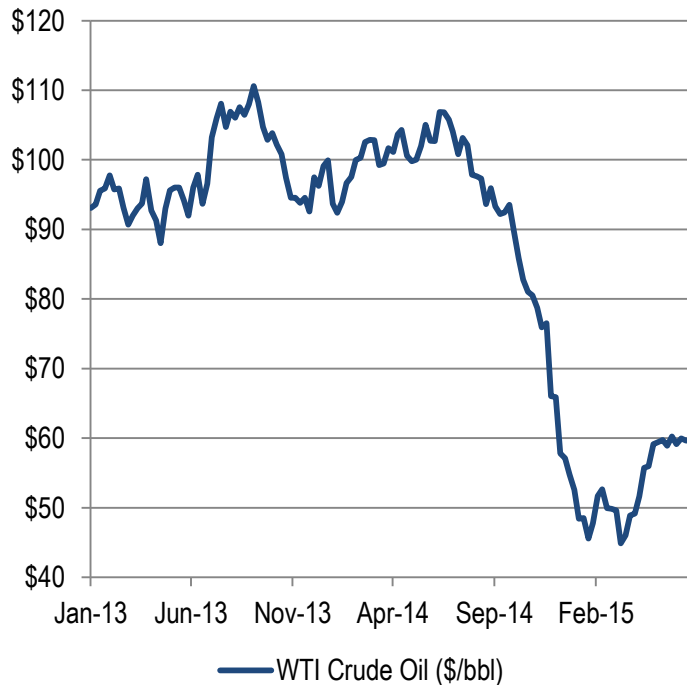


A Quick Look at 2015's Economic Landscape

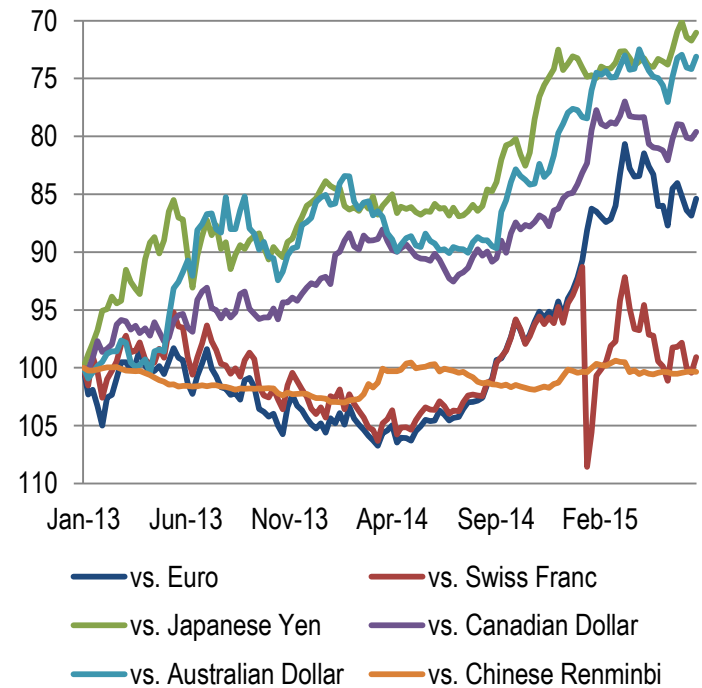


The story has been about two elements:

Crude's Weakness

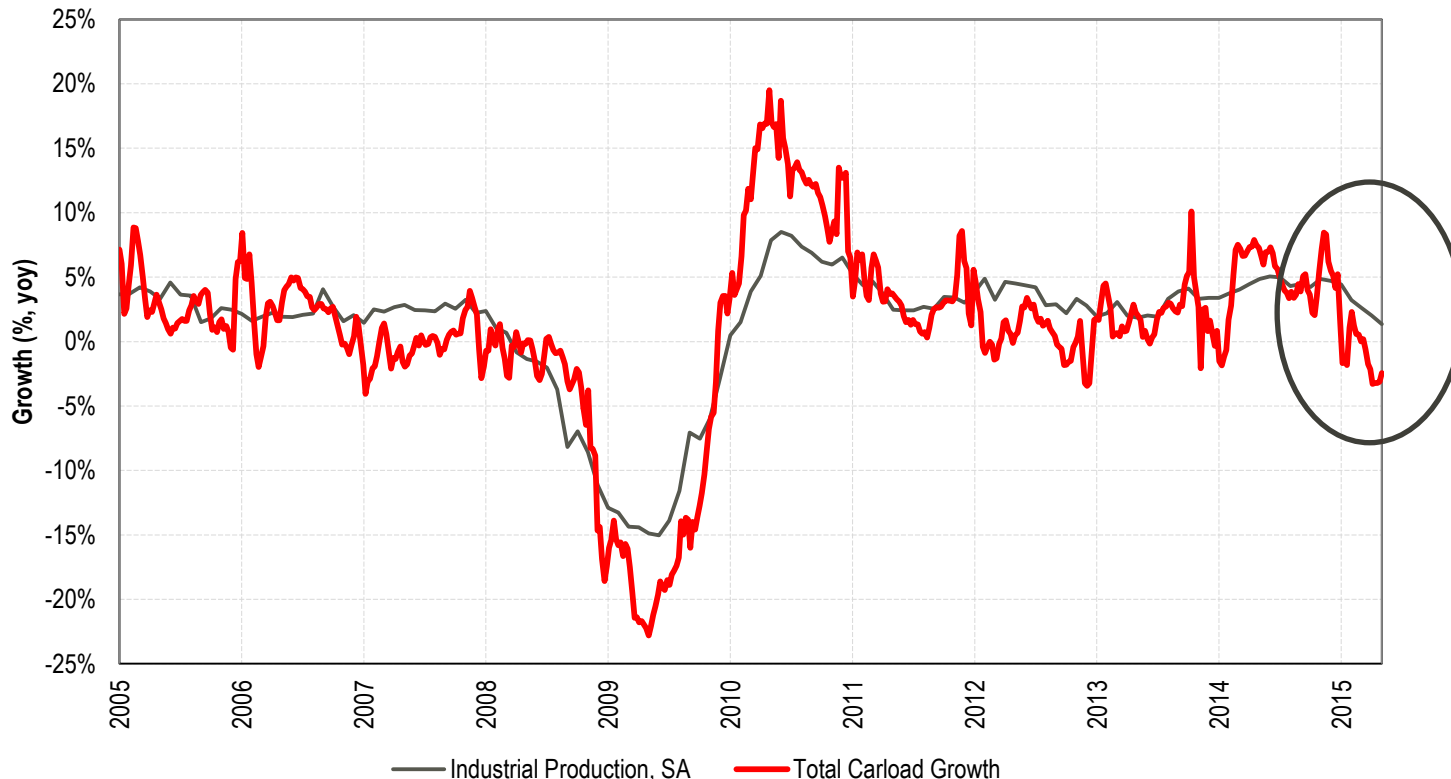


US Dollar's Strength



A Quick Look at 2015's Economic Landscape

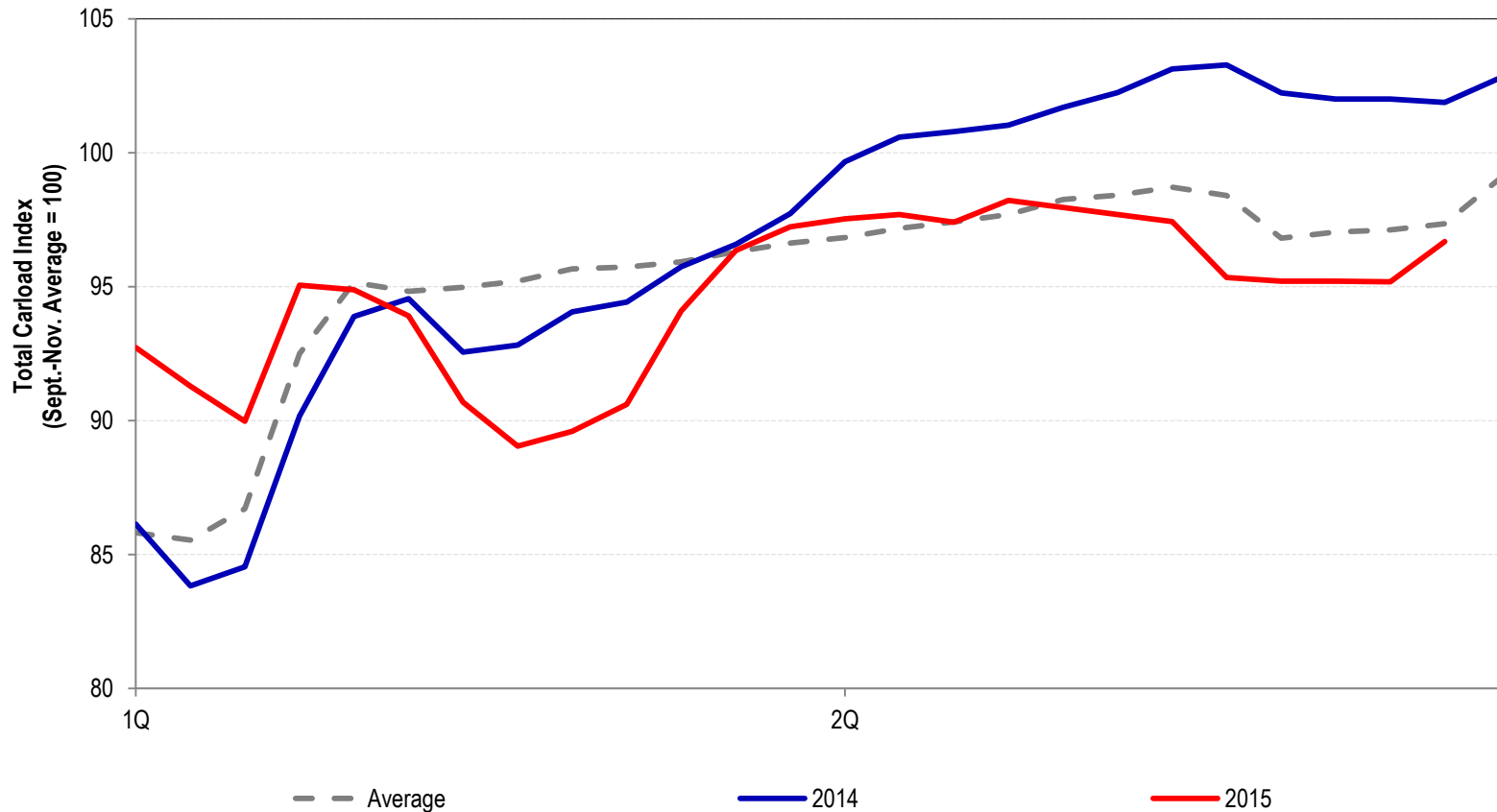
Given crude's weakness and the USD strength, US industrial activity has been weaker than expected to begin 2015, leading to rail volume weakness.



A Quick Look at 2015's Economic Landscape



Overall carloads have been below seasonal during 2015...

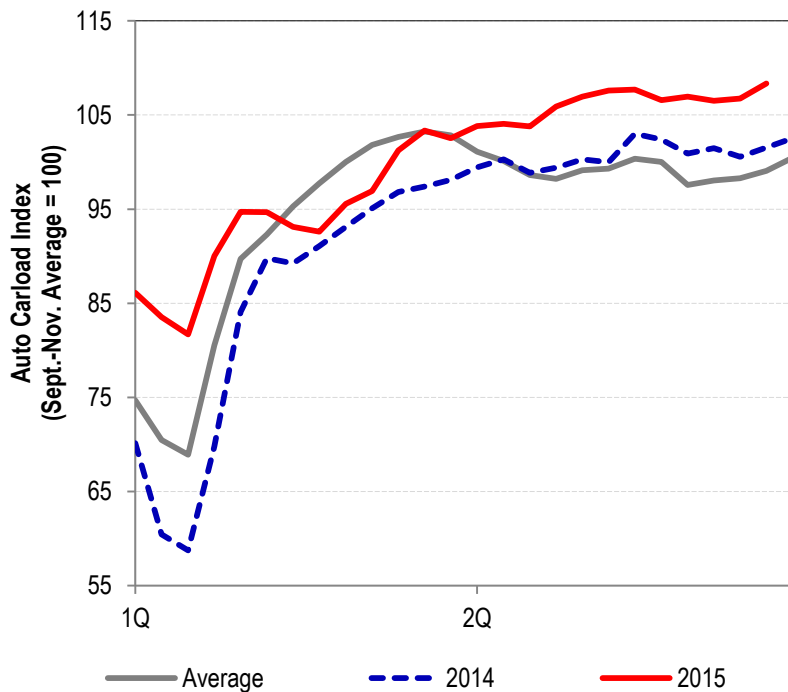


A Quick Look at 2015's Economic Landscape

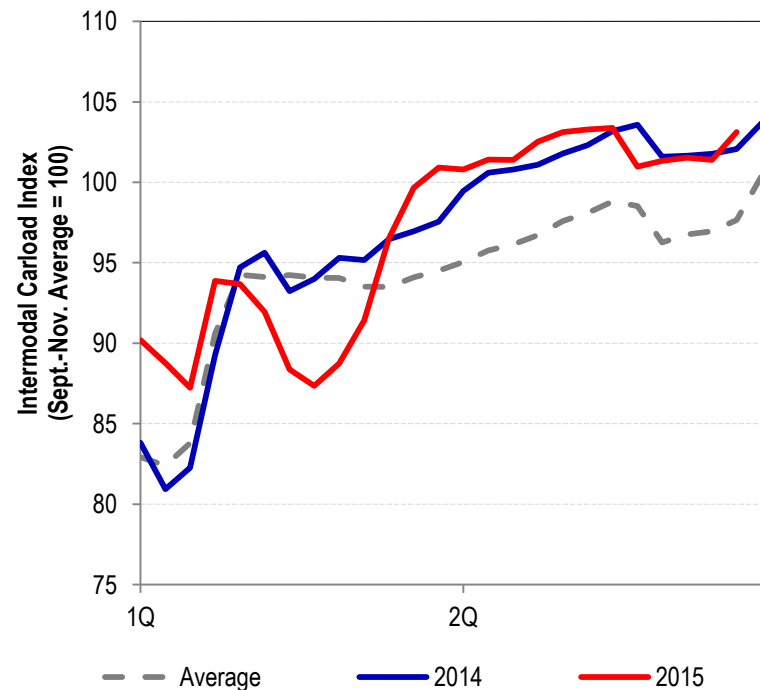


Some bright spots within the commodity types:

