Industry Update

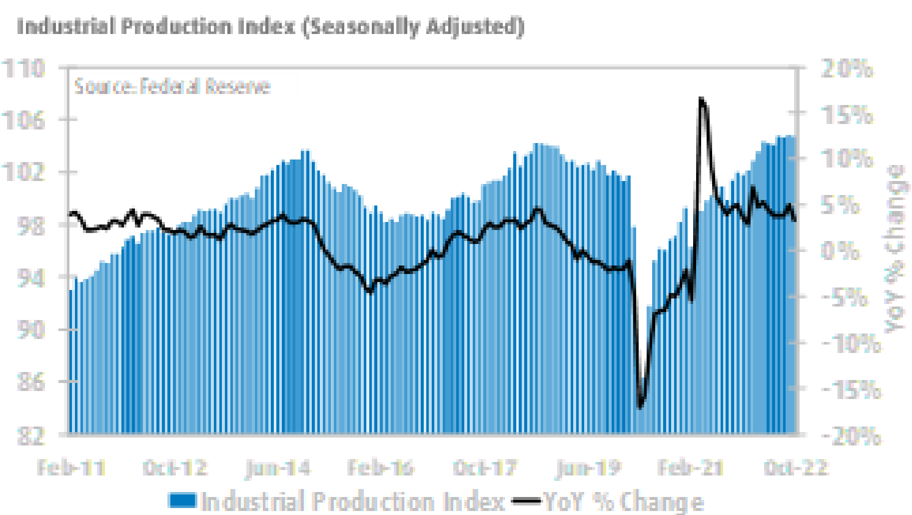
Truck Transportation

Key Developments

- According to the **National Retail Federation (NRF),** 2022 holiday sales are expected to increase between 6% to 8%, which is slower than the record 14% increase last year but well above the 10-year average growth of 4.9%. Online sales continue to increase at double-digit, year-over-year levels, with the NRF forecasting online and other non-store sales to increase by 10% to 12%.
- A recent study of highway charging requirements conducted by **National Grid Plc** found that by 2030, electrifying a typical highway gas station will require as much power just for electrified passenger vehicles as a professional sports stadium. As more electric trucks hit the road, the projected power needs for a big truck stop by 2035 will equal that of a small town.
- Data from the **FMCSA Drug and Alcohol Clearinghouse** show that as of November 1st, 73% of 156,510 drivers with at least one violation remain in "prohibited status." Further, 76% of those in prohibited status (86,501) still need to start the return-to-duty (RTD) process.
- Be sure to check out the latest perspectives from BMO economists on the influence of inflation and Fed rate increases on the U.S. macro outlook (page 8).

Industry Fundamentals

Lower Diesel prices in November offer a modest but welcome reprieve from the most challenging industry climate in several years, particularly for carriers that primarily transact in the spot market. But, despite the near-term positive for carrier cash flows, the reason behind declining fuel prices may be unwanted slowing growth. Fuel price volatility aside, decelerating but elevated overall tonnage has masked relentless spot market rate pressure caused by evaporating overflow freight from the contract market, gradually increasing fleet capacity, and an underwhelming peak season. Given typical seasonal freight softness in the early months of a calendar year and capacity continuing to enter the market, durable relief from rate headwinds may wait until mid-2023. The good news, however, is that the Fed is signaling a slower pace of rate increases as soon as December. Further, with employment demonstrating resiliency, economists are raising the likelihood of dodging a recession or at least a later starting, shallower, and more protracted recession than currently forecast.

