Industry Update

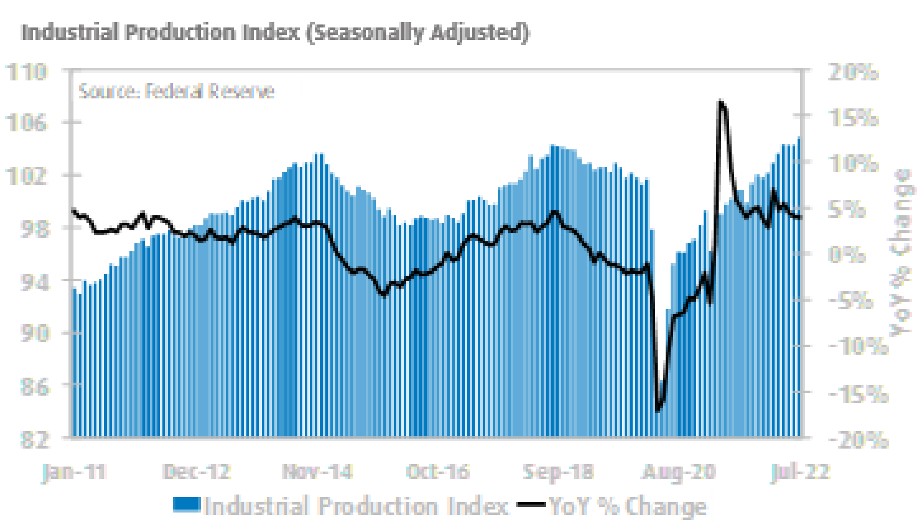
Truck Transportation

Key Developments

- The U.S. Supreme Court decided not to hear a case brought by the **California Trucking Association** challenging **AB5**. AB5 is a California state law that restricts businesses from classifying workers as independent contractors if those workers are in the same business. The CTA estimates that 70,000 owner-operators will be affected by the law. Other states, such as New Jersey, Illinois, Washington, and New York, are reportedly contemplating similar laws.
- **Heartland Express** announced the acquisition of CFI's U.S. truckload operation, CFI Temp-Control, and the Mexican cross-border TL and LTL asset-light logistics, valued at $525 million. The combination will elevate Heartland to the eighth largest truckload fleet with approximately 5,550 tractors and 17,800 trailers.
- Data from the **FMCSA Drug and Alcohol Clearinghouse** show that as of July 1st, 74% of the 135,393 drivers with at least one violation remain in "prohibited status." Further, 76% of those in prohibited status (75,717) have not yet started 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

Carrier operating costs are past their peak as the price of Diesel has declined for the better part of two months, and it seems like ages ago when the driver shortage was the number one industry challenge. Judging by the solid 2nd quarter earnings reports of the public carriers, contract freight also seems to be holding up quite well. Nonetheless, although it may take a few more months for the NBER to formally announce the start of a recession, the conversation has quickly pivoted from inflation, where prices for energy and many commodities have rolled over, to slowing macro growth and, by extension, freight growth. That said, the fortunes of truck carriers are not homogenous in the same way that other industries are whipped around by the ebbs and flows of specific commodities. While there are few places to hide during a severe recession, depending on their geographic location, freight segment, market (spot v. contract), and customer exposures, some carriers are faring much better than others.