Auto



Intermodal

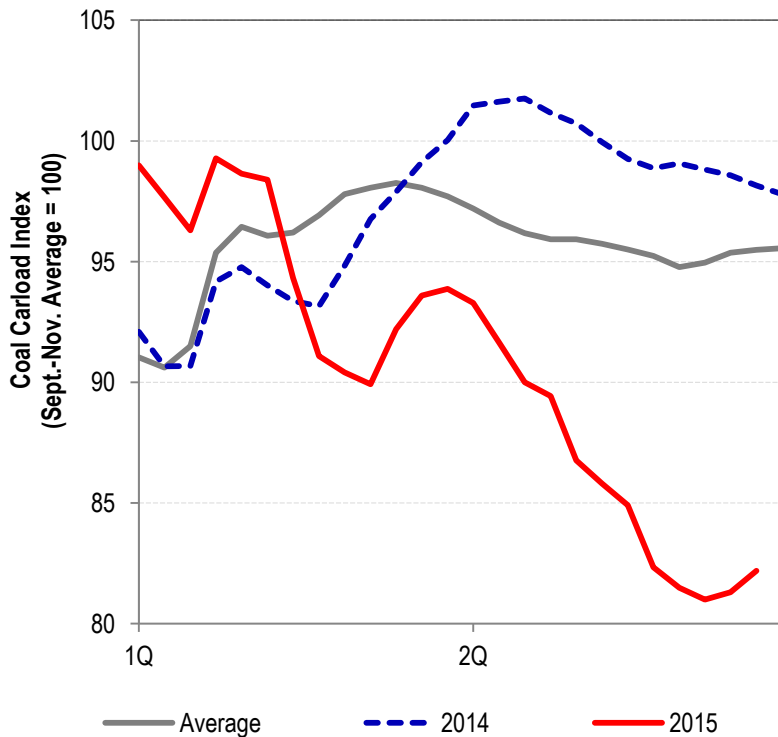


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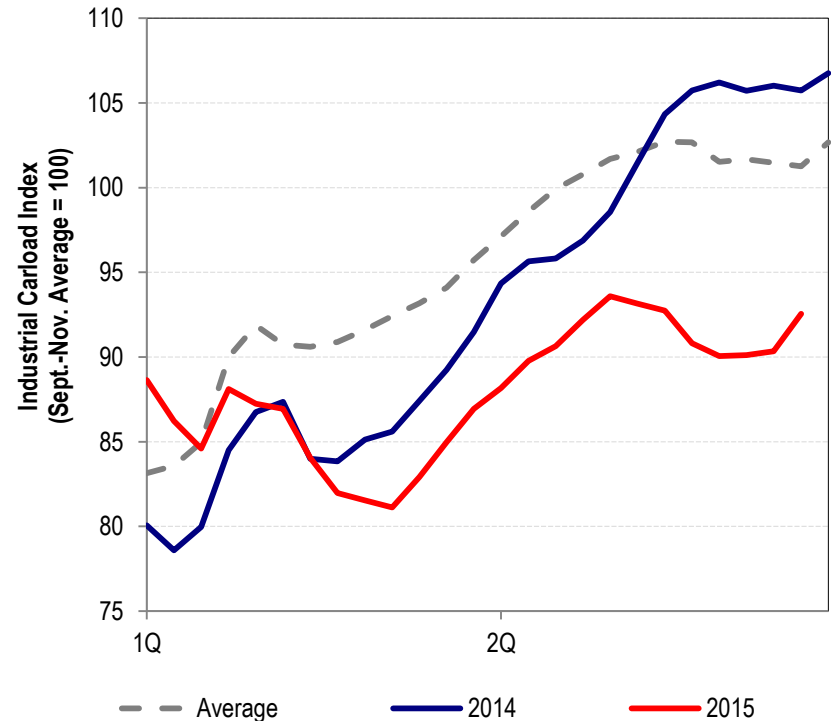


But those have been more than offset by weakness in key commodities:

Coal



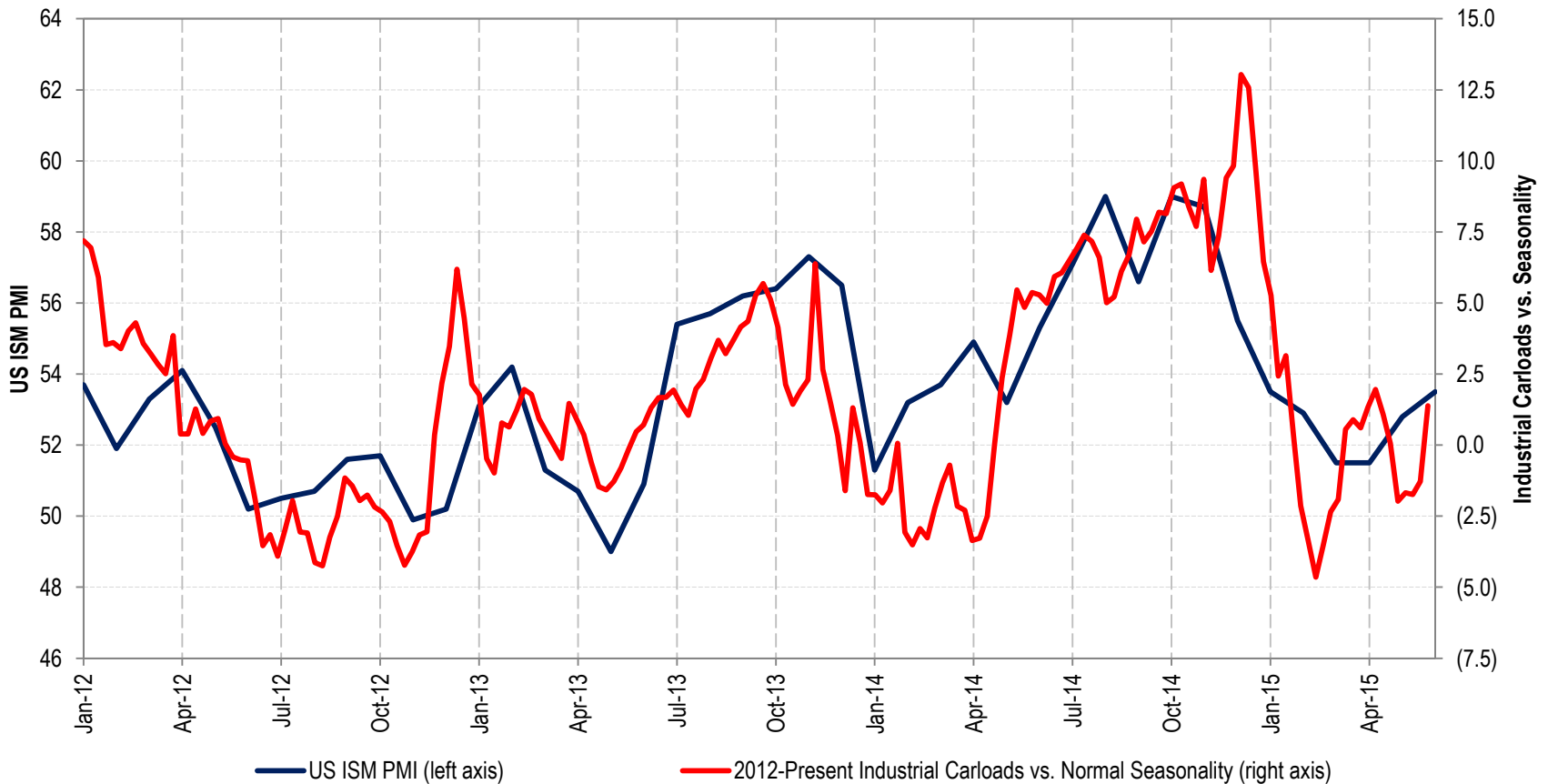
Industrial



A Quick Look at 2015's Economic Landscape

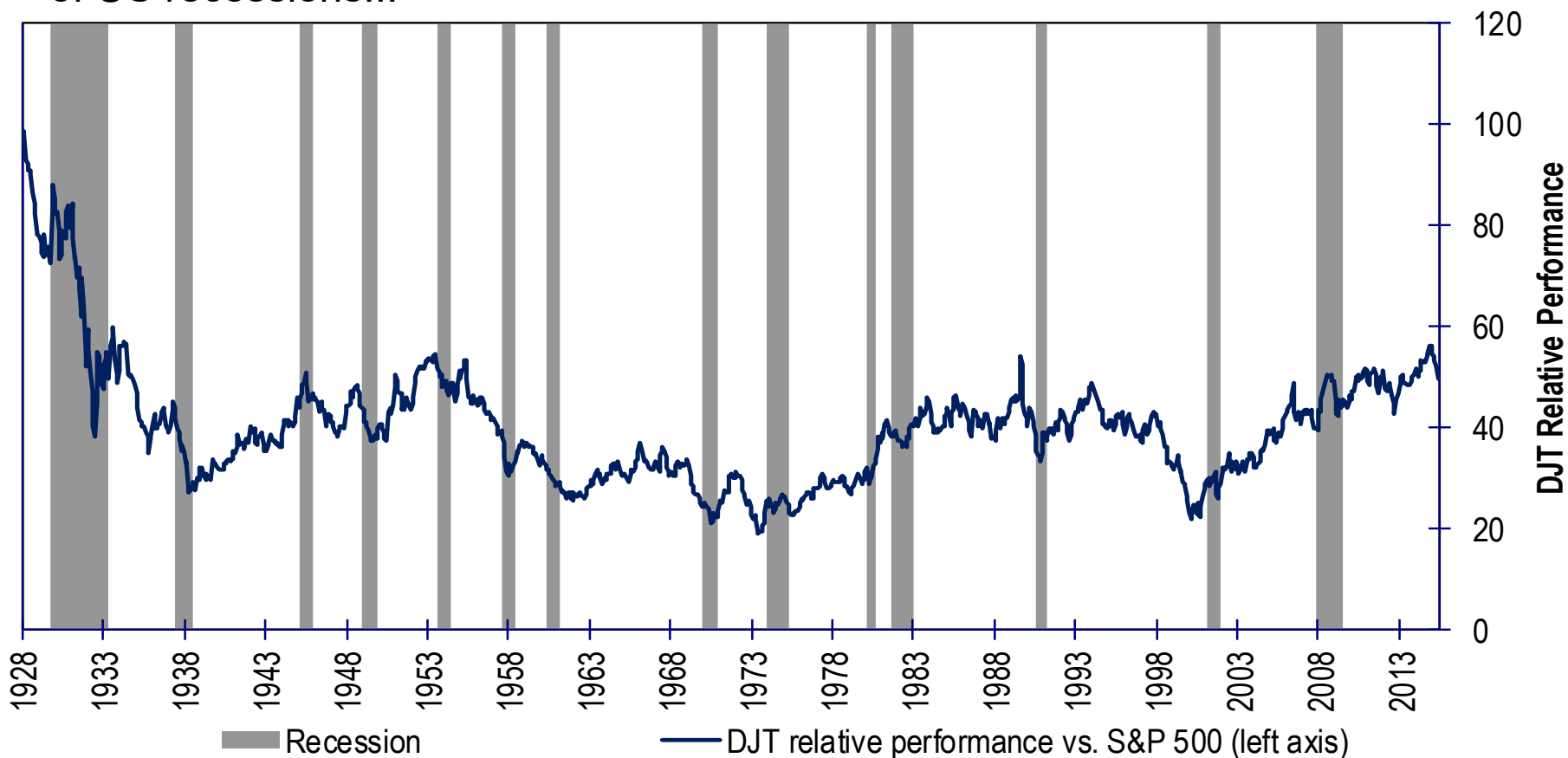


Weak US industrial activity to begin 2015 into lower crude oil prices and a stronger USD has led to below-seasonal industrial rail carload trends in 1H15.



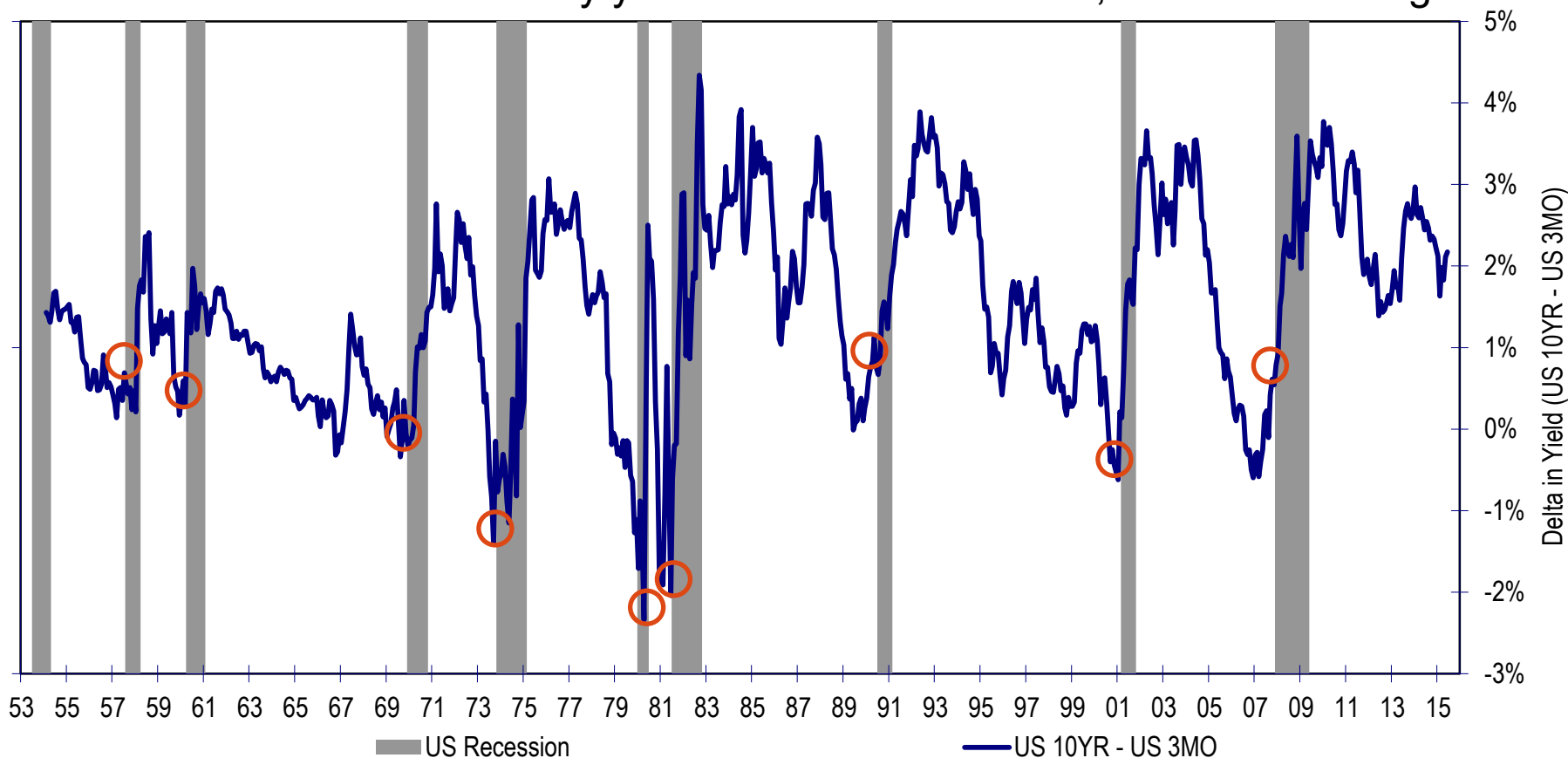
Where Does The US Recovery Go From Here?

