Industry Update

Canada Truck Transportation

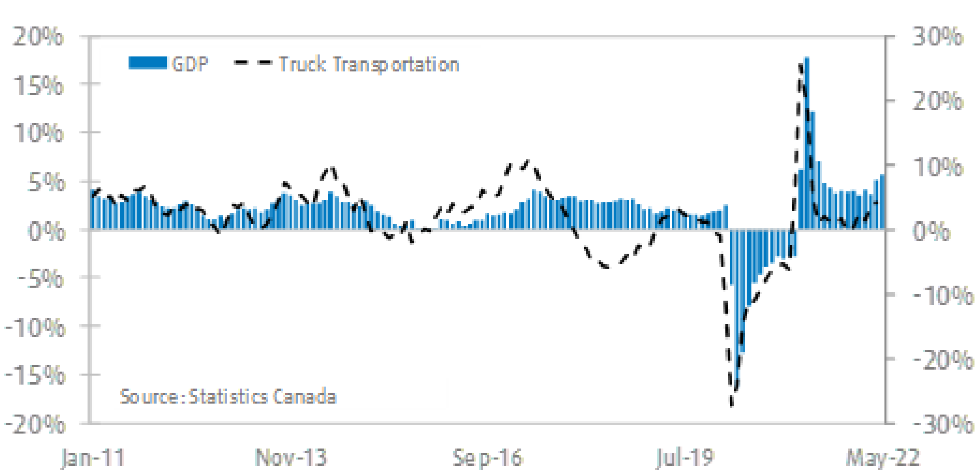
Key Developments

- Following several postponements, the **Canadian Council of Motor Transport Administrators** confirmed full enforcement of the electronic logging device (ELD) mandate starting January 1st, 2023. In addition to Canadian operators, the ELD directive covers U.S. motor carriers operating across the northern border.
- Data from a recent mid-year report by **Ritchie Brothers** shows that used truck price inflation in Canada continues to decelerate. Average year-over-year used tractor transaction prices during the 2nd quarter were up 31% compared to an average increase of 50% during the 1st quarter. Similarly, year-over-year used prices of vocational trucks decelerated from 30% in the 1st quarter to 14% during the 2nd quarter.
- According to **ACT Research**, natural gas-powered truck sales in the U.S. and Canada rose 11% year-to-date through May. However, ACT noted that most announcements for planned infrastructure investments supporting alternatively powered trucks remain focused on electrification.
- Be sure to check out the latest perspectives from BMO economists on the Canadian macro outlook (page 6).

Industry Fundamentals

While Canada's resource-rich economy held up remarkably well during the first half of the year, softening commodity prices, a slowing U.S. economy, and the Bank of Canada's aggressive rate hike campaign will have a gravitational pull on macro and freight trends during the 2nd half of 2022 and into 2023. The Canadian spot freight market, albeit with a several-month lag, has begun to parallel slackening conditions in the U.S., with demand declining and capacity gradually increasing. Historically low unemployment and sticky wage growth, retreating Covid protocols, improving supply chains, healthy consumer and corporate balance sheets, and pent-up demand should blunt most downside scenarios. Nonetheless, freight headwinds will be stubbornly persistent until the BoC and Fed pivot from a myopic focus on inflation.

Canada Monthly GDP Y/Y Growth (Seasonally Adjusted)



Canadian real GDP was flat in May (+5.6% y/y annualized), a better-than-expected outcome than the flash estimate of a 0.2% drop. Notably, StatCan's preliminary estimate for June shows the economy delivering a modest 0.1% gain. But even with the relatively listless May/June performance, the early estimate for all of Q2 growth was a solid 1.1% gain, or roughly 4.5% annualized, which is ahead of the estimates from BMO and the Bank of Canada for the quarter (both were 4.0%).

While well off the pandemic bottom and more than 4.0% above year-earlier levels, **truck transportation** sector activity remains 2.8% below where it was just before the pandemic in February 2020.