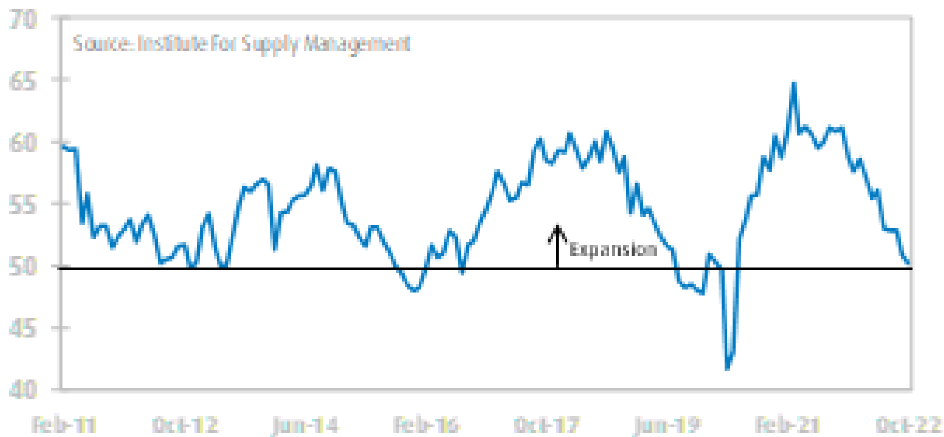


U.S. industrial production fell 0.1% in October, which leaves it 3.3% above the year-ago level. Moreover, September's previous 0.4% gain was revised to just 0.1%. While industrial production remains at a high level, the revisions indicate that growth has slowed significantly since the Fed began its hiking cycle, with the overall index up a modest 0.4% since April.

Manufacturing output, approximately 75% of industrial production, increased by 0.1%, with motor vehicles and parts leading the way (+2.0%). Nonetheless, **capacity utilization** dropped 0.2 percentage points to 79.9%, which coincides with the weaker-than-expected PPI reading for October.

Macroeconomic Indicators

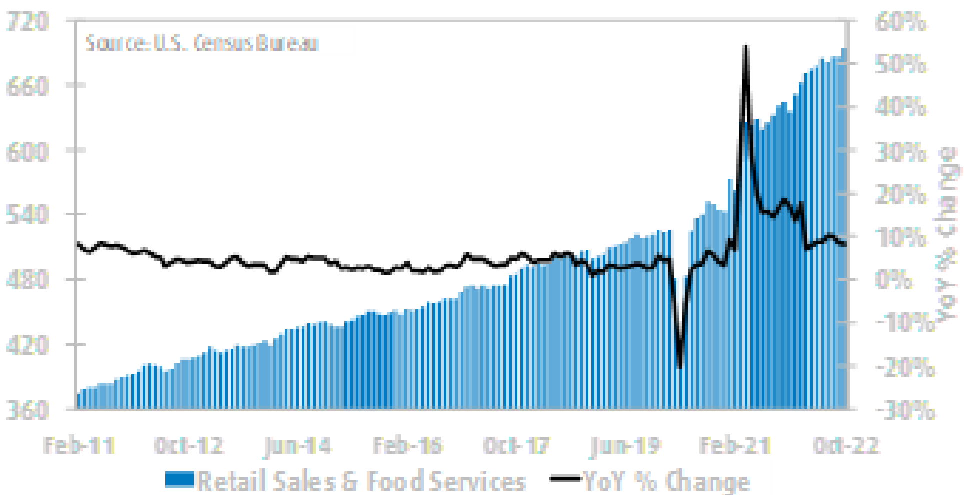
ISM Purchasing Managers Index



The **Purchasing Managers' Index (PMI)** is a sentiment measure of near-term business conditions in the manufacturing sector. In October, the index extended a multi-month downtrend, down 0.7 points to 50.2 while holding barely above the 50-mark separating expansion and contraction and the lowest since May 2020. Of the five equally weighed sub-components, new orders (still below 50), production, and employment improved from September. Of the six largest manufacturing sectors, only three (down from four in September) reported growth.

The past relationship between the PMI and GDP suggests that the October PMI corresponds to an annualized GDP growth rate of 0.5%, 20 basis points above BMO Economists' current estimate for year-over-year growth during the 4th quarter.

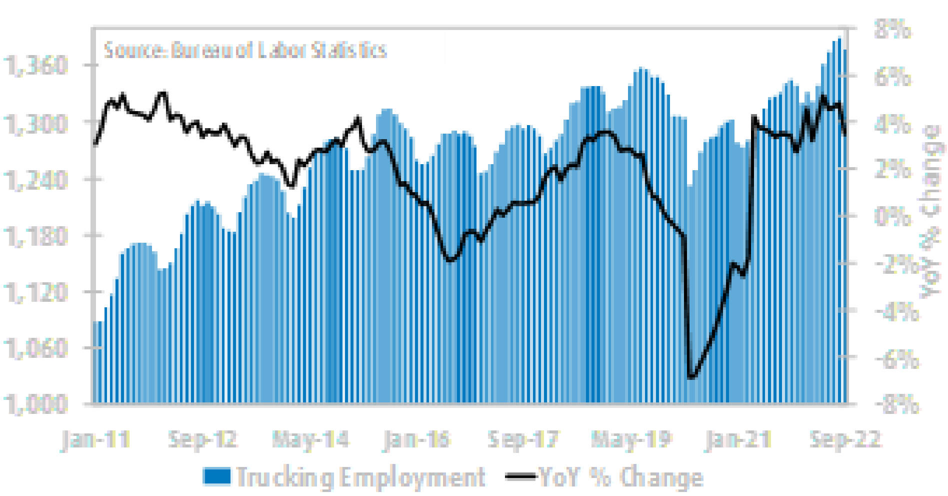
Retail Sales & Food Services (Seasonally Adjusted $Bn)