While transport stock performance historically has not been a good predictor of US recessions...



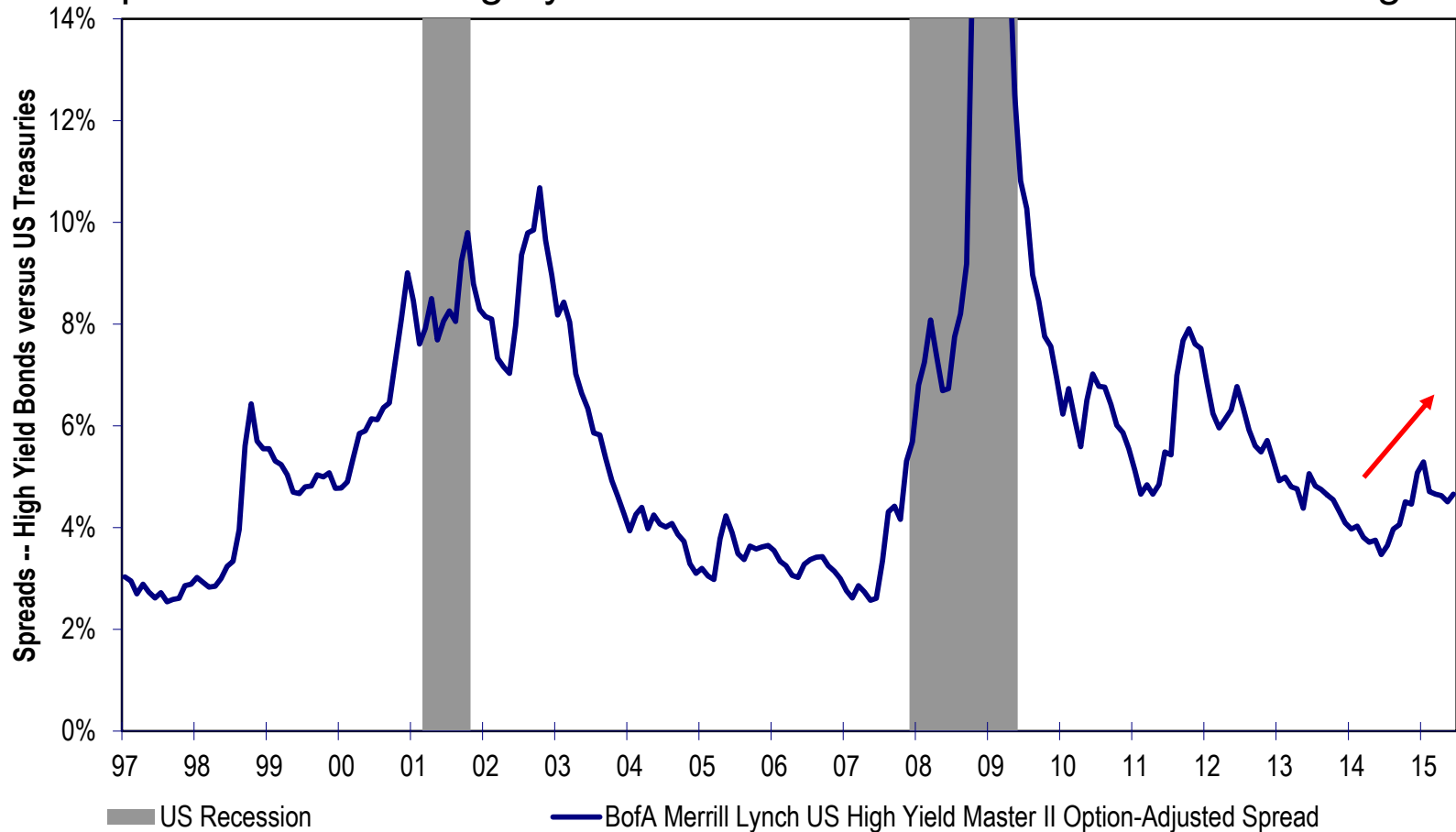
Where Does The US Recovery Go From Here?

...Rising commodity prices and rising yields are better predictors of recessions. The US Treasury yield curve hasn't inverted, but it is flattening...



Yields Need To Be Watched...

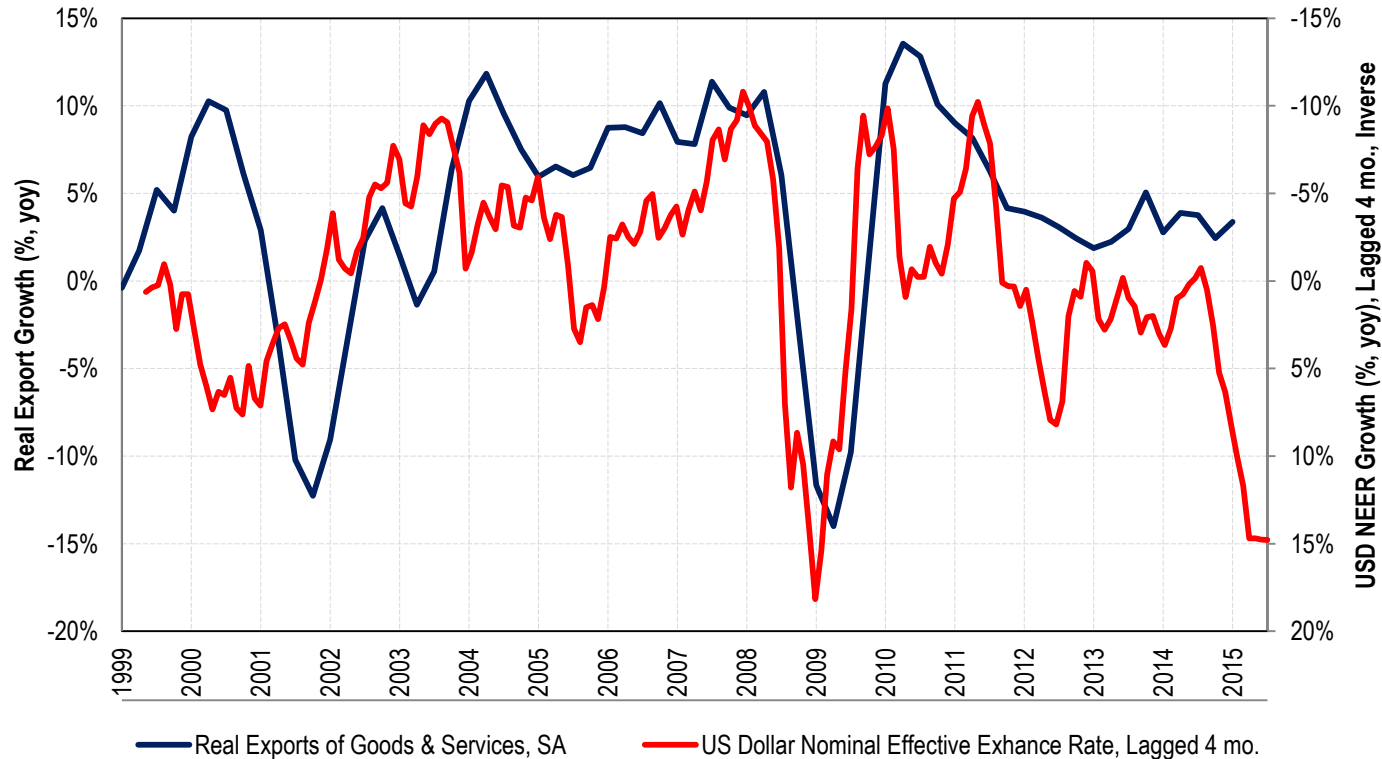
...And spreads between high-yield bonds and US Treasuries are widening.



And A Strong USD Still Presents Risk...



Further weakness/risk in US exports given recent USD strength.



...But There's Room In This Recovery



US Industrial Production trends, since WWII, suggest more room for growth this recovery.

Peak	Trough	Peak-to-Peak Duration (months)	Peak-to-Peak Growth
February-45	October-45	45	-10%
November-48	October-49	56	36%
July-53	May-54	49	11%
August-57	April-58	32	8%
April-60	February-61	116	65%
December-69	November-70	47	18%
November-73	March-75	74	12%
January-80	July-80	18	-1%
July-81	November-82	108	21%
July-90	March-91	128	45%
March-01	November-01	81	11%
Average		69	20%
December-07	June-09	90	5%*

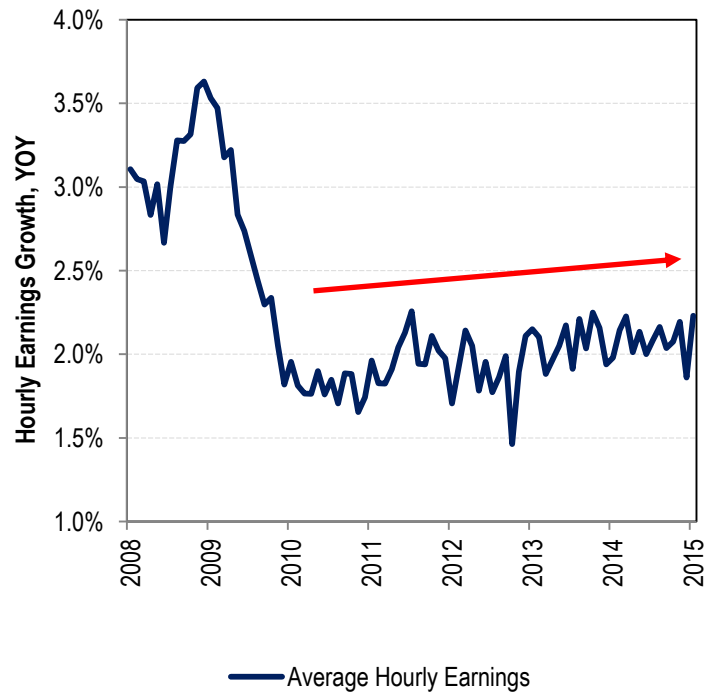
*Through 5/31/15

Hope/Optimism for Consumer-Led, US-Centric Growth in 2015

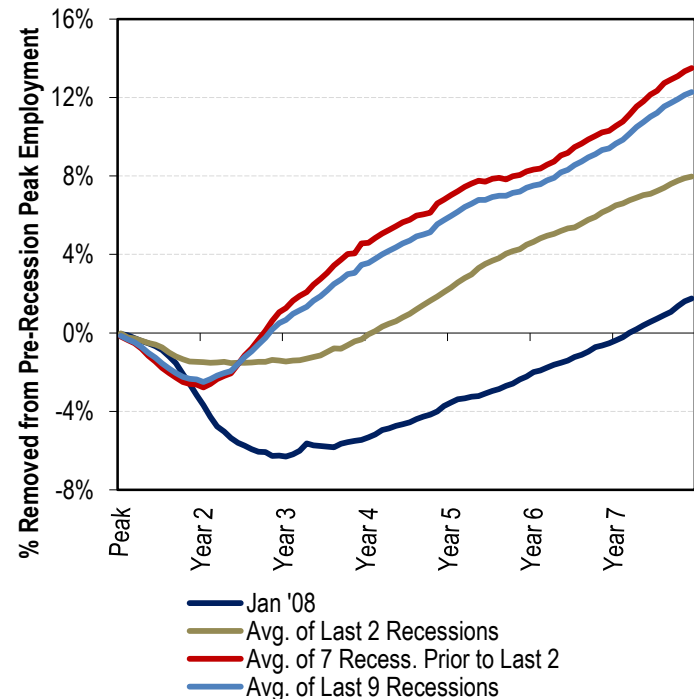


Signs of progress in the US this recovery; watch for accelerating wage growth.