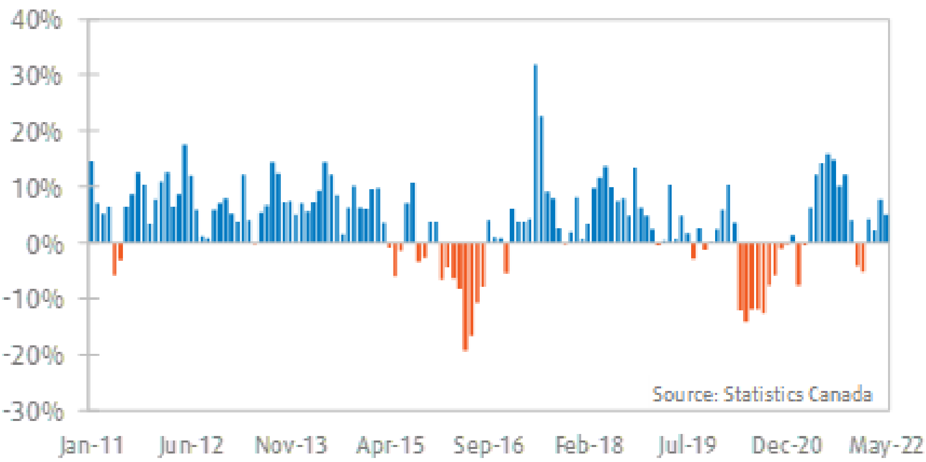
Trucking Business Influencers

Canada Weekly Diesel Fuel Retail Price (Cents/Liter)

Since peaking at an all-time high in June, **Retail Diesel fuel prices** across Canada have been on an unrelenting downtrend. As of early August, the average weekly Diesel price of 178 cents/liter was down 51 cents (-22%) from the recent peak but still up 15 cents (+9%) since the invasion of Ukraine and 45 cents (+34%) over the past year.

Despite a recent plunge in energy and most other commodity prices, the current BMO outlook suggests that crude prices will remain elevated (WTI averaging $105 US$/bbl in 2022 and $95 in 2023) for the foreseeable future as increasing demand for non-Russia crude is only partially offset by slowing global macro growth and a modest amount of new supply creeping into the market.

Canada Crude Oil Production Y/Y % Change



Canadian drilling is largely seasonal as rigs are prevented from moving to new drilling sites in the Spring, partly because the ground is thawing, making access by heavy equipment difficult. In an average year, the rig count will fall 85-90% from its peak in the winter to its minimum in April and May. Nonetheless, a +4.9% increase in **crude oil production** during May represented the fourth consecutive month of year-over-year gains.

Longer-term, beyond the current global supply constraints, the big questions for crude oil production will be how the demand curve evolves due to climate change policies and the trend toward ESG-based investment evaluation and fossil fuel divestments.

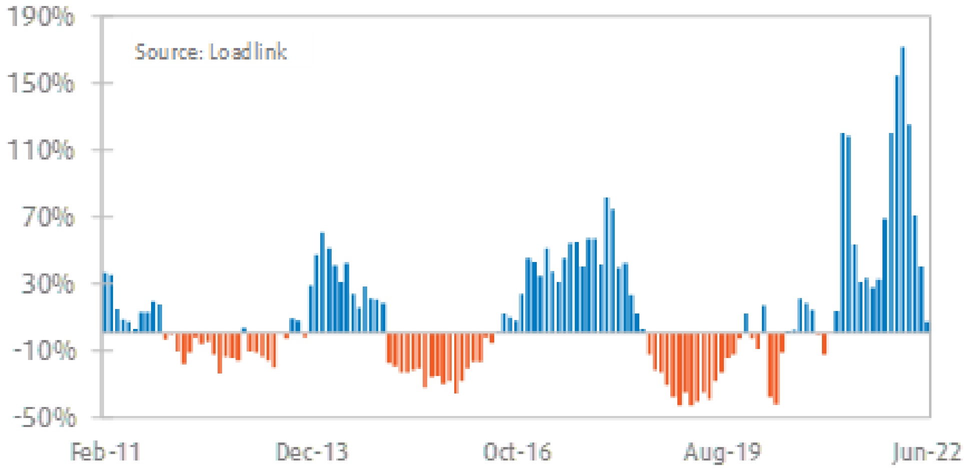
Interest Rates: 3 & 5 Year Interest Rate Swap Pricing

Interest rate swaps are derivative instruments commonly used by financial institutions to mitigate interest rate risk on a loan portfolio. The pricing of interest rate swaps (swap rates) mirrors expectations of interest rates' future direction.