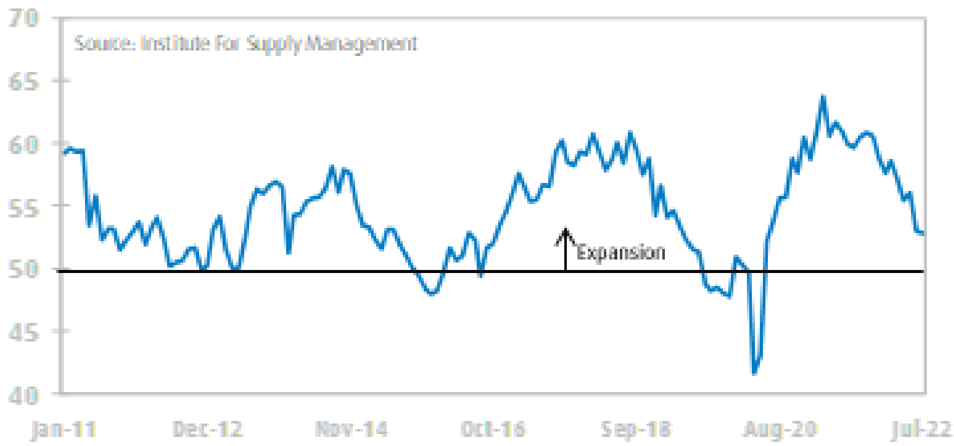


U.S. industrial production jumped 0.6% in July, double the expected pace but only 3% above the pre-pandemic level of February 2020. Despite the fast start to the 3rd quarter, the year-over-year improvement slowed for the third consecutive month and is expected to continue to decelerate amid slowing consumer demand and rising interest rates.

Manufacturing, approximately 75% of industrial production, climbed 0.7% and reversed back-to-back monthly declines. Motor vehicles and parts (+6.6%) and most other durable goods posted solid growth of at least 1%. Capacity utilization during July increased by 0.4 ppts to 80.3%, marking the highest since September 2018.

Macroeconomic Indicators

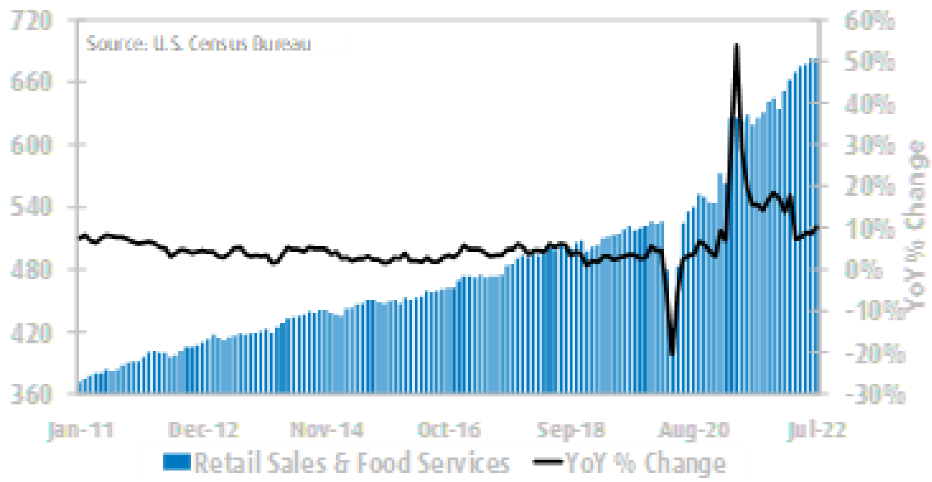
ISM Purchasing Managers Index



The **Purchasing Managers' Index (PMI)** is a sentiment measure of near-term business conditions in the manufacturing sector. The index nudged lower in July, down 0.2 points to 52.8, still above the 50-mark separating expansion and contraction but the lowest since June 2020. Four of the six largest manufacturing sectors reported growth. Further, the month-over-month decline in reported prices paid for commodities was the fourth largest decline on record and the most since 2010. On a less positive note, new order volumes contracted for a 2nd month after growing for 24 consecutive months.

The past relationship between the PMI and GDP suggests that the July PMI corresponds to an annualized GDP growth rate of 1.4%, 20 basis points above BMO Economists' current estimate for year-over-year growth of 1.2% during the 3rd quarter.