Consumers—the biggest engine of the U.S. economy—are still holding up. Solid job and wage growth are shoring up households, despite still-high inflation, tightening financial conditions, and overall weakening macro trends.

U.S. retail sales climbed 1.3% in October after stalling a month earlier, as consumer demand for goods stayed healthy despite high inflation. The better-than-expected gain marks the fastest pace in eight months. Purchases at motor vehicle and parts dealers rose 1.3% amid easing supply chain snags, and gas station receipts jumped for the first time in four months, up 4.1% on higher prices. Excluding autos and gas, sales were up 0.9%, with broad-based gains suggesting consumers remain resilient despite the risk of a looming recession.

Truck Transportation Production and Non-Supervisory Employment



Employment in the truck transportation industry has accelerated and reached an all-time high in August. **Production and non-supervisory employment** during September retreated from the record high by 0.9% (~13,400 jobs) month-over-month but was up 3.5% (~46,700 jobs) year-over-year.

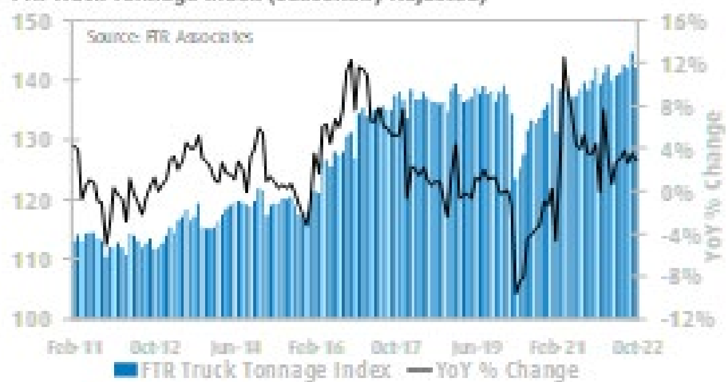
Driver availability has gradually improved with the incentive of solid earnings potential (Walmart offering salaries up to $110k) and accelerating training throughput. The data also captures what is likely to be a growing number of drivers who previously had ventured out independently but have since been squeezed by high fuel prices and lower spot rates and have returned to the relatively safe harbor of employment with larger for-hire carriers.

Freight Indicators

Despite strengthening macro headwinds and an underwhelming peak season, most freight indices held up surprisingly well heading into the final quarter. Durable goods orders and backlog are at multi-year highs, energy production remains robust, the number of new homes under construction is at a record level, and replenishment of auto inventories has made progress but remains incomplete. That said, ominous clouds continue to gather, and similar to the lagged macro response to increasing interest rates, the brunt of freight growth challenges has yet to materialize fully. Financial conditions continue to tighten, homebuilder sentiment is at a 10-year low, consumer confidence is off the bottom but still at recessionary levels, and retail inventories remain bloated. Given at least another 100 basis points of Fed rate increases still on the near-term horizon, freight growth will likely continue to decelerate and probably even decline through the usually seasonally weak first half of 2023.

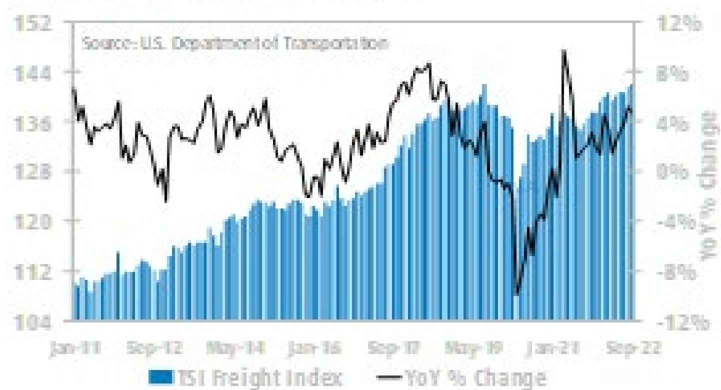
ATA Truck Tonnage Index (Seasonally Adjusted)