Short-term bond yields have bolted higher as the Bank of Canada and the Fed have embarked on an unequivocally hawkish path in response to multi-decade high inflation. BMO's economists forecast the BoC to raise the target overnight rate to 3.5% (from 2.5% currently) by the end of 2022. Nonetheless, a recent slight rollback of swap rates reflects a potential peak in year-over-year inflation and likewise increasing odds that central banks are moving closer to pivoting toward a less hawkish stance.

Freight Indicators

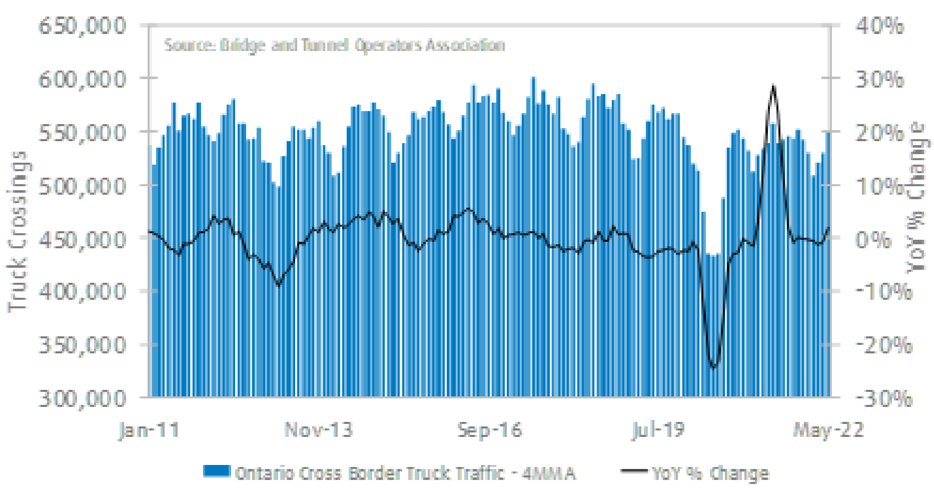
Canadian Truckload Spot Freight Volume Index Y/Y % Change



Balance in the Canadian spot market has shifted, with capacity expanding and demand softening. Since reaching an all-time high in March, **truckload spot freight volume** has decreased rapidly in the subsequent three months through June. Compared to the March peak, the index during June has contracted 58% but remains modestly higher (+7%) compared to a year earlier.

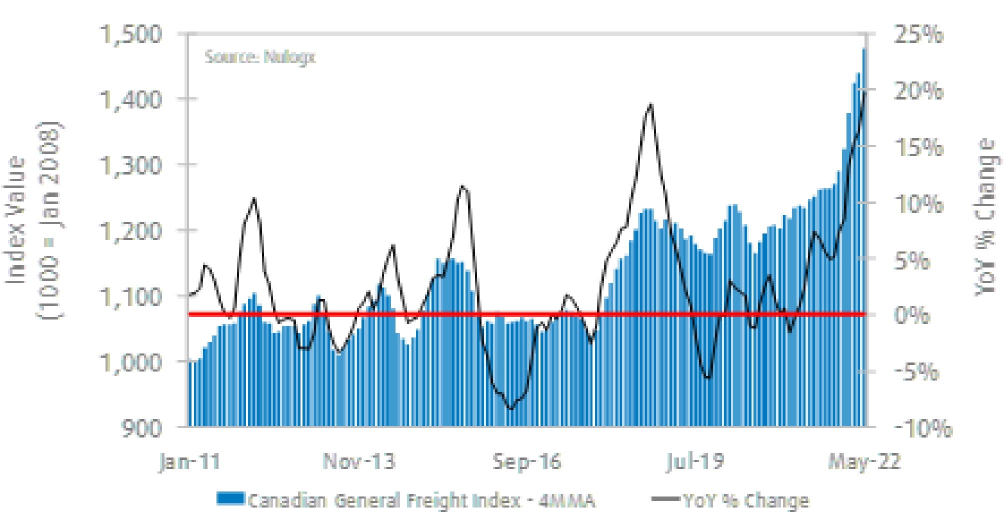
Capacity continued to loosen, with the truck-to-load ratio climbing from the record-setting lows seen during the pandemic. The ratio for June of 2.53 available trucks for every load posted was significantly higher than 0.63 as recently as February but still nearly 6 percent lower compared to 2.68 a year earlier.