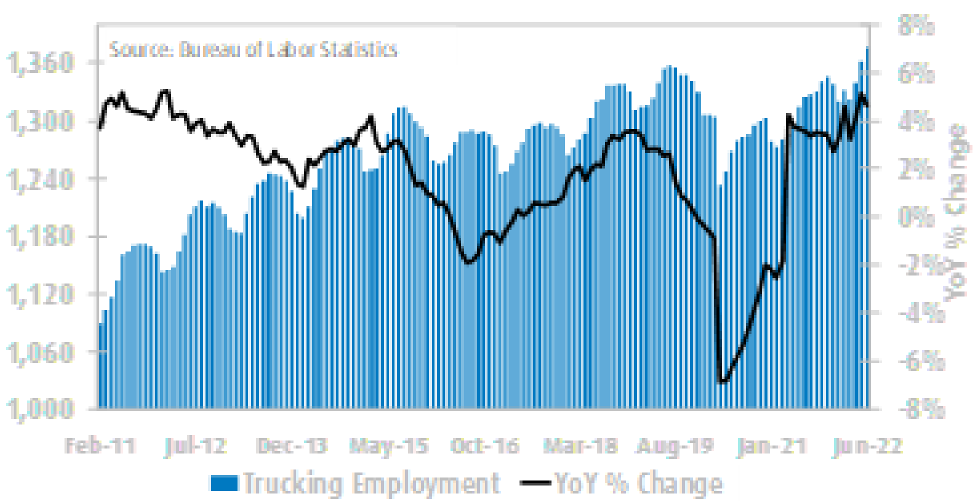
Retail Sales & Food Services (Seasonally Adjusted $Bn)



Amid support from solid job and wage gains and excess savings, real consumer spending improved slightly at the outset of the 3rd quarter after slowing to a 1.0% annualized rate in the 2nd quarter. Still, there's little doubt that high inflation and rising interest rates are taking a toll on spending power.

U.S. retail sales were unchanged in July, just shy of expectations. The control measure of sales that is used to tally personal spending (excludes food services, autos, gas stations, and building supplies) jumped 0.8% following a near-similar sized advance in June, though part of the gain simply reflects higher prices. Notable weak spots were furniture and home furnishings, clothing, and restaurants. Food store purchases also rose much less than the spike in prices, meaning people are cutting back even on a key necessity.

Truck Transportation Production and Non-Supervisory Employment



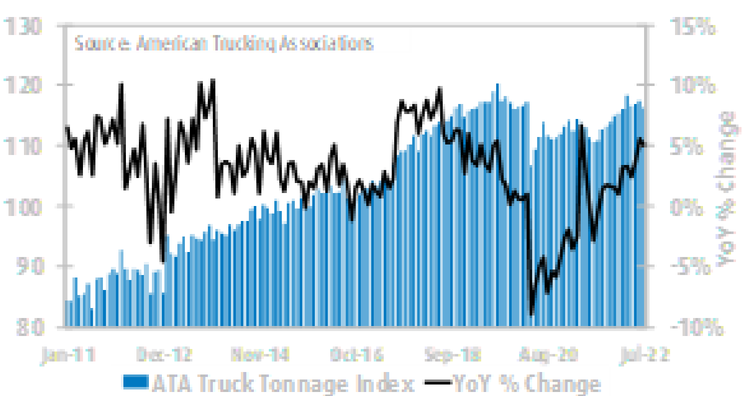
Following a brief Omicron-related pause earlier in the year, employment in the truck transportation industry has accelerated and reached an all-time high in June. **Production and non-supervisory employment** during June increased by 1.1% (~14,500 jobs) month-over-month and 4.6% (~61,000 jobs) year-over-year.

Driver availability has gradually improved with the incentive of solid earnings potential (Walmart offering salaries up to $110k) and accelerating training throughput. Note that payroll data only covers larger for-hire carriers and misses private fleet drivers and the many drivers that have left larger fleets to work for themselves. However, the data should capture what is likely to be a growing number of drivers who ventured out independently but have been squeezed by high fuel prices and lower spot rates and have since returned to the relatively safe harbor of larger for-hire carriers.