FTR Truck Tonnage Index (Seasonally Adjusted)



Cass Freight Index – Shipments (Seasonally Adjusted)

Transportation Services Index (Freight)

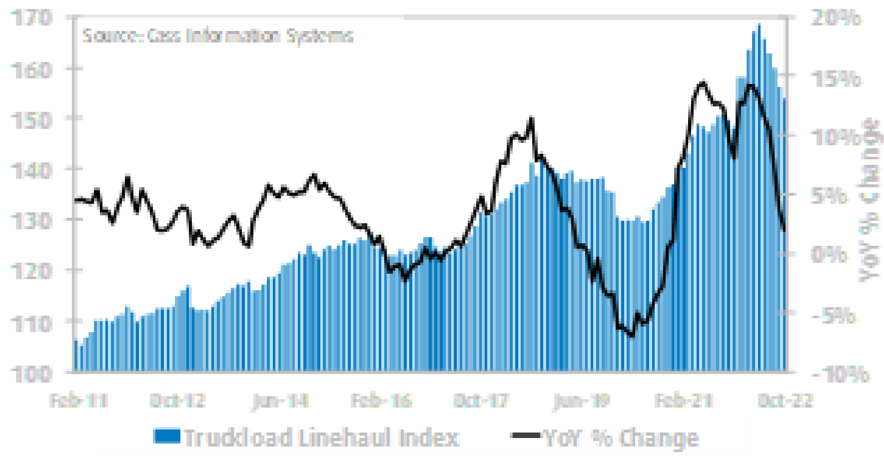


Class 8 Fleet Capacity Utilization

- The **ATA For-Hire Truck Tonnage Index** (primarily contract freight) during October saw the largest month-over-month decrease since the pandemic but also the 14th consecutive year-over-year increase.
- The **FTR Truck Tonnage Index** has been flat since the end of last year but remains near an all-time high.
- The **Cass Freight Shipment Index** (all modes) has been choppy at high levels but has generally decelerated since reaching a post-pandemic high last December.
- The **TSI Freight Index** was in a strong uptrend through September, approaching the all-time high reached in August 2019.
- The **FTR Class 8 Capacity Utilization Index** has retreated to a nearly 2-year low but remains slightly above its long-term average.

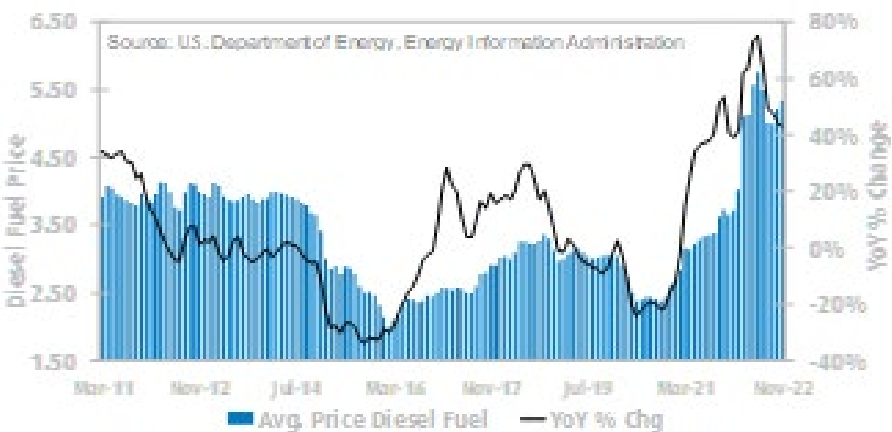
Revenue And Expense Indicators

Cass Truckload Linehaul Index



The **Cass Truckload Linehaul Index,** which reached an all-time high in May, reflects a mix of base rate pricing (excluding fuel and other surcharges) in both the contract and spot dry van freight markets. Due to the periodic nature of the contract pricing cycle, there is typically a five or six month lag from when the contract market reflects trends in spot freight pricing. With spot rates having seen relentless pressure throughout much of the year, a softening of contract rates is also well underway but still has plenty of catching up to do.