Ontario Cross Border Truck Traffic



Despite persistently constrained auto manufacturing supply chains and the introduction of vaccine mandates at the beginning of the year, monthly **truck border crossings** have exhibited resilience. Year-to-date crossings through May were up 0.6% but during May alone were 6.5% higher than a year earlier.

Canadian General Freight Pricing Index

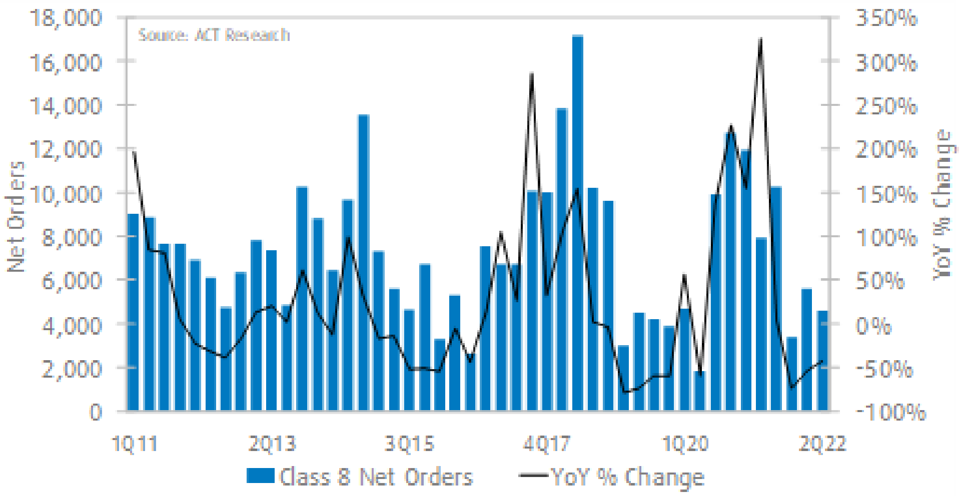


In May, an index representing the **total cost** (fuel surcharges + base rates) of over-the-road freight transportation for Canadian shippers reached a new all-time high. Although base rates are significantly higher than pre-pandemic levels, most of the overall surge in total freight costs is attributable to rapidly increasing fuel surcharges. Fuel was 31.69% of base rates in May versus 29.03% in April and 16.27% a year earlier. Overall, year-over-year shipping costs during May were up 19.7%, more than double Canada's overall inflation rate of 7.7% and easily above the full-year 2022 CPI estimate by BMO economists of 8.3%.