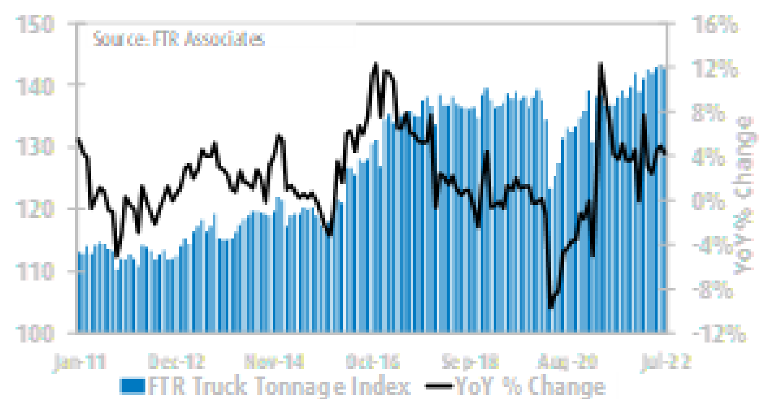
Freight Indicators

Despite strengthening macro headwinds, most freight indices held up surprisingly well through the year's first half. Durable goods orders and backlog remain at multi-year highs, energy production remains robust, replenishment of auto inventories remains incomplete, and freight from China appears to be on a path toward gradual normalization. That said, more recent notable weakness in the housing sector and consumer confidence coupled with an ongoing shift in consumer spending away from discretionary goods and over-extended retail inventories are challenges that will not likely dissipate soon. Further, with the Fed intent on stamping out inflation and macro repercussions from the most recent large increases in the Fed Funds rate yet to be fully reckoned with, the odds are that freight growth with continue to decelerate and maybe even decline.

ATA Truck Tonnage Index (Seasonally Adjusted)

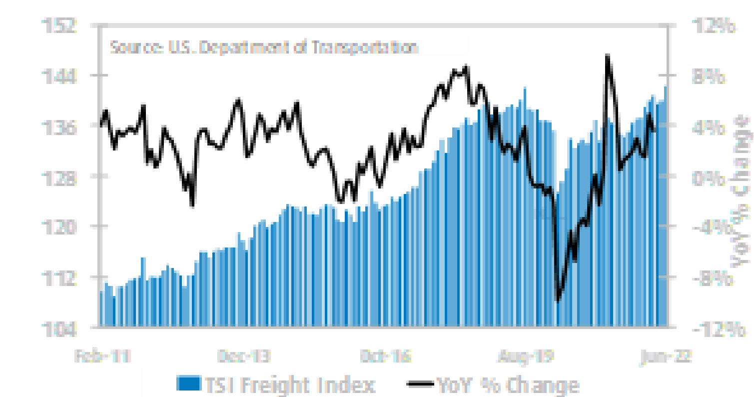


FTR Truck Tonnage Index (Seasonally Adjusted)

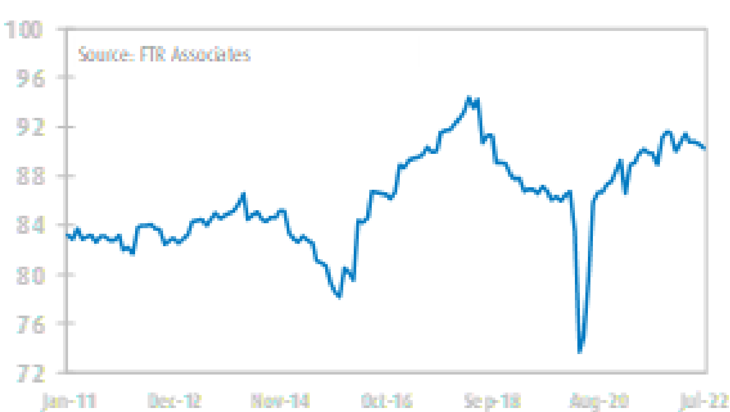


Cass Freight Index – Shipments (Seasonally Adjusted)

Transportation Services Index (Freight)



