BMO Transportation Finance

Summer 2021

Industry Update

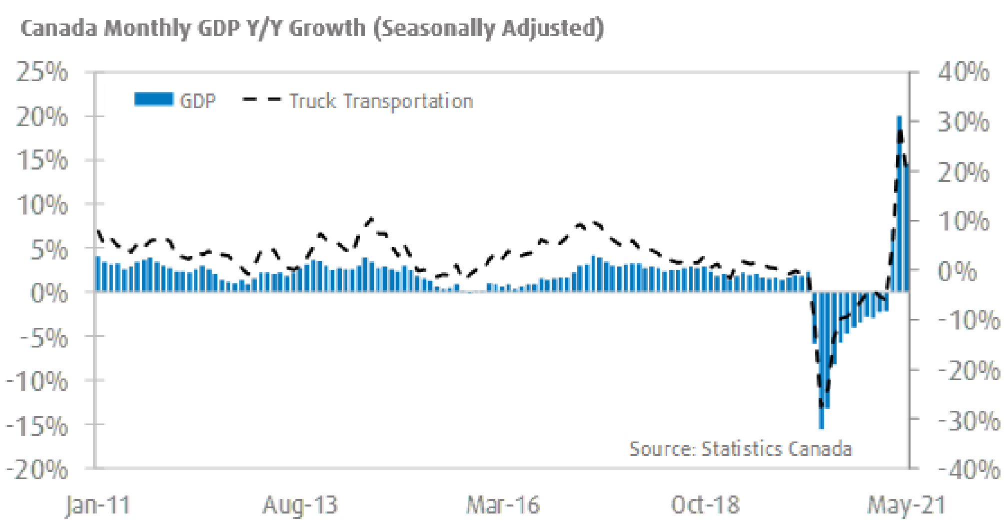
Canada Truck Transportation

Key Developments

- The **Canada Border Services Agency** ended a brief work slowdown that caused significant delays at border checkpoints before reaching a new four-year agreement with the government. Border agents had been without a contract for over three years.
- According to a recent report from the **C.D. Howe Institute**, achieving Ottawa's emissions targets would require a roughly 18% reduction in the average emission intensity of freight trucks by 2030. Despite an expected 17% increase in annual tonne-kilometers driven, improvements in efficiency, electrification, or adaptation of alternative fuels, emissions from freight-carrying trucks specifically are projected to fall from 65 MT C02e in 2018 down to 62 MT C02e in 2030.
- **Hydro One Limited** will receive a $4.95 million government grant to develop a pilot for heavy-duty electric truck charging stations in Ontario.
- The **Hutch Connect** is the first ELD to pass third-party certification tests. The ELD mandate for federally regulated carriers officially took effect on June 12th, but Canadian jurisdictions are using a 12-month phased-in enforcement approach.
- Be sure to check out the latest perspectives from BMO economists on the Canadian macro outlook (page 6).

Industry Fundamentals

A cruel twist of fate has the long-awaited loosening of virus mitigation measures colliding with the emergence of a variant induced fourth wave of the pandemic. Additionally, accelerating inflation caused in large measure by persistent supply bottlenecks poses an increasingly stiff challenge to a full-throttled macro recovery. Nonetheless, BMO economists remain optimistic that the variant and resulting headwinds may at worst slow and elongate but not derail the country's forward progress. Further, an unexpected but welcome new fiscal lift may be in store, with the announcement of a surprise snap Federal election and a bevy of obligatory generous spending promises undoubtedly to follow.



Canadian real GDP fell 0.3% in May but is projected to rebound by a hefty 0.7% in June as the economy began to re-open again after third-wave restrictions. The pullback in May matched initial estimates but followed a downwardly revised 0.5% drop in the prior month (first pegged at -0.3%). Spring lockdowns in much of the country triggered the first monthly GDP declines in a year, but those setbacks are expected to be reversed in relatively short order, with June's rebound alone almost doing the job.

While well off the bottom and handily above year-earlier levels, **truck transportation** sector activity remains nearly 8% below where it was in the same month in 2019.