BMO Transportation Finance

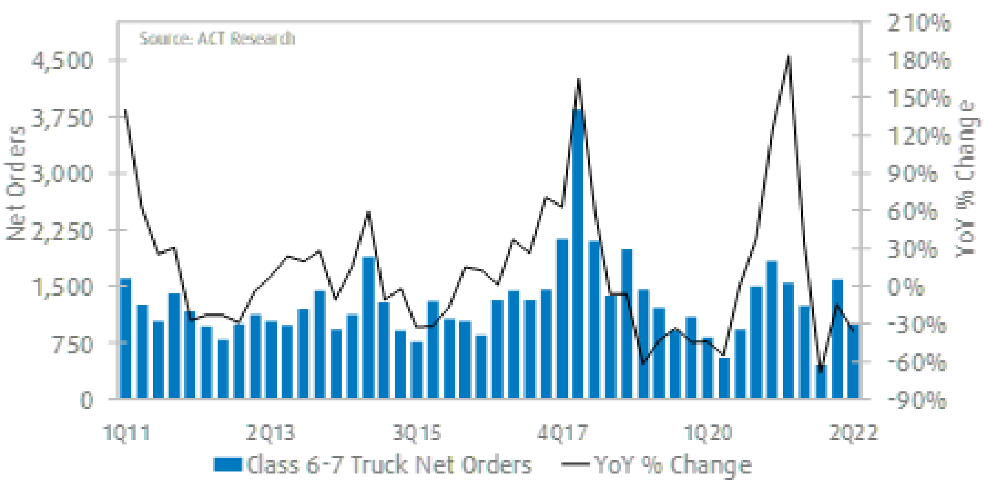
Truck Orders

Canada Class 8 Net Orders



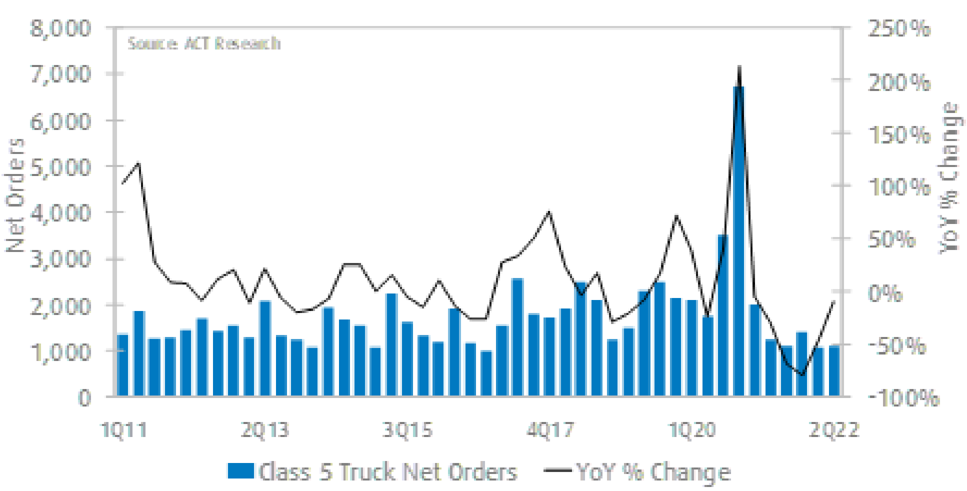
Net new Class 8 orders were lackluster during the 2nd quarter of 2022 and remain profoundly negative on a year-over-year basis as OEMs attempt to keep backlog manageable and in line with supply-constrained manufacturing capacity. That said, almost non-existent (0.1%) cancellations as a percentage of the backlog confirm that carrier appetite for capacity remained steady throughout the quarter.

Canada Class 6-7 Truck Net Orders



At the end of last year, the same factors afflicting the Class 8 market also caused a steep contraction in **Class 6-7 truck net orders**. Similarly, this class saw a strong sequential order uptick during the 1st quarter, followed by a sequential downtick during the 2nd quarter. In the near-to-intermediate term, activity in the energy and construction sectors should keep a floor under the severe-duty segment of this class.