Hourly Wage Growth

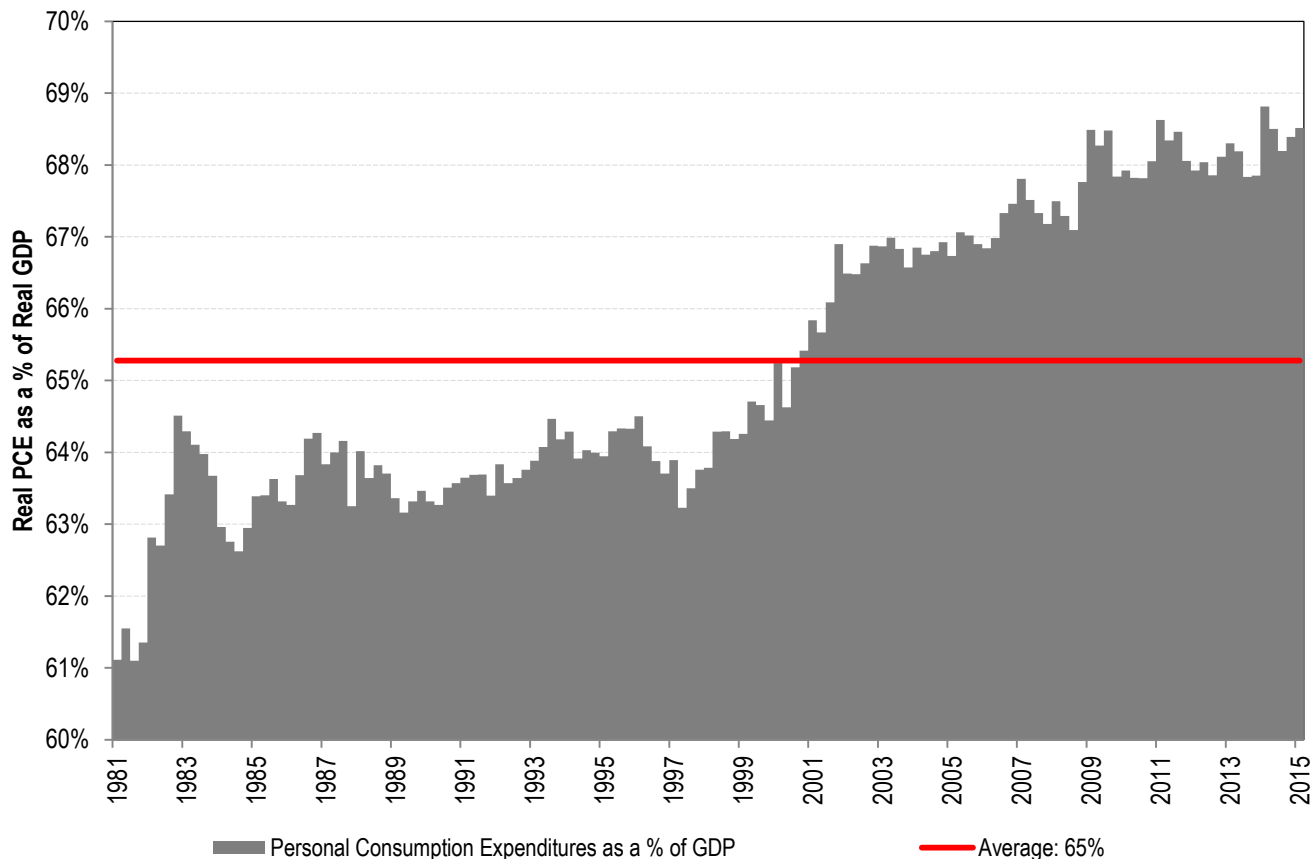


US Employment



Hope/Optimism for Consumer-Led, US-Centric Growth in 2015

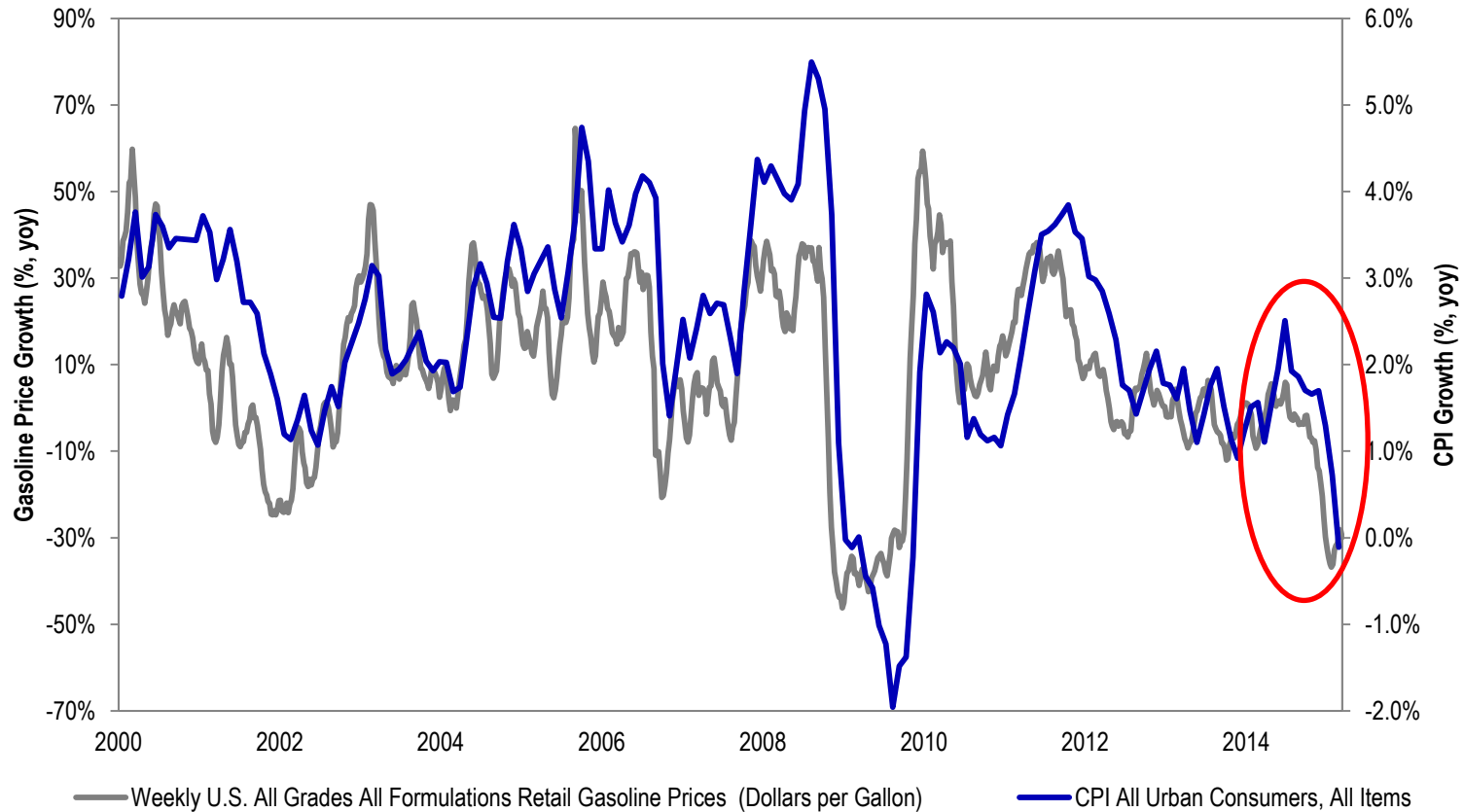
The strength and duration of the US recovery now depends on the consumer.



Hope/Optimism for Consumer-Led, US-Centric Growth



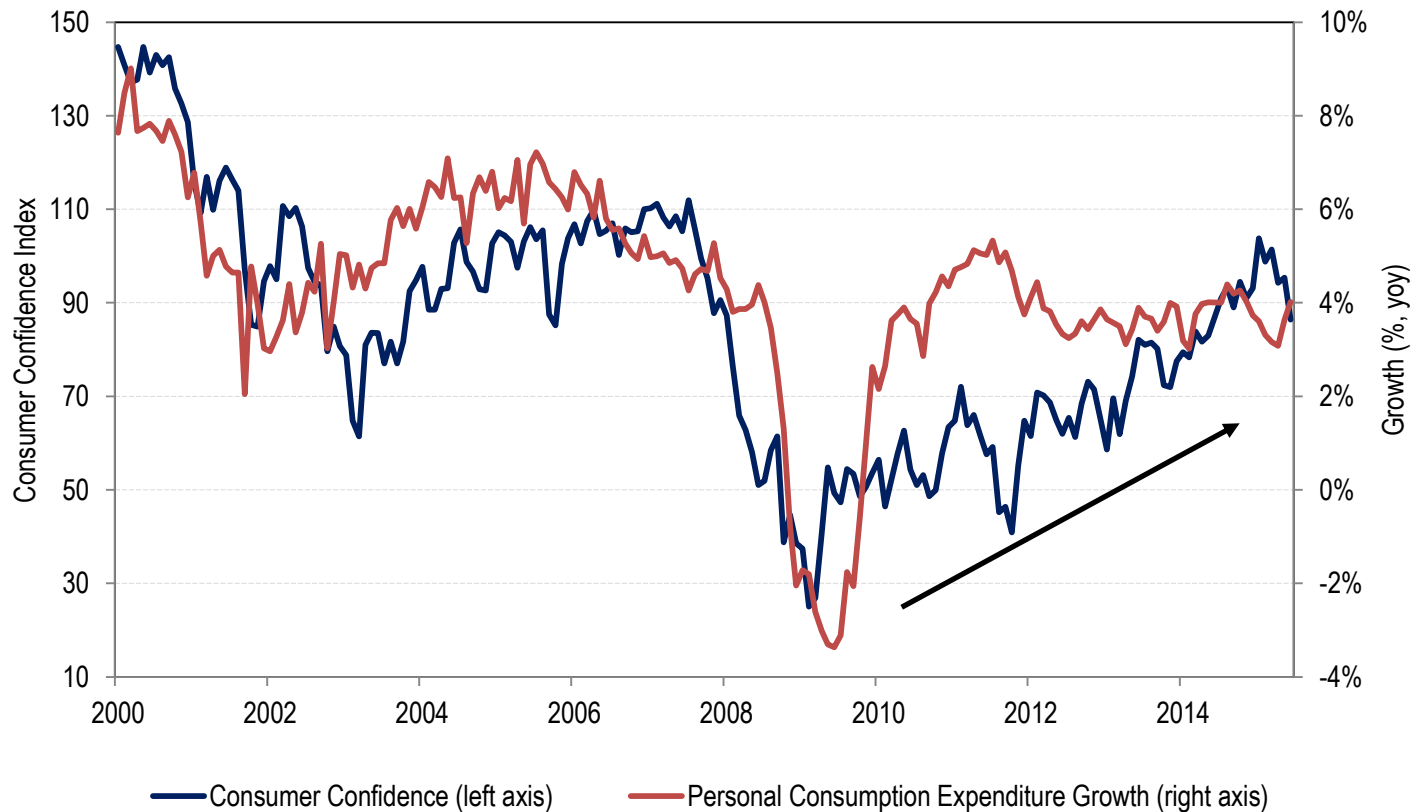
Falling fuel prices no doubt add to disinflationary/deflationary pressures, but they bring positive implications to the consumer...



Hope/Optimism for Consumer-Led, US-Centric Growth

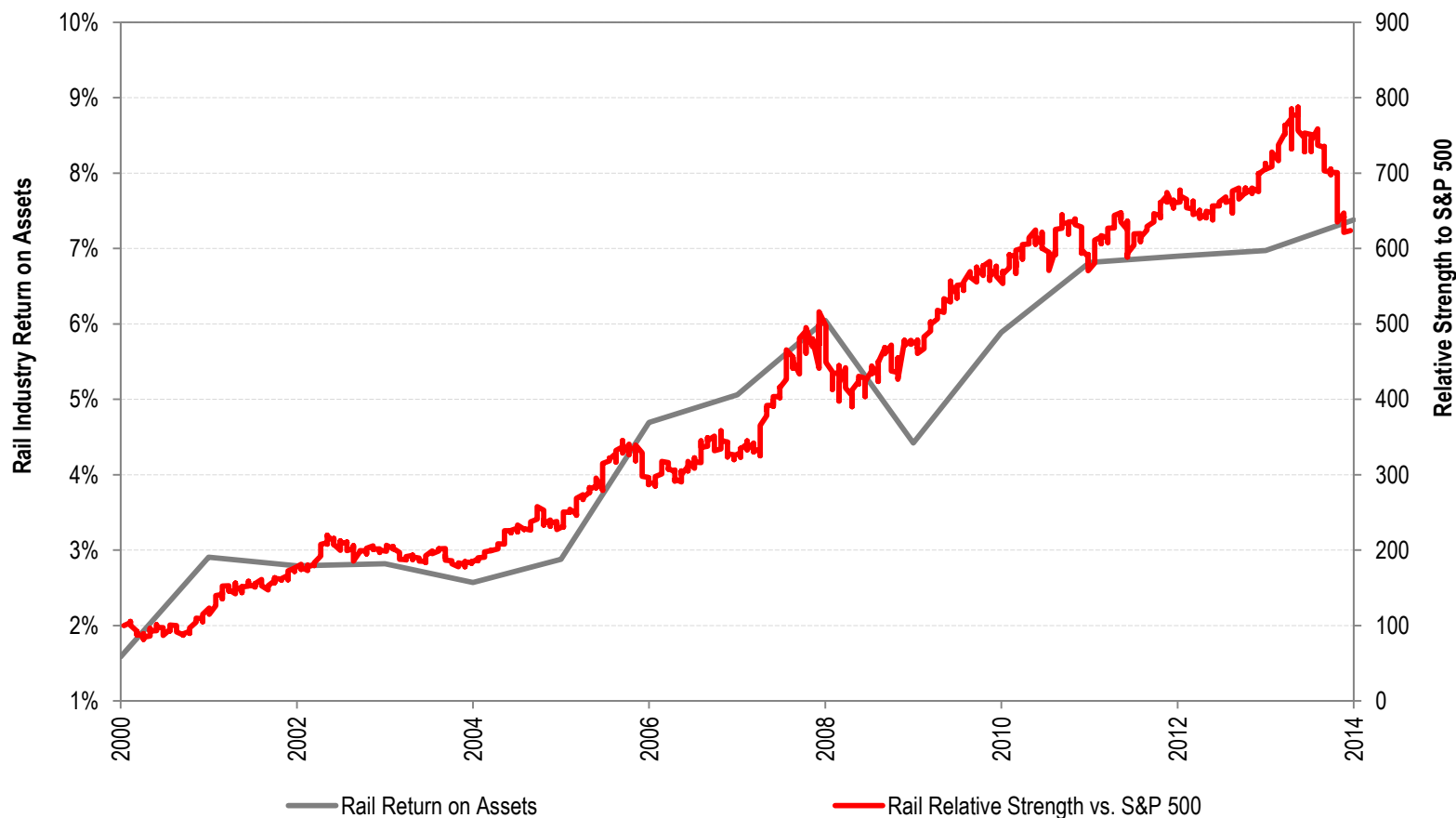


...Supported by both rising consumer confidence and accelerating personal consumption expenditure growth.



For Rails – The Emphasis Is Changing

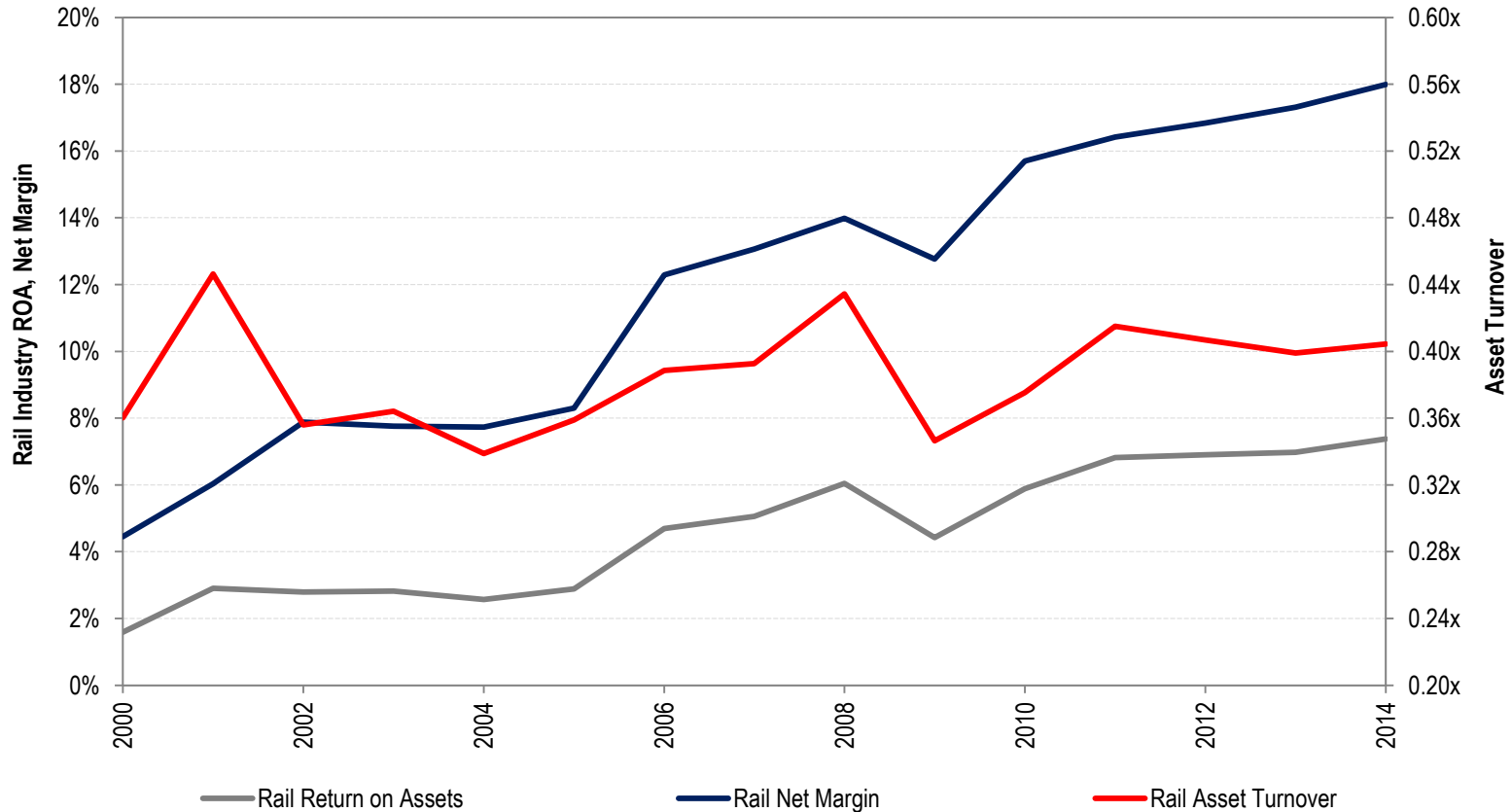
It has been a tough 2015 for rail stocks, but let's keep it in perspective:



For Rails – The Emphasis Is Changing



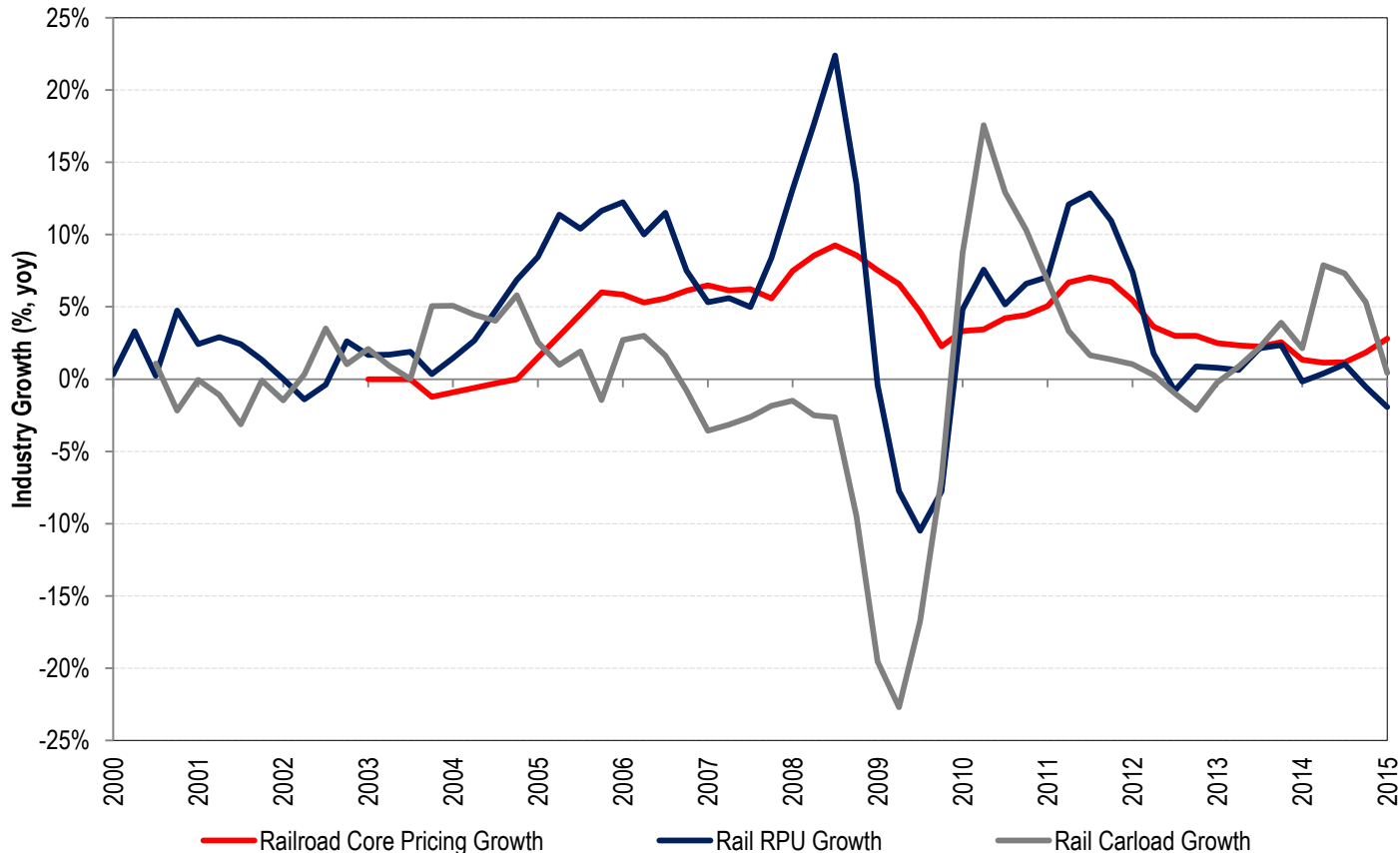
Since 2000, rail industry Return on Asset (ROA) improvement, which has driven the group's relative stock outperformance, has been driven by operating margin gains...



For Rails – The Emphasis Is Changing

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...and the operating margin gains have been driven almost exclusively by strength in core pricing growth, on the heels of the legacy repricing renewals.



10-year CAGRs

Carloads: +0.1%

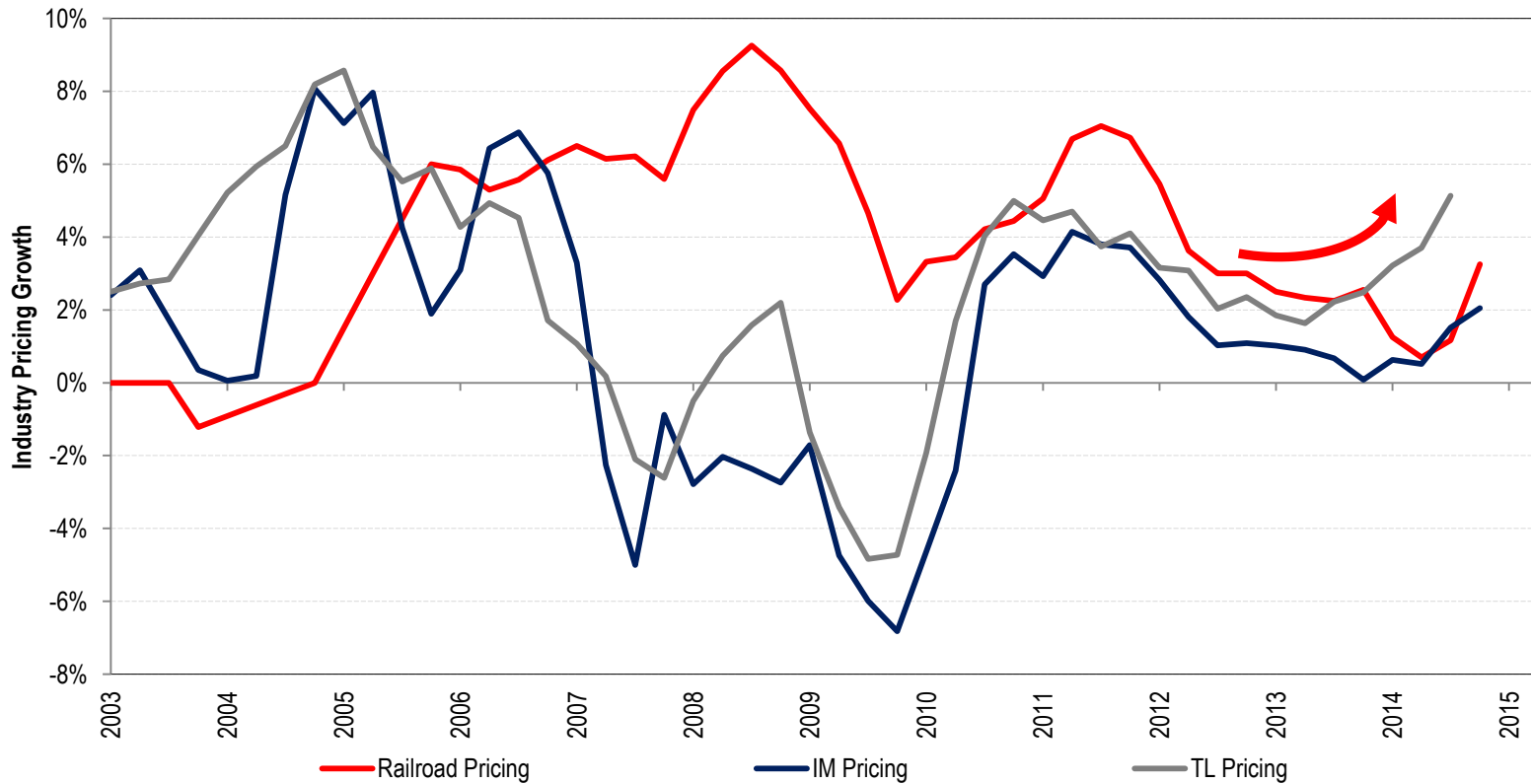
RPU: +5.8%

Core pricing: +5%

Back to 2015's Transportation Industry Fundamentals



After 2014's inflection, we expect "real" pricing growth in 2015, led by Truckload (+5% yoy). But for how long?



Some of 2014's Factors Will Go, but Some Will Stay



We expect “real” pricing growth in 2015, led by Truckload (+5% yoy).
But for how long?

Some factors to 2014's truckload market will go, but two important factors will remain:

1. Regulations
2. Demographics

Both factors, in our view, will lead to higher operating costs in the industry – and promote consolidation among transportation service providers.

Some Easing of Regulations in Early 2015, But Long-Term Productivity Headwinds Are Real

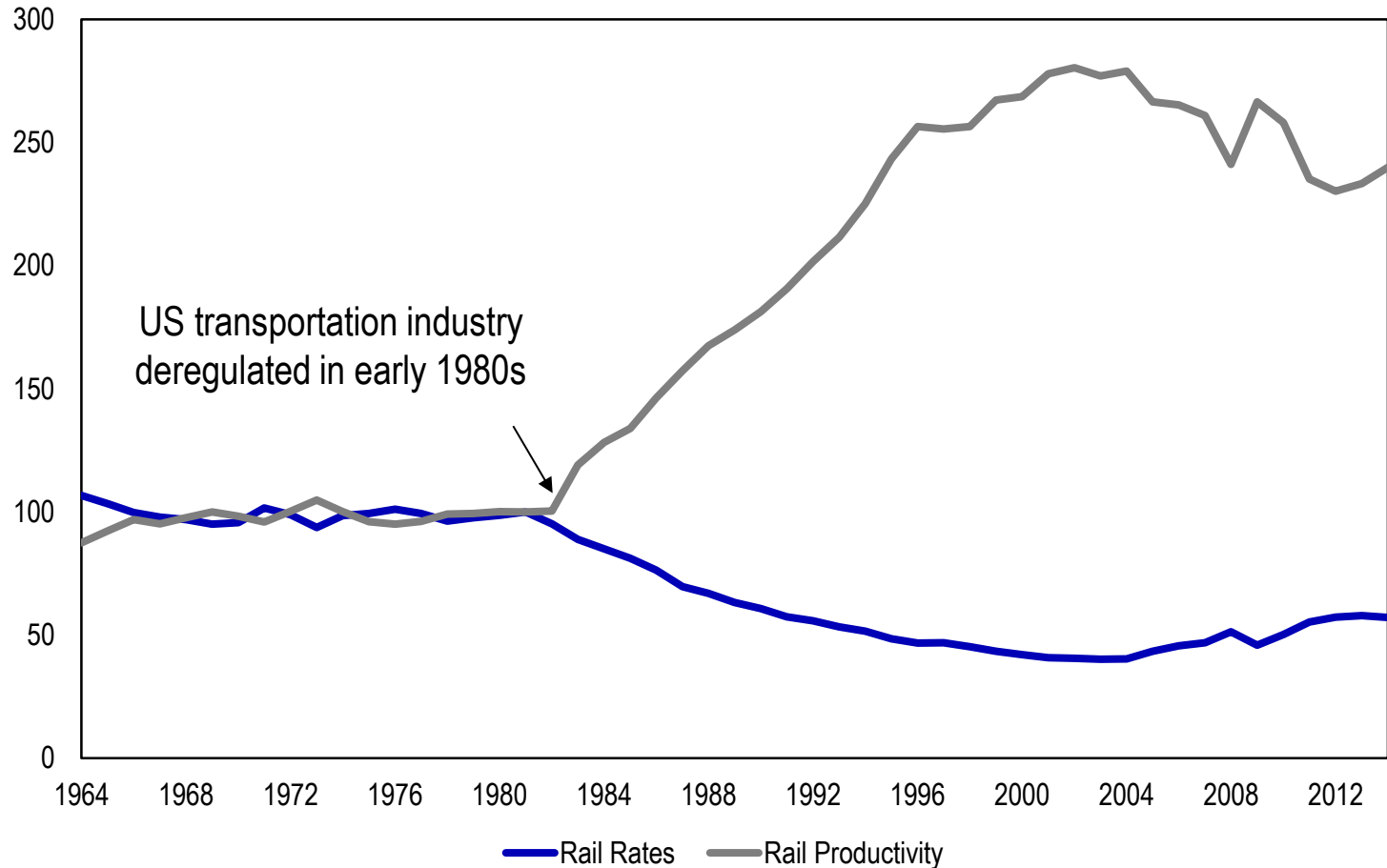
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Two items of note in the FY2015 Omnibus Appropriations Bill

1. July 2013 HOS modifications suspended (~2-4% tailwind to productivity among compliant carriers)
2. Final regulatory action on industry-wide Electronic Logging Device (ELD) adoption by September 30, 2015 (a potential 4-8% headwind to productivity over the next 2-3 years)