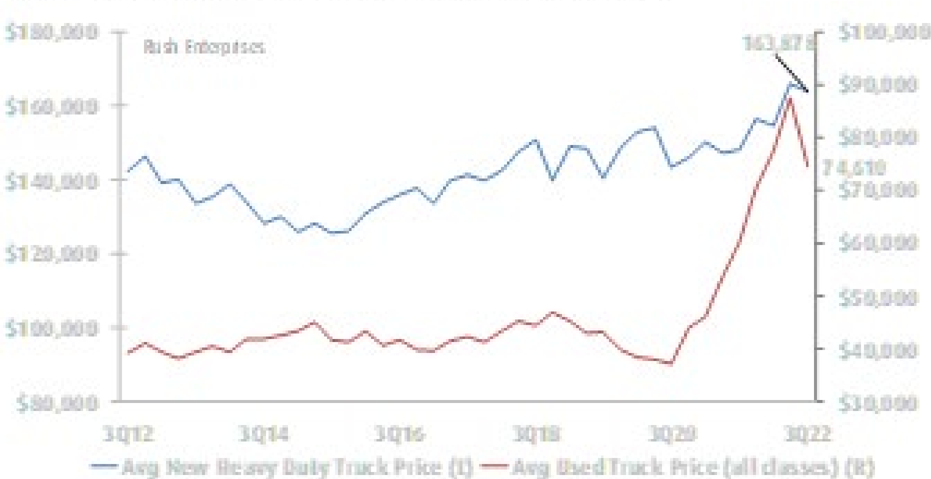
On-Highway Diesel Fuel Price (Monthly Average $/Gallon)



Since peaking at an all-time high in June, **Retail Diesel** fuel prices have been on a high-altitude roller-coaster. As of mid-November, the average weekly Diesel price of $5.23 per gallon had recovered 40 cents (+8%) from a plunge in late-September and early-October but was still 58 cents (-10%) below the prior peak.

The current BMO outlook suggests that crude and Diesel prices may drift modestly lower but remain elevated given low inventories and the possibility that OPEC+ would likely cut output further in response to a weakening global economy.

Average New Heavy Duty and Used Truck (All Types) Prices ($)



With a somewhat improving but still constrained supply chain, the **average price of new heavy-duty trucks** sold by Rush Enterprises during the 3rd quarter retreated slightly from an all-time high. Altogether, heavy-duty ASPs decreased by $1,967 (-1.2%) from the 2nd quarter but were still up $15,606 (+10.5%) from the year-earlier quarter.

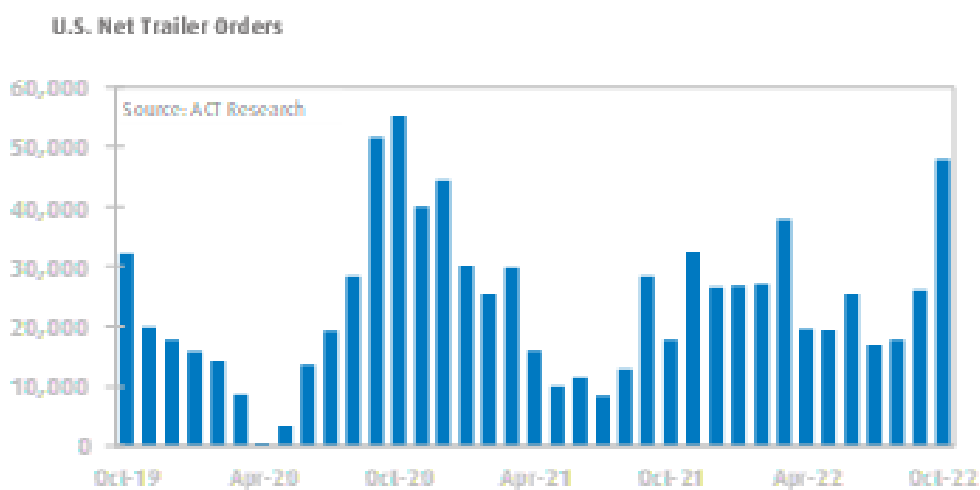
The record imbalance of supply and demand in the used truck market has begun the process of normalizing. The **average price of all used trucks** sold by Rush Enterprises during the 3rd quarter plunged from an all-time high (-15% q/q) but remained well above the year-earlier quarter (+24% y/y). With spot freight rates under significant pressure and operating costs, particularly fuel remaining elevated, spot carriers who were active marginal buyers of used equipment throughout the pandemic have retreated from the market.