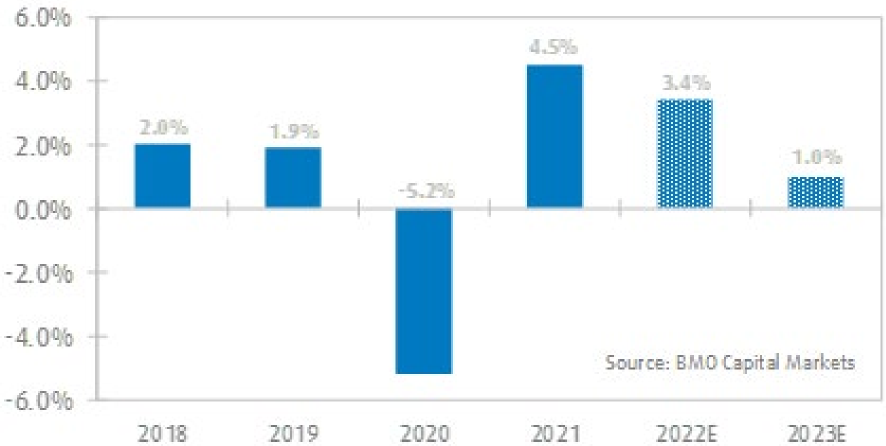
Canada Class 5 Truck Net Orders



In addition to factory supply chain issues that limit available build slots, the **Class 5 truck market** continues to digest record orders at the end of 2020. Nonetheless, the Class 5 market bucked the trend of the larger classes and saw a slight uptick in net orders during the 2nd quarter. Further, the long-term demand outlook remains positive with the support of diverse end markets, consistency in vocational sectors, and the durable tailwinds of e-commerce and last-mile delivery.

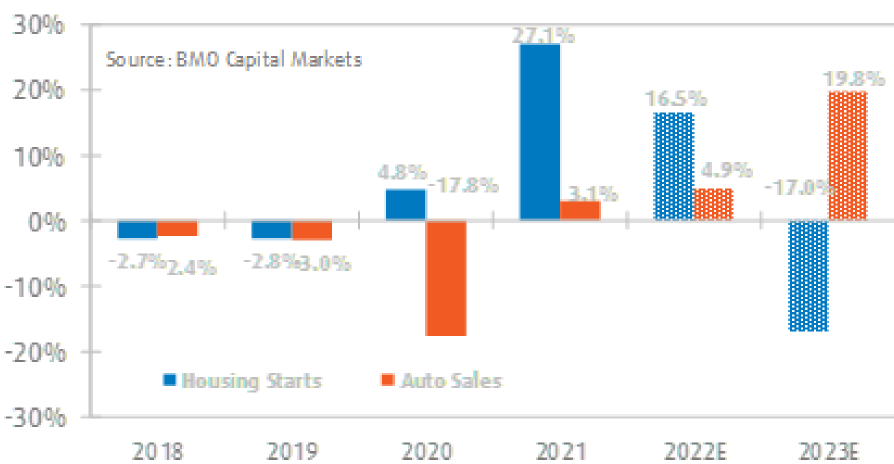
Macroeconomic Indicators

Canada Annual GDP Estimated Y/Y % Change



Canada's economy is seemingly holding up better than the U.S. due to a later reopening bounce and support from still-elevated commodity prices. Real GDP growth likely strengthened to 4.5% annualized in Q2 from 3.1% in the prior quarter. However, recent data suggest activity has weakened due to the same headwinds swirling south of the border. Most notably, employment has fallen this summer, reflecting softer demand and the challenge of finding new workers in a drum-tight labour market—the 4.9% unemployment rate is the lowest in five decades—amid an aging workforce. Altogether, BMO Economists expect real GDP to grow just 1.0% in the 3rd quarter and to contract early next year before resuming modest growth.

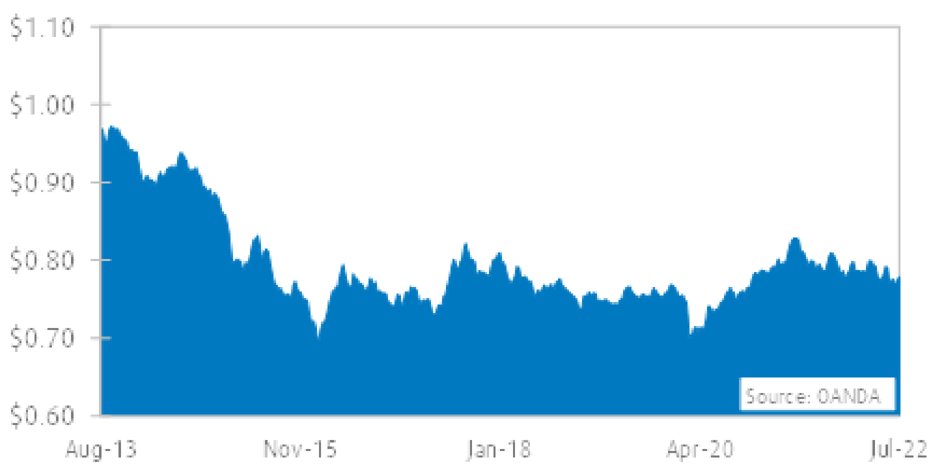
Canadian Annual Housing Starts and Auto Sales Estimated Y/Y % Change