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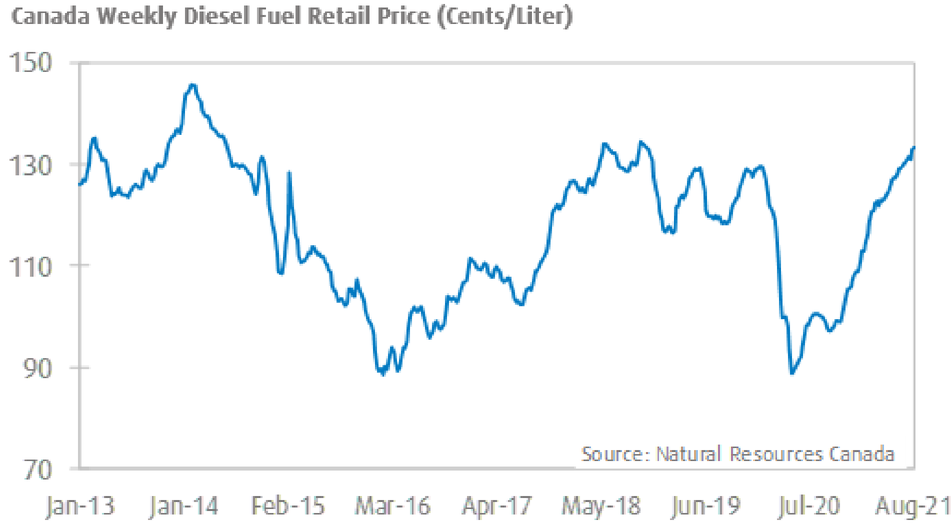
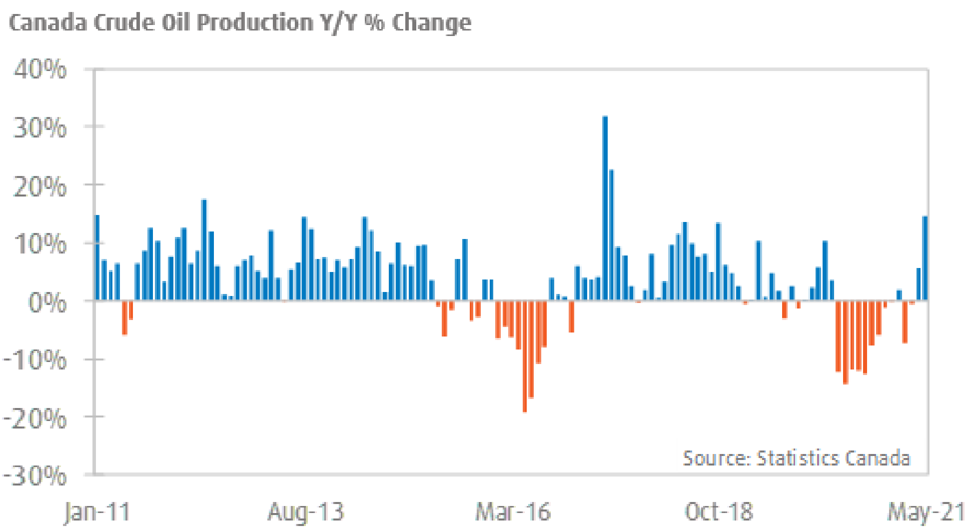
Trucking Business Influencers