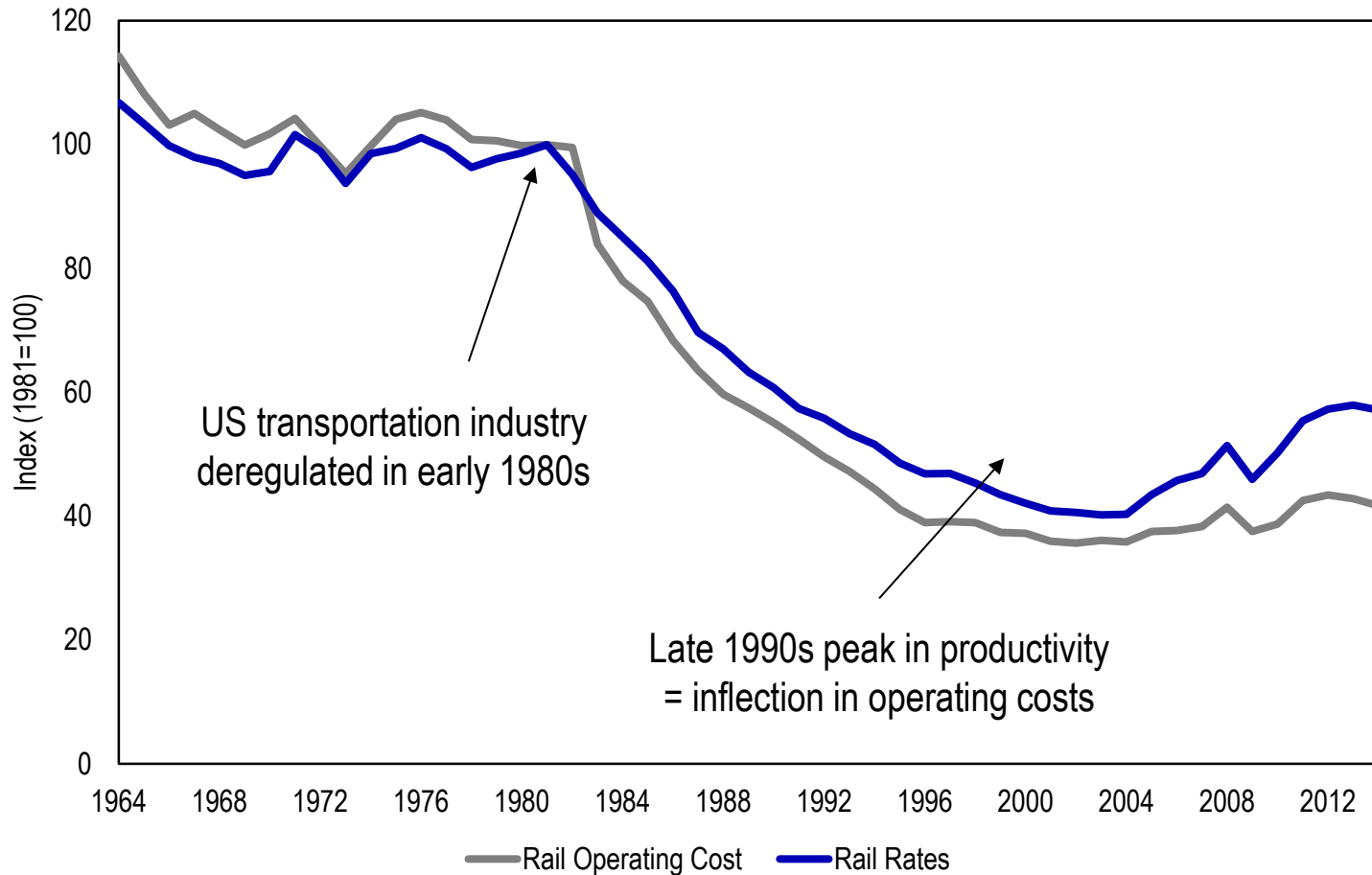
Long-Term Productivity Headwinds Are Real

Rail industry trends since deregulation are instructive for transports broadly.



Long-Term Productivity Headwinds Are Real

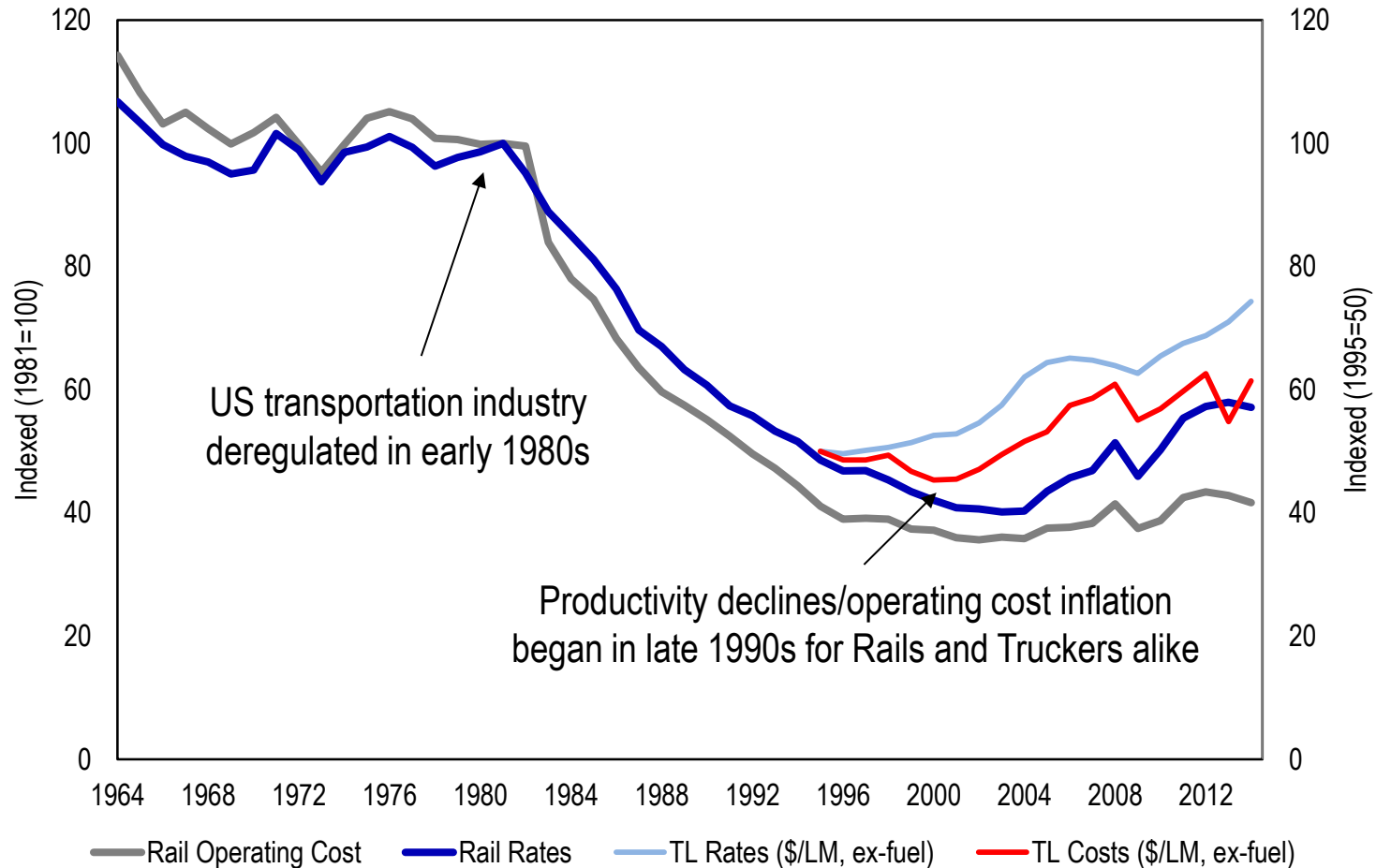
Peak in productivity/trough in operating costs provided basis for real rate gains.



Long-Term Productivity Headwinds Are Real



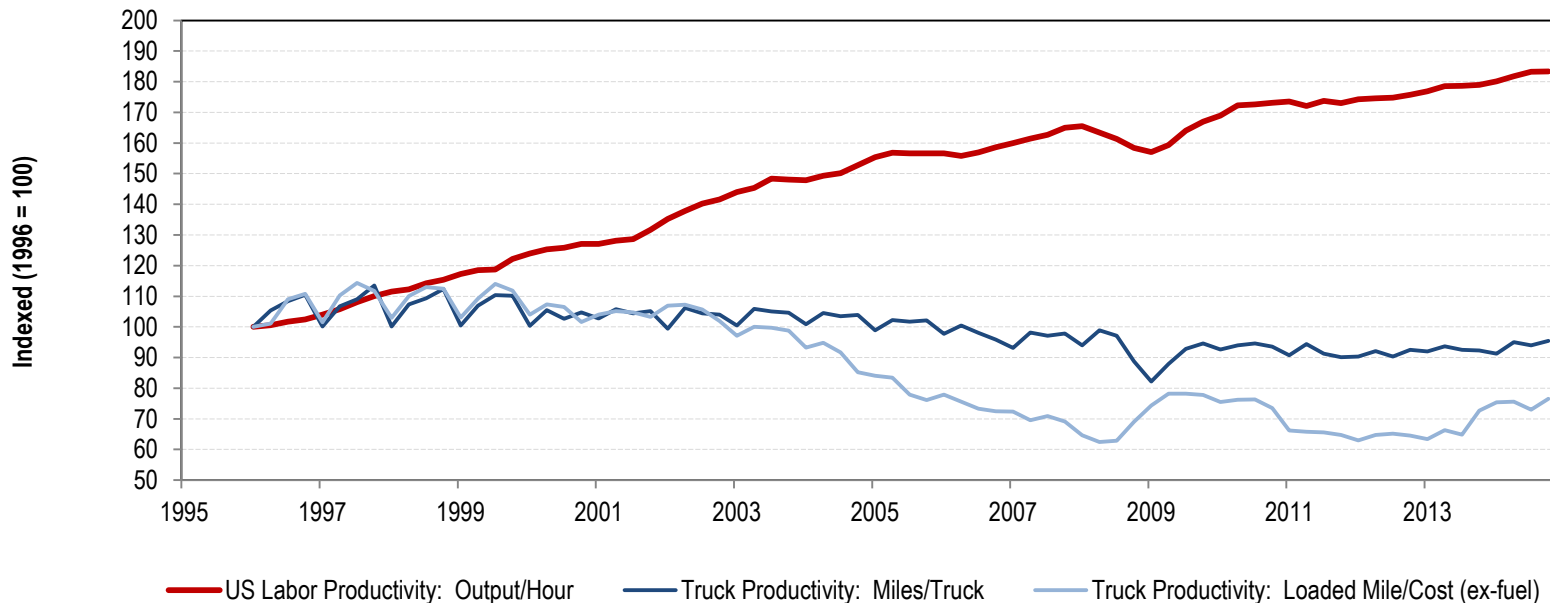
Trucking has followed a similar trend line since the mid-1990s.



Some Easing of **Regulations** in Early 2015, But L-T Productivity Headwinds Are Real

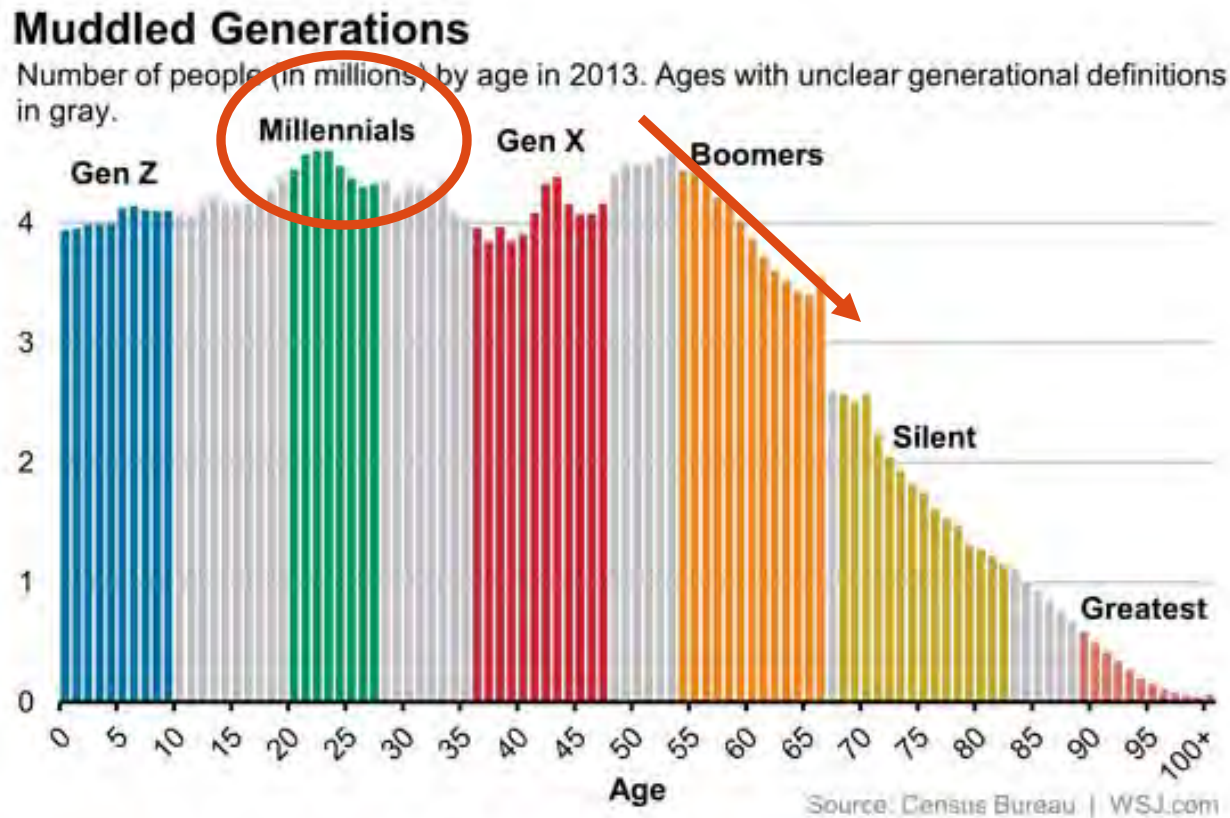
Since 2003, large public truckload carriers' fleet **productivity has fallen ~5%** due to the cumulative effect of various drivers' hours-of-service regulations.

Over the same period, **US labor productivity has risen ~27%**.



Shifting US Demographics Affect Both Growth & Supply Chain Strategies

“2015 is the year of the millennial customer” -- Forbes



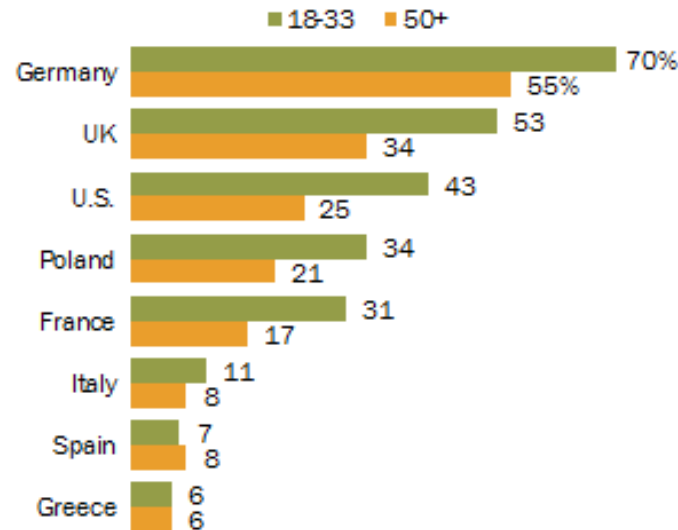
Shifting US Demographics Affect Both Growth & Supply Chain Strategies



Millennials' outlooks differ from Baby Boomers', too.