Canadian housing starts pulled back to 273,800 annualized units in June, a still robust level of new construction. That leaves the average pace over the year's first half at 258k and 272k for Q2. Urban single-family starts fell to 60.4k in the month, while multis jumped above 200k. Unlike the resale market, new building activity is running strong—but this market segment lags, so any cracks wouldn't begin to show in the data until later in the year. In summary, BMO expects 2022 to be the peak of the new home-building cycle.

Assuming a gradual normalization of the supply chain, the pent-up demand of well-capitalized consumers should propel the **auto sector** to a pre-pandemic sales pace by the end of 2022.

U.S. Dollar per 1 Canadian Dollar



Amid the U.S. dollar's strengthening, the **Canadian dollar** has been trending weaker. In July, it averaged C$1.294 (US$0.773), the lowest level in 21 months. If not for the Bank of Canada's Fed-like policy aggressiveness or stronger commodity prices (resulting in persistent trade and current account surpluses), the Canadian dollar would be even weaker.

With the U.S. dollar reversing slightly, BMO Economists expect the Canadian dollar to strengthen slightly, averaging C$1.275 (US$0.743) by the end of this year (appreciating about 1½%) and C$1.25 (US$0.80) by the end of 2023 (2%).

"Voice of the BMO Economics Team"

With the post-pandemic recovery challenged by volatile commodity prices, multi-decade high inflation, rising interest rates, and persistent supply chain constraints, we thought it would be helpful to check in on the BMO Economics Team's latest near-term outlook for the Canadian economy. For more: https://economics.bmo.com/en/

Straddling Recession – Sal Guatieri, BMO Senior Economist and Director Economics

The U.S. and Canadian economies have quickly lost steam with the former actually contracting in the first half of the year. The drag from rapidly-rising prices and interest rates has outweighed the lift from higher wages and excess savings. We reduced our 2023 growth forecast by half a percentage point to just 0.5% in the U.S. and to 1.0% in Canada, staying below consensus. Both economies will likely contract in at least one quarter near the turn of the year. Our outlook might not qualify as an official recession, but it will feel like one for many businesses and some workers.

The growth downgrade reflects recent weaker data and tighter monetary policy. U.S. real GDP contracted 0.9% annualized in Q2 following a larger decline in the prior quarter. Weaker consumer spending, a surprising decline in business investment, and a cooling housing market indicated an even softer underbelly than in the first quarter, when the contraction was concentrated in inventories and exports.

Given strong job growth, **the U.S. economy is probably not in recession**. Over half a million payrolls were added in July, on top of 2.8 million in the first half of the year. The surge in hiring, despite recession talk and worker shortages, fully erased the 22 million jobs that were lost at the start of the pandemic. It also lowered the unemployment rate to 3.5%, matching the 53-year low set before the pandemic. Still, job prospects are beginning to dim and will only worsen as the jobless rate heads toward 4.6% by late next year.

Canada's economy is seemingly holding up better than the U.S. due to a later reopening bounce and support from still-elevated commodity prices. Real GDP growth likely strengthened to 4.5% annualized in Q2 from 3.1% in the prior quarter. However, recent data suggest activity has weakened due to the same headwinds swirling south of the border. Most notably, employment has fallen this summer, reflecting softer demand and the challenge of finding new workers in a drum-tight labour market—the 4.9% unemployment rate is the lowest in five decades—and amid an aging workforce. We expect real GDP to grow just 1.0% in the current quarter and to contract early next year, before resuming modest growth.