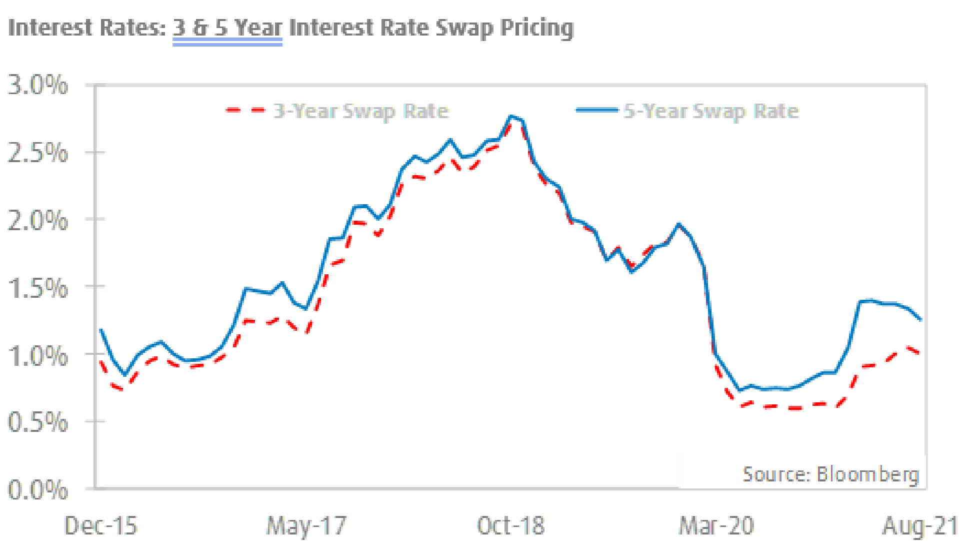


Retail Diesel fuel prices across Canada have been on a steady uptrend and are now higher than before the pandemic's onset. As of early August, the average weekly Diesel price of 133 cents/liter was up 25 cents (+23.0%) since the beginning of the year and up more than 50% since the bottom last year. That said, the current BMO outlook suggests that crude prices are past the peak as new supply creeps into the market while the Delta variant dampens global re-opening macro momentum.



Following maintenance shutdowns throughout April and May, **crude oil production** across Canada saw year-over-year growth entering the summer as rigs were brought back online at the same time that comparisons became much easier. Further, data from Baker Hughes as of early August showed the number of active oil rigs reaching a six-month high while also exceeding the number of active rigs during August 2019 before the pandemic. As a result, forthcoming production data is likely to trend higher throughout the summer.

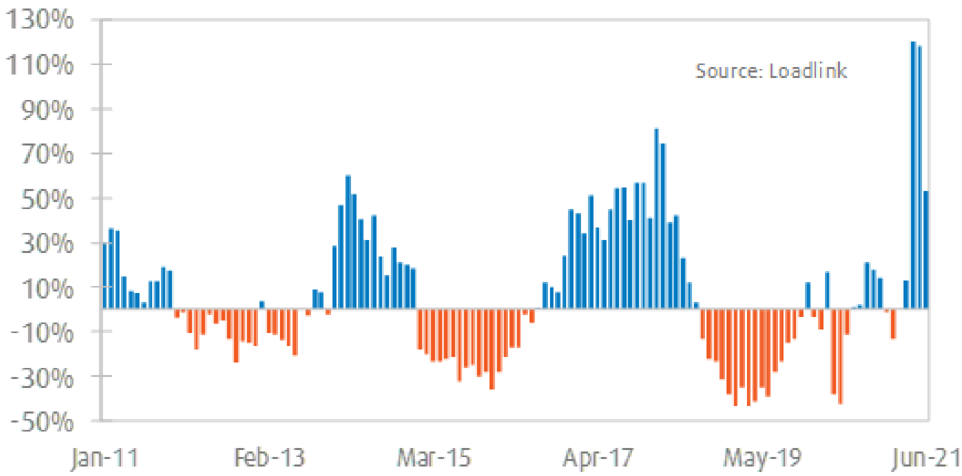
Longer-term, the big questions for crude oil production will be how the demand curve evolves, coupled with climate change policies and the trend towards fossil fuel divestments.



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. That said, the widening spread between the 3-year and 5-year has begun to reflect a bias toward higher rates further into the future as a typical response to a resumption of economic growth and likewise the possibility of increasing inflationary pressures. Most recently, however, expectations for interest rates have been under modest pressure as the Delta variant has raised concerns about a possible interruption in the economic reopening.