Millennials More Satisfied than Their Elders with Country Direction

Satisfied with the way things are going in our country today



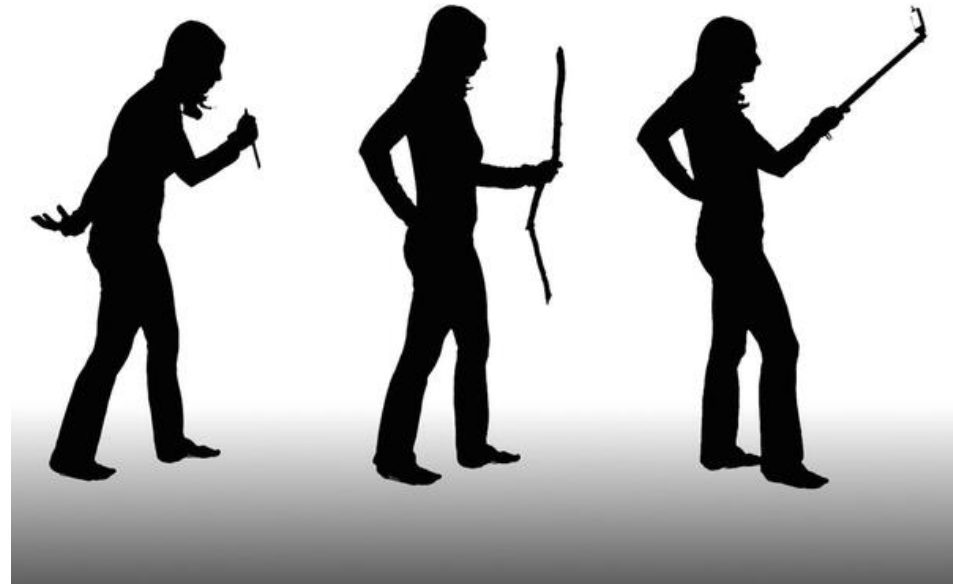
Source: Spring 2014 Global Attitudes survey.

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What We're Not Discussing: Millennials' Clothing...



...Or Other Forms of Self Expression



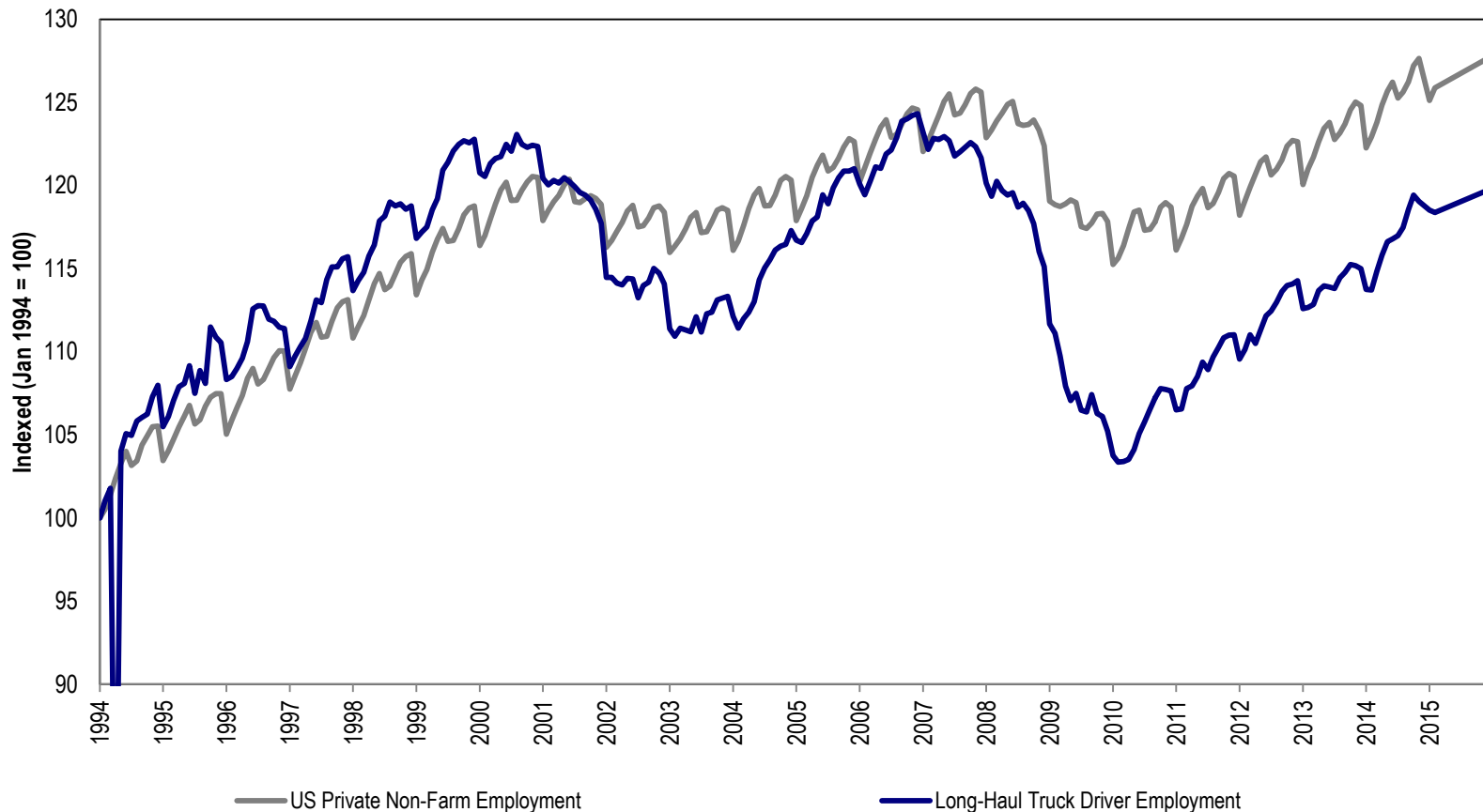
The Original Selfie?



Rates Need to Rise in Order to Address The **Demographic Issue**

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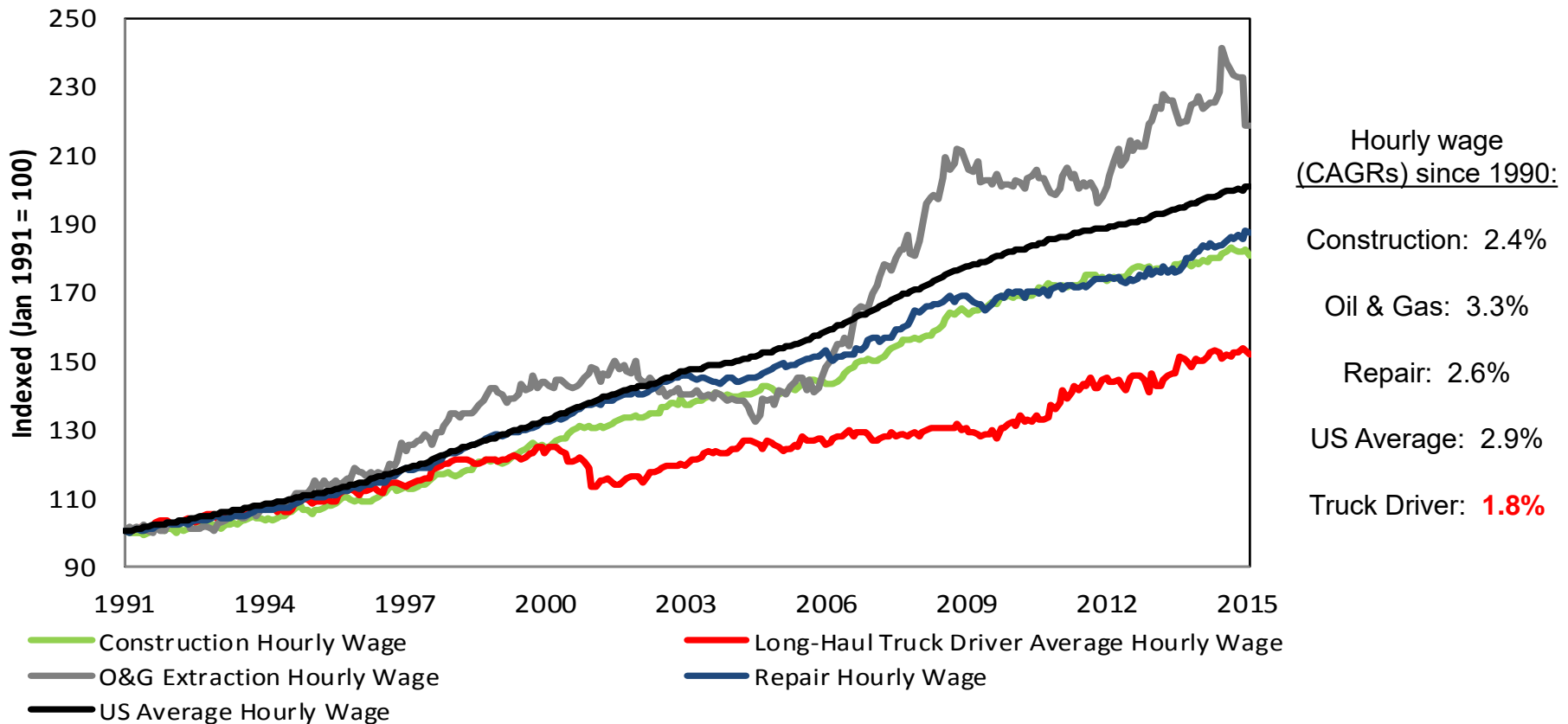
Since 2000, long-haul truck driver employment has **fallen ~2%**, while US private non-farm employment has **risen ~8%**.



Rates Need to Rise in Order to Address The **Demographic Issue**

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Truck driving wage growth has lagged competing jobs and broader US labor wage growth over the past 25 years.



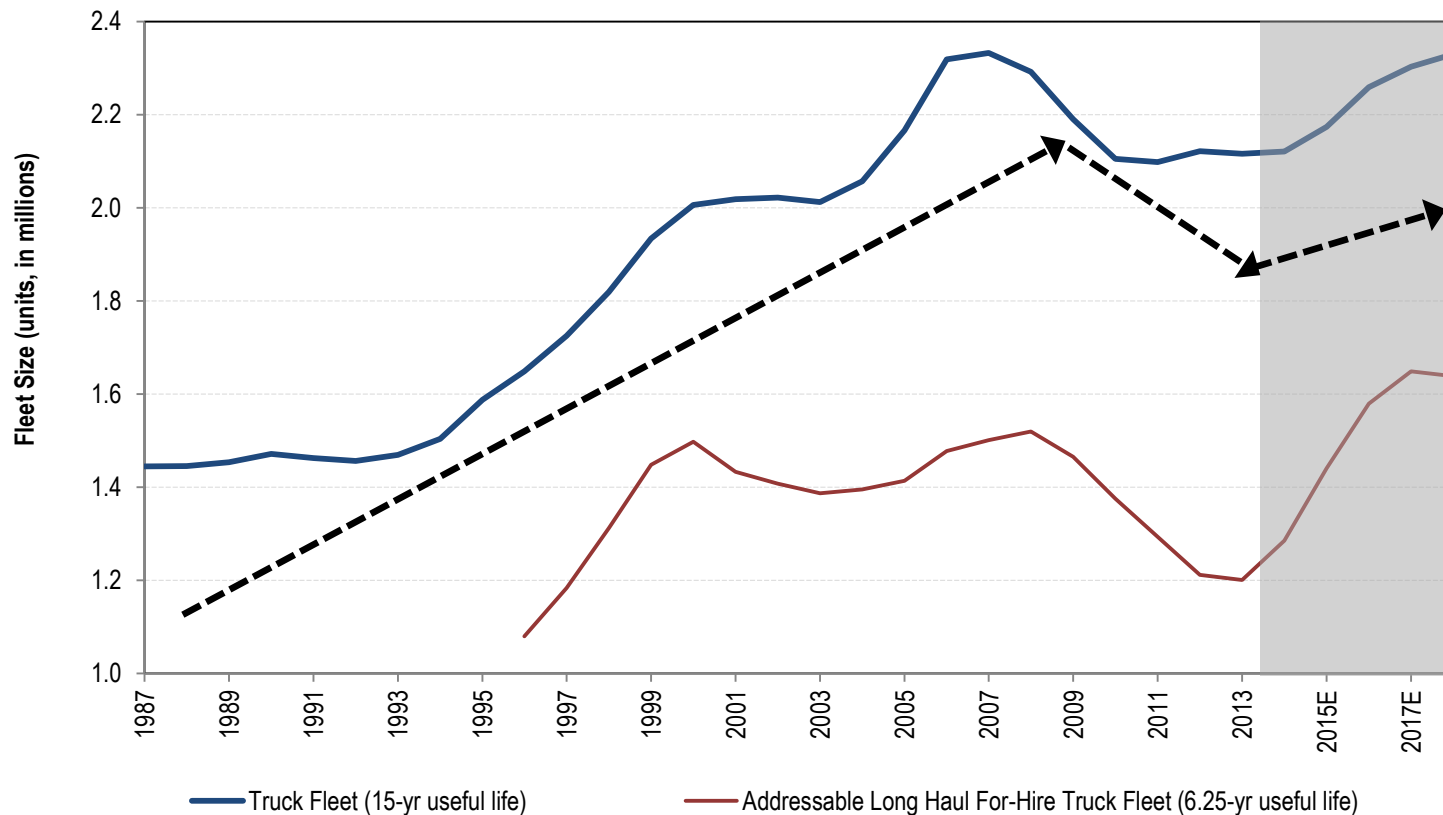
In the Interim, Freight Rates Are Likely To Continue to Rise

Given these two important factors (**regulations** and **demographics**), we expect to see:

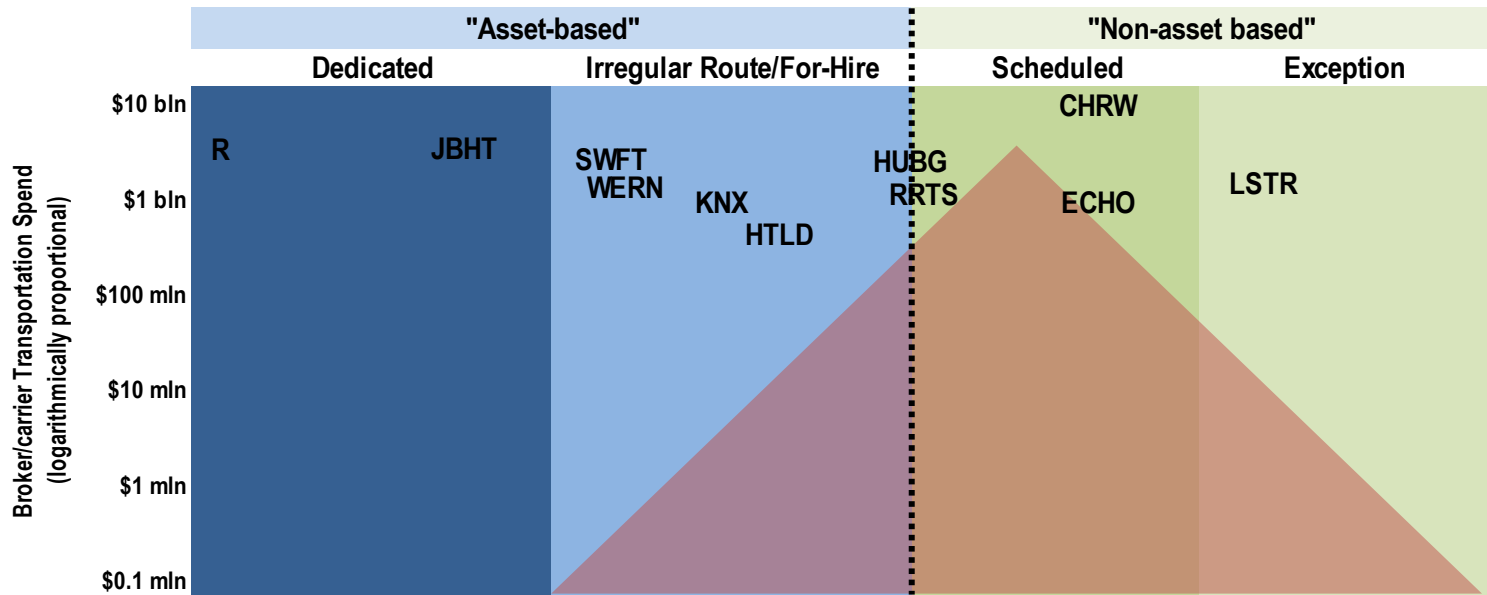
- Upward bias to US surface transportation rates
- Slower consumption/volume growth
- Continued consolidation among carriers and brokers
- Greater concentration of freight into key international gateways

Who Is Going to Invest in Capacity?