In both countries, the earlier mania gripping **housing markets** has quickly fizzled, as the rapid rise in mortgage rates worsened already poor levels of affordability. Sales have plunged to below pre-pandemic levels and look to stay soft this year. **Prices have fallen for several months in Canada and are expected to tumble 20% by next spring**, marking the biggest correction on record. The decline should take prices back to levels of spring 2021 and affordability to moderately above long-run norms from the worst levels since the 1989 bubble. By next summer, prices will likely resume rising amid record immigration and a tight rental market. **U.S. resale prices rose through the spring** due to low listings, pushing affordability to the worst levels since 2006. However, timelier data from Redfin suggests prices are softening (as per new home prices), and we expect a 10% correction in the year ahead.

Central banks will need to press a little harder on the brake than we thought previously to suppress inflation. We added 25 bps to our call on peak policy rates, with the **Bank of Canada** expected to stop at 3.5% and the **Fed** at around 3.6% by year-end. These levels are sufficiently above neutral levels of roughly 2.5% to chill inflation while not putting the economy on ice. Following the Bank's jumbo 100-bp hike last month and the Fed's second straight 75-bp punch, both central banks are expected to scale back to smaller 50-bp moves in September due to the weaker economy. Following two additional moves later this year, both are expected to pause in 2023 as the economy stalls and inflation falls. While markets are starting to price in rate cuts in 2023, we suspect that a greater fear of inflation than recession will delay such until early 2024. Even if the economy slips into a mild downturn, the need to reestablish (badly tarnished) inflation-fighting credentials will likely delay the cavalry's ride to the rescue until inflation is headed convincingly back to the 2% target.

Straddling Recession (Cont.) – Sal Guatieri, BMO Senior Economist and Director Economics

It all comes down to inflation, of course. For a change, not all the news has been bad. Commodity prices have reversed meaningfully, led by base metals, lumber, and crops. The Commodity Research Bureau's spot index is down 10% from April's high, nearly reversing the past year's gain. Oil prices have slid below $90 a barrel, though scorching temperatures have cranked up air conditioning and natural gas prices. Supply chain bottlenecks have eased a little amid shorter delivery times, fewer order backlogs, and less clogged ports. While scant inventories are still propelling car prices at double-digit rates in the U.S. and Canada, automakers aim to boost production as more microchips become available. Large retailers are now cutting prices to clear out unsold inventory, such as exercise bikes. Perhaps the best news is that most measures of long-term inflation expectations have eased a bit, giving central banks some breathing room. In addition, there is anecdotal evidence that U.S. companies are having a slightly easier time finding and retaining workers, possibly due to recession fears.

But inflation that stops rising is one thing; how quickly it retreats from four-decade highs is another. Here, prospects are less sanguine. Rising wages and rents due to tight labour and rental markets flag persistence. Faster increases in services prices are offsetting the benefit of slower goods prices. Consequently, current CPI rates of 9.1% in the U.S. and 8.1% in Canada will likely still hover near 5% by the middle of next year and around 3% in late 2023. The latter is still well above the 2% inflation targets, meaning central bankers will need to bite their lip to avoid sending the economy into a tailspin.

A key question is: **how much weakness in demand is required to restore price stability?** In our view, and assuming some further retreat in commodities and lessening of supply chain pressures, it will take enough weakness to lift the jobless rate sufficiently to cool wages. The Fed believes the so-called neutral rate of unemployment is around 4.0%, though Powell suspects it may have risen due to a shift away from customer-facing jobs. In any case, the current jobless rate must exceed the neutral rate to slow wage growth and ease inflation pressure. While a recession is not a necessary condition for this to occur, a period of sustained soft demand is, as per our outlook.

Stubborn inflation continues to pose the **single biggest threat to the economy**. Inflation may not fall according to plan, let alone as fast as the consensus view, which is a full percentage point lower than our call in 2023. In this event, policy rates would need to be much more restrictive, somewhere in the 4%-to-5% range. If so, there won't be much debate about whether the economy can avoid a deep downturn. As well, along with the potential for the war in Ukraine to escalate, heightened tensions between the U.S. and China over Taiwan are a growing concern.

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