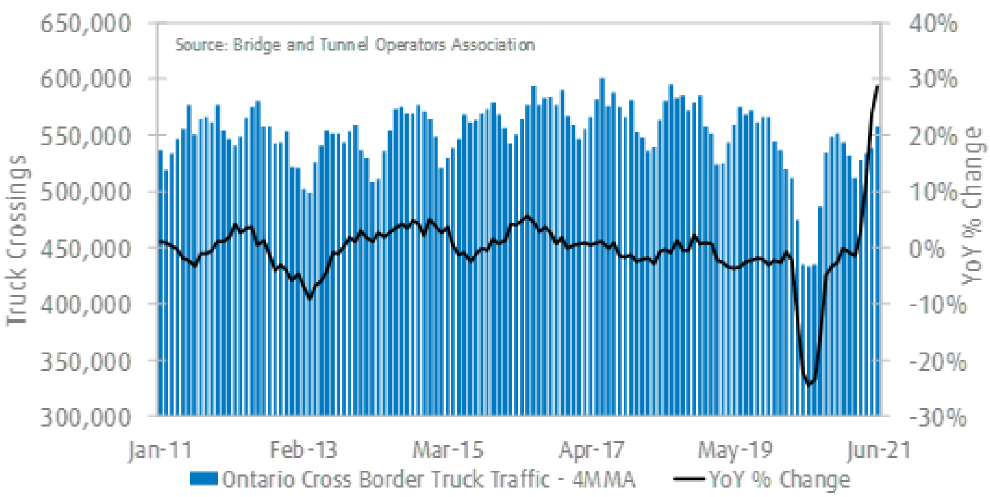
Freight Indicators

Canadian Truckload Spot Freight Volume Index Y/Y % Change



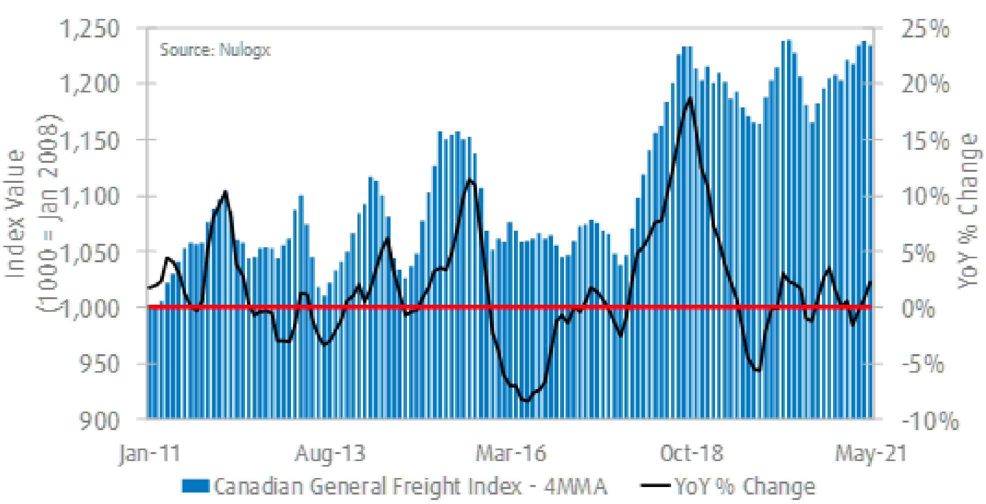
During the second quarter of 2021, **truckload spot freight volume** increased 10% compared to the first quarter, marking the 2nd highest 2Q volume behind only the 2nd quarter or 2018. Further, given the strong recovery in freight since the middle of last year and despite a growing number of trucks in the market, spot market capacity remained tight through mid-2021. The truck-to-load ratio of 2.58 during the 2nd quarter was essentially flat compared to the 1st quarter and significantly tighter than the 3.84 ratio in mid-2020.

Ontario Cross Border Truck Traffic



With rapidly improving vaccine availability and a significant decline in new case counts since a peak in April, monthly **truck border crossings** have recovered to near-normal levels. Crossings during June were 10% higher than a year earlier and essentially equaled the pre-pandemic level recorded in June 2019. Further, the four-month (ending June) moving average of crossings reached its highest level since November 2019. Crossings during the entire 2nd quarter increased 1.6% from the 1st quarter but were still nearly 6% lower than the pre-pandemic 2nd quarter of 2019.