Truck and Trailer Orders

OEMs have opened the floodgates on 2023 build slots, and evidently, there is no shortage of takers. Although down from a multi-year high in September, **U.S. Class 8 net truck orders** were again robust during October and the second-best month since early 2021. Although there's no clear line of sight into precisely who is ordering, it's not a stretch to expect that the overwhelming majority of ordering is coming from medium-to-large fleets that are well beyond their regular replacement cycles and still flush with capital from the post-Covid freight bonanza.

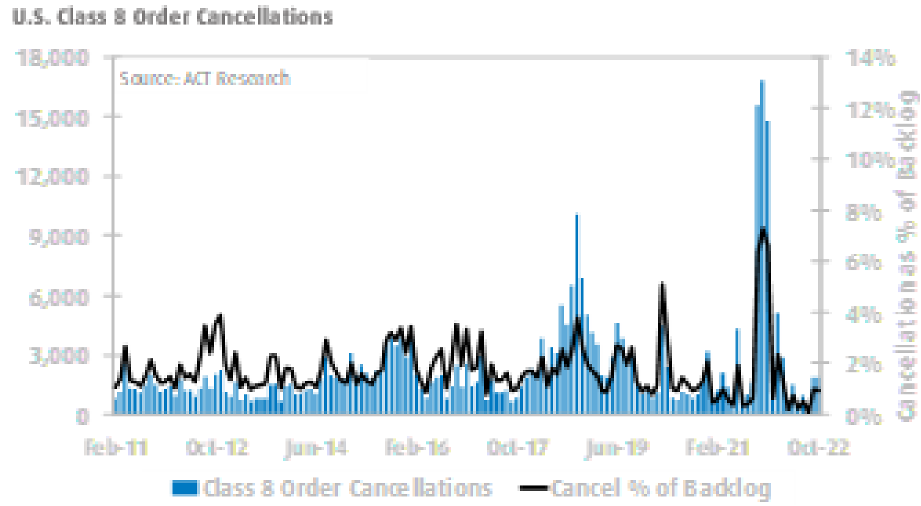
Supply chain issues affecting medium-duty production throughout most of 2022 had been compounded by re-directing standard components across classes to the production of higher margin larger trucks. That said, component and labor availability has improved, and medium-duty build rates are approaching pre-Covid levels.

Despite growing headwinds in the construction sector, **medium-duty orders** surged during September and October, and the near-term demand outlook remains stable, with cancellations lower than average. The longer-term view continues to feature the usual support of diverse end markets, the secular trend toward shorter hauls, and the durable tailwinds of e-commerce and last-mile delivery.



Similar to the heavy and medium-duty OEMs, trailer manufacturers only recently had been willing to open build slots and book orders for next year. But given the combination of improving supply chain visibility, pent-up demand, and typical seasonal fall/winter order strength, **net trailer orders** during October surged to the highest monthly total in two years. Further, carrier appetite appears durable, with monthly cancelation rates hovering slightly above 1% of backlog compared to the long-run average of 2%.

Other Equipment Indicators



With the overall freight picture on a tenuous footing, the possibility of slackening demand for freight capacity is a growing concern. For now, however, carrier appetite appears intact, given a recent surge in orders and a year-to-date average monthly cancelation rate of 0.8% compared to the long-run average of 2.2%.

The 8-month manufacturing backlog has undoubtedly contributed to below-average **Class 8 cancellations** through October. That said, given sustained stress on cash flows in the spot market and growing concerns about the durability of the freight market, the pace of cancellations is likely to trend higher. Still, following two years of limited availability, plenty of fleets seem anxious to get in line and stay in line.

OEMs have been managing the intake of orders intending to gradually reduce the Class 8 manufacturing backlog, which had steadily declined for nearly a year until the order surge in September and October. Further, the monthly build rate has significantly improved since last year (see below). As a result, the **heavy-duty backlog-to-build** ratio has been nearly halved over the past year. But at eight months in October, the backlog is still above the long-run pre-pandemic average of six months.

Given the recent improvement in builds, Class 8 inventories were hovering near 2 ½ year highs at the end of October. Still, given the strength in demand, the **heavy-duty inventory-to-sales** ratio was at the low end of the long-term average range of 2-2 ½ months.