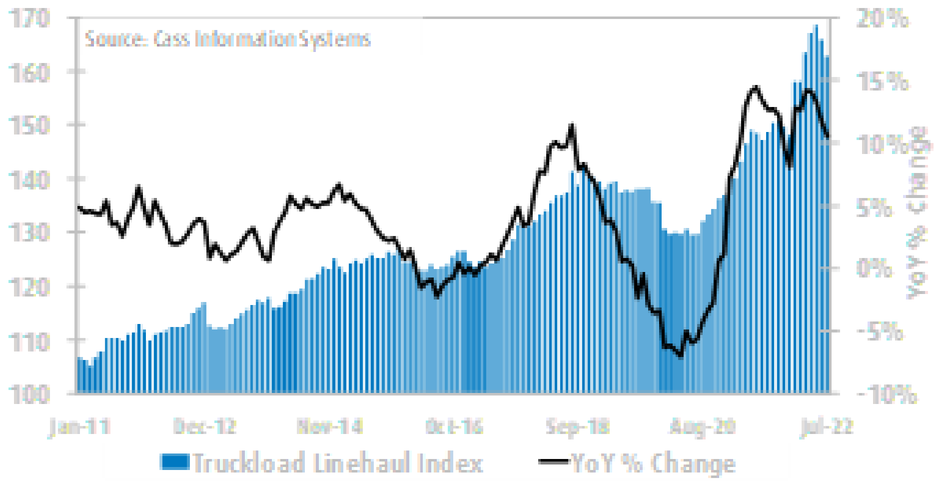
Class 8 Fleet Capacity Utilization



- The **ATA For-Hire Truck Tonnage Index** (primarily contract freight) during July saw only the 2nd month-over-month decrease over the past twelve months but also the 11th consecutive year-over-year increase.
- The **FTR Truck Tonnage Index** has been flat since May but remains near an all-time high.
- The **Cass Freight Shipment Index** (all modes) has generally weakened since reaching a post-pandemic high last December.
- The **TSI Freight Index** was in a strong uptrend through June, approaching the all-time high reached in August 2019.
- The **FTR Class 8 Capacity Utilization Index** has retreated from a 3-year high but remains above its long-term average.

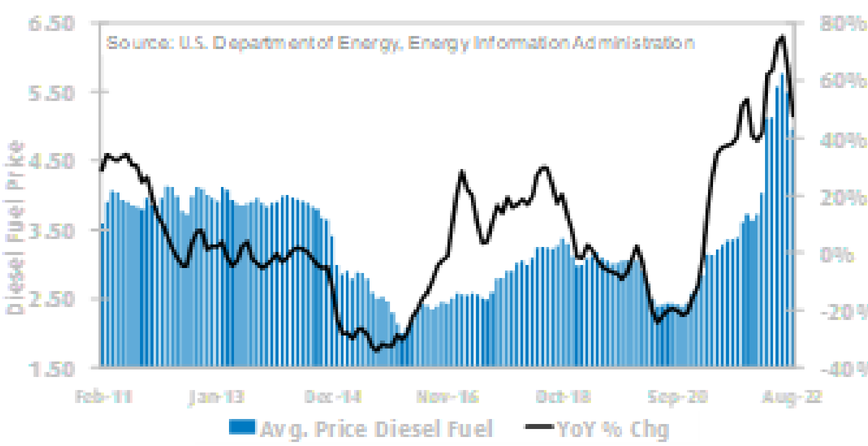
Revenue And Expense Indicators

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 lag from when the contract market reflects trends in spot freight pricing. With spot rates having seen significant pressure throughout much of the year, a softening of contract rates is likely only in the early stages.

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



Since peaking at an all-time high in June, **Retail Diesel** fuel prices have been on an unrelenting downtrend. As of mid-August, the average weekly Diesel price of $4.91 was down 90 cents (-16%) from the recent peak but still up 81 cents (+20%) since the invasion of Ukraine and $1.56 cents (+46%) over the past year.

Despite the recent plunge, BMO estimates that crude and Diesel prices will remain elevated for the foreseeable future (WTI averaging $100 in 2022 and $95 in 2023) as slowing global growth and new supply only partially offset demand for non-Russia crude. Further, incremental demand for Diesel could emerge as Europe contemplates the fuel as a potential natural gas substitute during the upcoming winter.