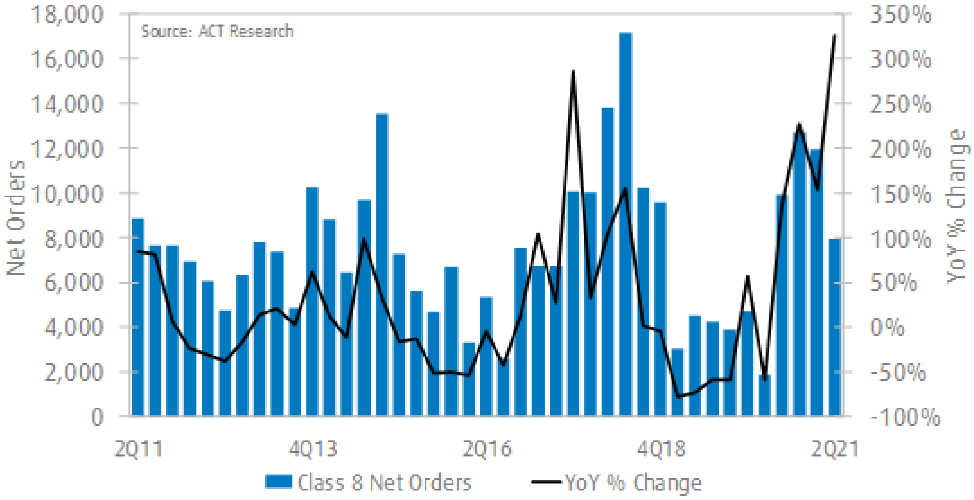
Canadian General Freight Pricing Index



An index representing the **total cost** (fuel surcharges + base rates) of over-the-road freight transportation for Canadian shippers has been at historically elevated levels since the middle of 2018. Over much of that timespan, tight capacity has put significant upward pressure on base freight rates, more than offsetting downward pressure on fuel surcharges. That said, there has been a reversal in that trend since late last year as base rates have been gradually trending downward while fuel surcharges have been trending progressively higher. Altogether, the overall price level remained elevated through May, with the four-month moving average off only 0.4% from an all-time high in March 2020 and up nearly 6% from a more recent low last Summer.

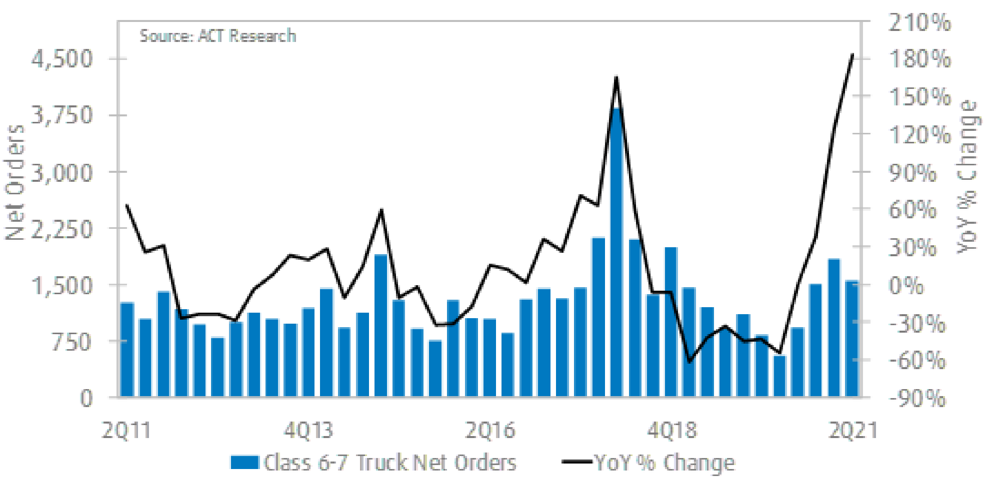
Truck Orders

Canada Class 8 Net Orders



Net new Class 8 orders during the 2nd quarter of 2021 saw a somewhat typical seasonal downtick. No doubt, long delivery lead times that extend into next year also dampened the intake. That said, orders were still the 3rd most for any 2nd quarter over the past decade. What's more, year-to-date through the first half of the year, orders were running 35% ahead of the pre-pandemic five-year average.