Small and medium-sized carriers still comprise 80-90% of the truckload industry fleet, and shoulder the burden of regulatory and demographic changes.



In Our View, Carriers and Brokers with Scale



	Dedicated	Irregular Route/For-Hire	Scheduled	Exception
Dynamics this cycle	<p>*Pressures to shippers operating private fleets (rising equipment costs, capital scarcity, driver regulations) leading to elevated inquiries about outsourcing management to dedicated fleet operators</p>	<p>*Core carrier concept among shippers highlights credible concerns about access to reliable capacity</p> <p>*Carriers with scale strategically positioned to protect margins and expand service offering</p> <p>*Small carriers/individual owner-operators facing numerous headwinds, limiting</p>	<p>*Pressures to small carriers/owner-operators (~80% of TL market) limit available capacity base</p> <p>*Coupled with slower end-market growth and increasing competition, expect gross margin pressure for brokers lacking</p>	<p>*Constraints to capacity base similarly pressures gross margins</p> <p>*But, brokers filling need (exception/emergency freight) or niche (specialized equipment) in position to deliver value, particularly among small/medium-</p>

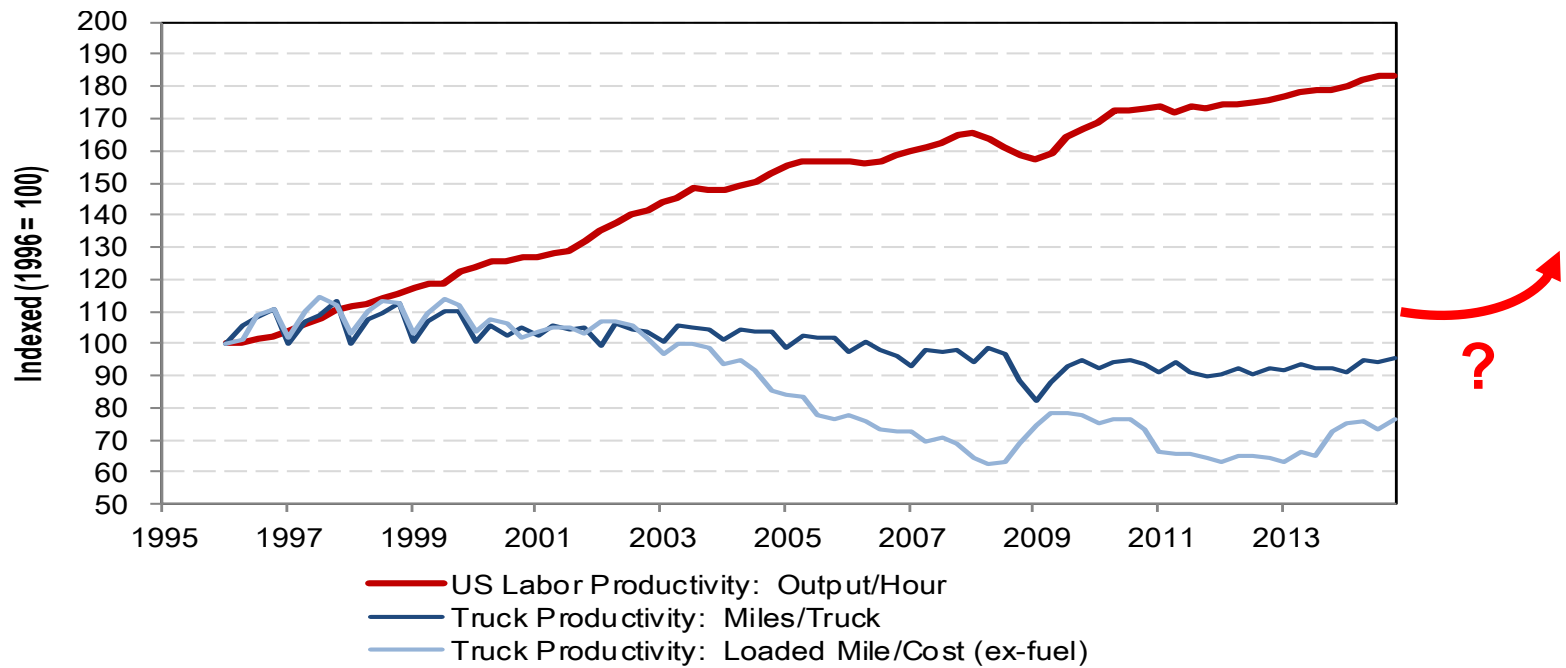
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 - Regulations (supply headwind)
 - Demographics (supply headwind)
 - Technology (supply tailwind)

How Do Models React? “Bend the Curve”

ELD Math: $80\% * 10\% = 8\%$ potential incremental capacity reduction

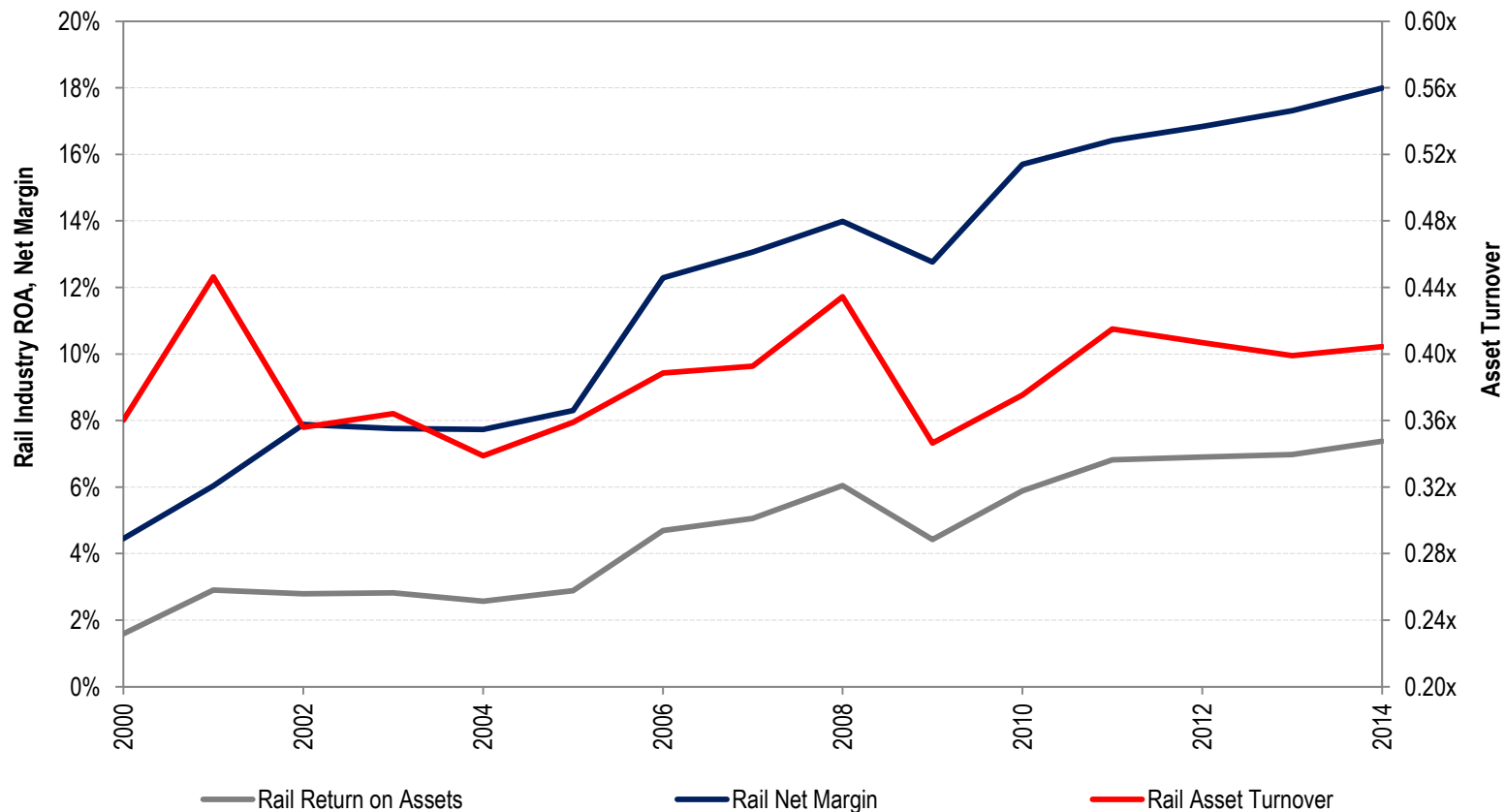
We believe opportunity is presented this cycle to models that can “bend the curve” into the regulatory and demographic constraints. Models (carriers and brokers alike) with robust IT platforms can benefit from “network effect” economies of scale and expected industry consolidation.



Technology Should Enable Further Rail ROA Improvement As Well



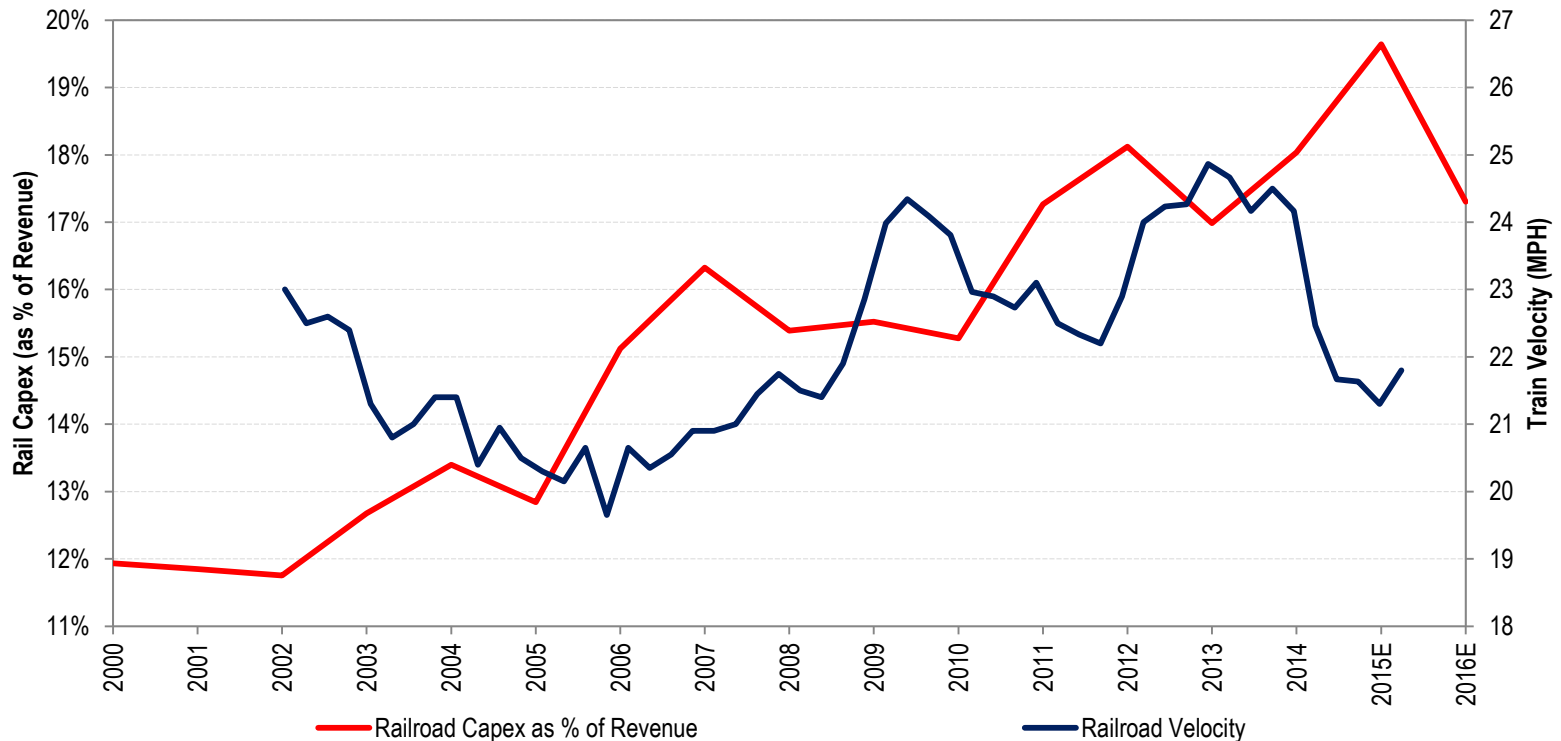
Improvement in asset turnover needed this cycle to drive rail ROA higher.



Technology Should Enable Further Rail ROA Improvement As Well



Rail velocity has improved over the past decade into increased rail investments. 2014-15's experience has been a setback, but continued improvements are required to drive asset productivity and ROA higher.



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