The above replacement pace of **U.S. Class 8 unit retail sales** over the past six months (270k annualized rate from May through October) is a clear sign that OEMs have made significant progress with their supply chains while also demonstrating that plenty of carriers have not lost their appetite for capacity.

Class 8 production has improved significantly from a monthly average of 18,000 units in 2021 to 20,000 during the first five months of this year and, more recently, an average of nearly 24,000 from June through October.

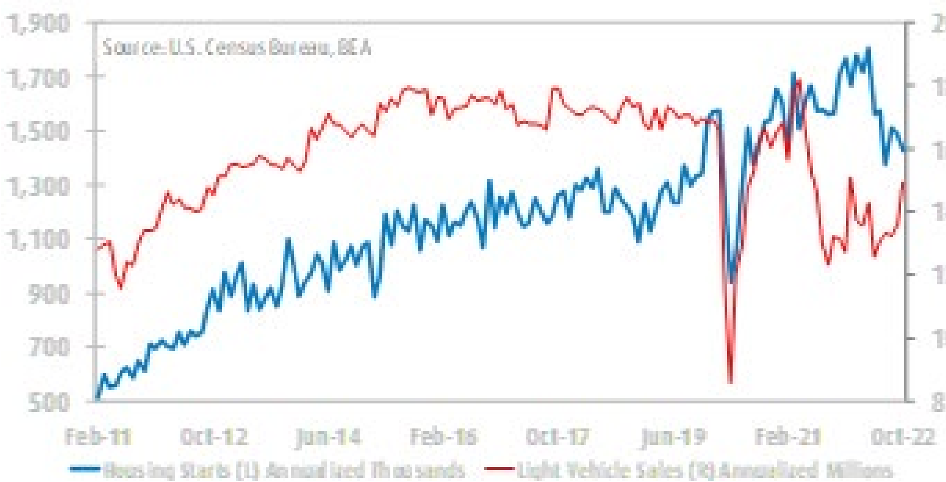
Other Business Indicators

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 Fed embarked on an aggressively hawkish path in response to multi-decade-high inflation. Although the pace is expected to slow, BMO's economists forecast the Fed Funds Rate to peak at 4.75-5% (from the current 3.75-4%) by mid-next year. 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.

U.S. Housing Starts & Light Vehicle Sales (Seasonally Adjusted)



Construction of single-family homes during October plunged 6.1% to the lowest level since May 2020. The downtrend since April aligns with the plunge in homebuilder sentiment, which in November was at a 10-year low (outside of 2020) of 33 and indicates that a large majority of builders view sales conditions as poor. BMO economists expect new homebuilding to continue drifting lower and bottom during the 3rd quarter of 2023 at an average annual rate of 1.34 million units.

Judging by recent improvements in production and inventory data, supply constraints of components within the auto sector appear to be gradually easing, albeit still not normal. Annualized **U.S. sales of light vehicles** of 14.9 million during October improved by 18% from a recent low in May but was still down 18% from the post-Covid high.

U.S. Business Inventories/Sales (Seasonally Adjusted)

The **total business Inventories-to-sales** ratio bottomed at an all-time low a year ago and has since been slowly grinding higher. A closer look reveals that manufacturing inventories remain under pressure, while retail inventories, excluding motor vehicles and parts, have overshot to the upside. Inventories of motor vehicles and parts have also begun to trend higher but remain below historical norms.

"Voice of the BMO Economics Team"

With macro conditions supported by solid employment & wage growth but challenged by moderating but still unacceptably high inflation, rising interest rates, and cracks in the housing market, we thought it would be helpful to check in on the BMO Economics Team's latest near-term outlook for the North American economy.

For more: https://economics.bmo.com/en/

U.S. Economy: Revisiting The R Word
Douglas Porter, Chief Economist and Managing Director August 25th, 2022

If the North American economy is headed for recession in the coming months, the equity market is certainly expressing its concern in an unusual fashion. The S&P 500 has quietly reeled off a 12.5% rebound from the October 12 closing lows and is now within reach of revisiting its 200-day moving average. It's not just equities that are behaving a bit peculiarly in the face of a possible downturn—corporate spreads have narrowed, the U.S. dollar has stepped back 6% in the past two months, and industrial metals prices have firmed by more than 11% in the same period.