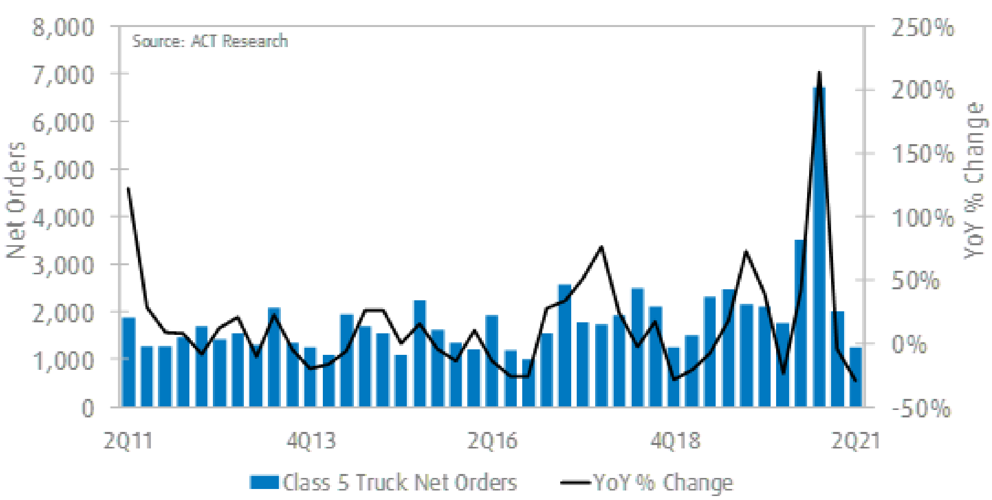
Canada Class 6-7 Truck Net Orders



Class 6-7 Truck Net Orders saw a typical sequential downtick during the 2nd quarter. During the 2nd quarter, class 6-7 net orders declined 16% from the 1st quarter, which was still better than the average 21% decline during the five years before the pandemic. Further, orders year-to-date through June are still running 8% ahead of the pre-pandemic five-year average despite long lead times.

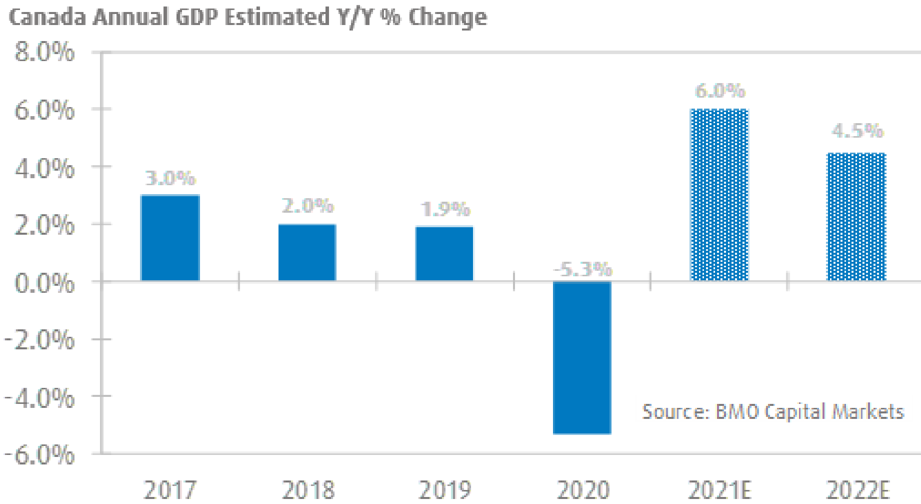
That said, the upper end of the medium-duty segment continues to face longer-term headwinds, particularly in end-markets such as energy production. Additionally, the ongoing buildout of regional distribution centers and a trend toward shorter hauls favor smaller trucks featuring more fuel-efficient engines.

Canada Class 5 Truck Net Orders

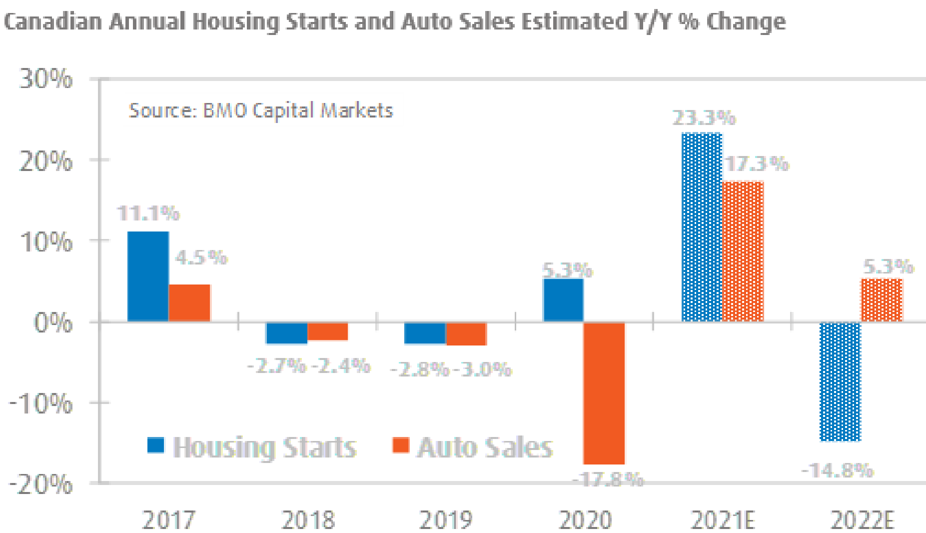


In addition to factory supply chain issues that continue to limit available build slots, the **Class 5 truck** market continues to digest record orders at the end of 2020. That said, the long-term demand outlook remains positive with the usual support of diverse end markets, consistency in vocational sectors, and the durable tailwinds of e-commerce and last-mile delivery.

Macroeconomic Indicators

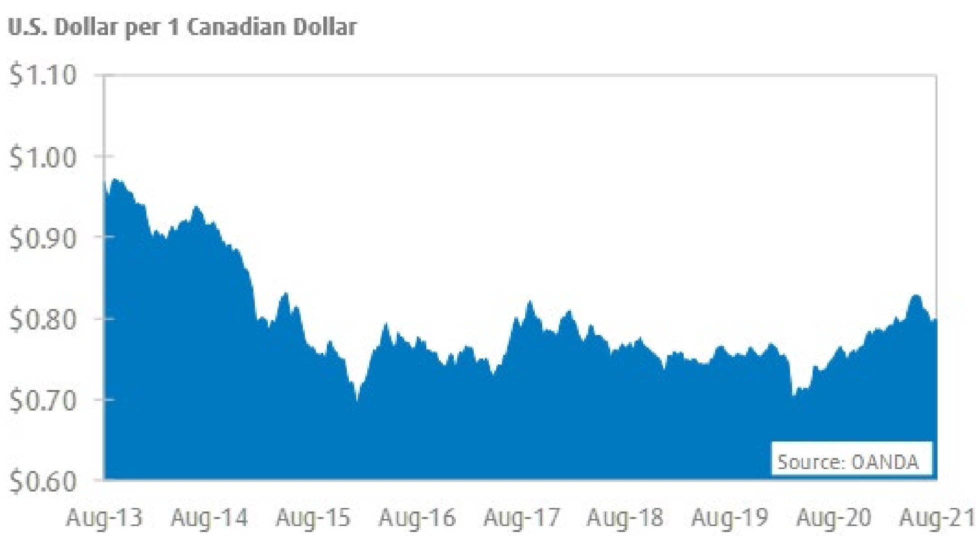


Despite the threat of a return to more stringent restrictions and increased consumer anxiety about the Delta variant, **Real GDP** remains on track to re-accelerate during the 2nd half of the year and still grow 6.0% (albeit against an easy comparison) for all of 2021. Underpinning the recovery will be less than the extreme mobility restrictions of last year, expanding vaccinations, fiscal stimulus, strong demand for housing, commodity inflation, supportive financial conditions, pent-up demand for services, elevated household savings, and a recovering U.S. and global economy.