True, most of these market moves have only reversed a small portion of the roiling over the first nine months of the year; to wit, the MSCI World Index is still down 15% in 2022. But after being walloped through the first three quarters, the more recent bounce-back is at least a suggestion that the coming economic blow may be lighter than earlier expected. It also strengthens the view that most of the market action in 2022 is a reset to the brave new world for interest rates, and not necessarily a foreshadowing of tougher economic times. (The deeply inverted yield curve is, however, still very much sending a loud warning signal.)

Above and beyond the firming in the markets, there are **two more fundamental developments** that are at least **casting some doubt on the recession call**. First, **oil prices** continue to erratically retreat. After pushing above $90 earlier this month, they have since receded below $80, and were actually below year-ago levels at one point this week for the first time in almost two years. That dimming in what had previously been a fearsome inflation driver will both clip expectations of further inflation and provide real-time relief for global consumers.

The second fundamental factor is **the North American economic data flow** itself. There are clearly many signs of softness—the U.S. leading indicator has dropped more than 3% in the past six months, and consumer sentiment is very downbeat. However, **for every clunker, there seems to be another much more perky report**. For example, the Atlanta Fed's GDP Nowcast is currently pointing to a hearty Q4 gain of more than 4%—which, suffice it to say, is a long way from recession. (Aside: It's notable how the bears have suddenly gone quiet on that particular indicator, after putting the klieg lights on it earlier this year when it was struggling.) And, next week's highlight employment report is expected to post another sturdy payroll gain of about 200,000.

Still, **we are not throwing in the towel on the recession call**. In fact, any resiliency in the economy may just eventually prompt an even tighter set of policies from the Fed and BoC, and prolong the process. Along those lines, we are actively looking at pushing further out the shallow recession we currently have forecast for the first half of 2023 in both economies. One perfectly reasonable view is that because it takes 12-18 months for rate hikes to be fully reflected in the economy, the cumulative impact of tightening may not hit with full force until late next year. Notably, former BoC Governor Poloz weighed in this week, warning of the potential slow-release pain of the steep rise in rates. However, the counter argument is that the impact is unfolding faster in today's economy, and the early hikes are already hitting home.

"Voice of the BMO Economics Team" Continued

U.S. Economy: Revisiting The R Word (cont.)
Douglas Porter, Chief Economist and Managing Director

For some historical context to help settle the debate on timing, **let's look at the 1994/95 tightening episode**, which is perhaps the most relevant in terms of how aggressive the Fed and BoC campaigns were. The weakest quarters for growth in that period were within a year of the onset of the rate hikes, which would still put us in early 2023 in the current cycle. For example, in that earlier episode, the Fed hiked rates by 300 bps in the year to February 1995, and GDP growth cooled from a torrid pace of above 4% in 1994 to a near-stall in the first two quarters of 1995 (at just over 1% growth)—basically within a year of the start of rate hikes. But as rates stabilized in 1995, and even backed down a bit, growth also soon stabilized and rebounded by late that year. (Aside: Note that while the Fed did trim rates 75 bps that year, it then settled at 225 bps north of the pre-tightening levels, which may prove a telling example in the current environment.)

Bottom Line: The North American economy is finishing 2022 firmer than expected, supported by somewhat milder energy costs and likely also by savings stashes. This could point to a slightly later onset of outright GDP declines than earlier anticipated, although we are not pushing out the call just yet for two reasons. First, history tells us that weakness can arrive quickly when the rate hikes truly begin to bind, as in early 1995. And, second, the economic and market resiliency could just prompt an even harder push on the brakes from the Fed and the BoC.

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With **Black Friday** upon us, analysts are engaged in the annual ritual of attempting to gauge the overall health of the economy from this weekend's sales tallies. How quaint. There are at least a couple reasons to downplay these particular results. First, we will again stress the point that consumers are still rotating from goods to services, especially in Canada. The shock would be if spending on goods wasn't soft in inflation-adjusted terms after a couple of blow-out years. Second, the nature of Black Friday has clearly morphed in recent years. I've rarely been accused of being an active shopper (miser maybe), so this is mostly hearsay, but many retailers have jumped the gun with pre-sales in the week, or even the month, ahead of the event—thereby diluting the punch. So, even a drop in sales volumes year-on-year won't thwart the above theme of a resilient consumer.

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