Canadian housing starts fell 3.2% to 272,176 annualized units in July. While momentum has been moderating after unprecedented strength earlier in the year, the activity level remains historically high. The six-month moving average dropped to 286,620 units, which is still above the building booms in the 1970s and 1980s. The volatile multi-family segment fell 3.1% following two months of growth. Meantime, single-family homes, which have fueled much of the price gains during the pandemic, rose 7.1%.

Assuming a trend toward normalization of the supply chain and in-person purchasing, the pent-up demand of well-capitalized consumers should provide the **auto sector** with tailwinds necessary to return sales levels to pre-pandemic levels by 2022.



Assuming peak-fear of the Delta variant has passed, the U.S. dollar is likely to resume relative weakness over the coming months. On the flip-side, the Bank of Canada's schedule remains on track to be ahead of the Fed in tapering timing as well as rate hikes.

Despite the pullback from a recent high in early June, BMO economists expect the Canadian dollar to gradually appreciate through the end of this year and throughout 2022. Current expectations call for the Canadian dollar to finish this year at around US$0.816 (C$1.225) and US$0.833 (C$1.200) by the end of next year.

“Voice of the BMO Economics Team”

With the Delta variant proving that the pandemic is far from resolution, we thought it would be helpful to share some refreshed thoughts from the BMO Economics Team on the near-term outlook for the Canadian economy. For more: https://economics.bmo.com/en/

North American Outlook: Fourth Wave Rising – Sal Guatieri, BMO Senior Economist

As the U.S. climbs down the growth mountain, Canada is on the way up. While monthly GDP contracted in the spring due to a third round of constraints, easing restrictions sparked a 0.7% rebound in June according to Statistics Canada's initial tally. This should keep growth positive in Q2, while setting the stage for a brisk 6% annualized gain in Q3. The pick-up is despite some steam seeping out of the piping-hot housing market, which now accounts for a stunning 10.3% of GDP versus a long-run mean of less than 6% (those realtor fees really do add up). The release valve reflects exploding house prices (the benchmark is up 24% y/y) which are causing some buyer fatigue. But even with a relatively cooler housing market, the economy should grow 6.0% in 2021 and a solid 4.5% next year.

The rosy outlook, of course, assumes no serious upturn in hospitalizations and the need for significant new restrictions. Here, Canada's drive toward the top of the global vaccination ladder puts it at lower risk than most other countries of shutting down again. Around 80% of Canadians age 12 and older have received at least one shot, and the country is well on its way to having a similar share fully inoculated by late August. This should reduce stress on the health care system as caseloads inevitably rise due to the recent easing of restrictions.

Global growth concerns have breathed new life into the U.S. dollar, knocking the loonie off its perch, though it's still one of the top performing currencies this year. While we trimmed our forecast, we still see the currency strengthening to C$1.20 (US$0.83) by late 2022, partly because the Bank of Canada is likely to move ahead of the Fed in raising policy rates.

The Bank of Canada's confidence in the economic outlook has risen alongside rising vaccinations, though it still sees the output gap staying open until the second half of 2022. While the positive sentiment spurred another $1 billion reduction in its QE program to $2 billion per week, the persistent output gap could keep the Bank's finger off the policy-rate trigger for at least another year. Although CPI inflation has turned up to 3.1% in June, it is off a recent high and the core measures are averaging only modestly above the 2% target. While we advanced our call on the Bank's initial rate hike by a few months to October 2022, we still expect a very gradual course of tightening, with just six quarter-point moves taking the policy rate up to a neutral 1.75% by early 2025.

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