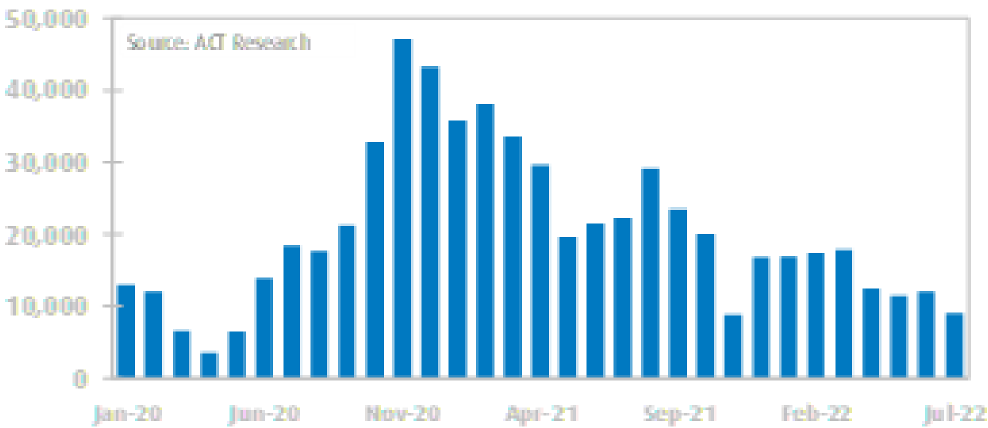
Average New Heavy Duty and Used Truck (All Types) Prices ($)

With an ongoing backdrop of lean inventories, constrained albeit improving supply, and steady customer demand, the **average price of new heavy-duty trucks** sold by Rush Enterprises during the 2nd quarter sprinted to a new all-time high. Altogether, heavy-duty ASPs increased by $11,043 +7.1%) from the 1st quarter and up $18,620 (+12.6%) from the year-earlier quarter.

The **average price of all used trucks** sold by Rush Enterprises during the 2nd quarter set yet another all-time high (+13% q/q and +63% y/y) while continuing to benefit from scarcity value. However, 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 are likely to retreat from the market and stay on the sidelines.

Truck and Trailer Orders

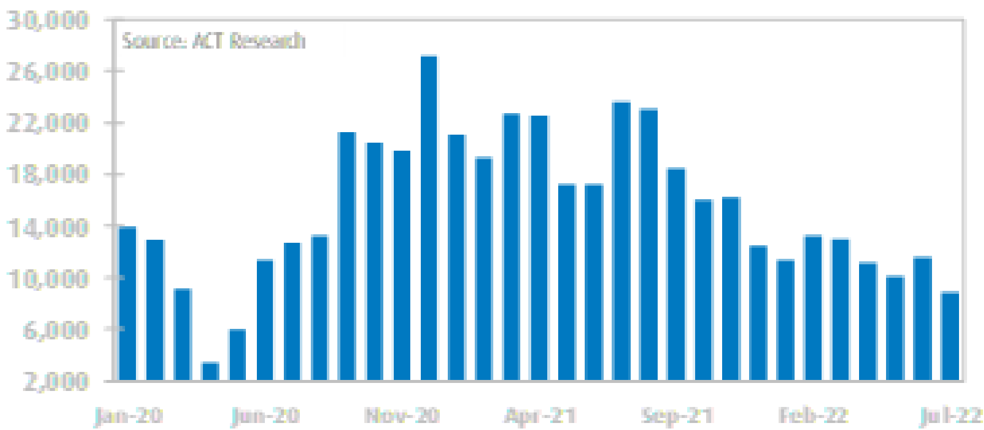
U.S. Class 8 Net Truck Orders



With the overall freight picture on tenuous footing, the possibility of slackening demand for freight capacity is a growing concern. For now, carrier appetite appears intact, given year-to-date average monthly cancelation rates of 0.9% compared to the long-run average of 2.2%. Still, the reluctance of OEMs to book new orders that outpace manufacturing capacity clouds any real-time read on market-based changes in truck demand.

Although **U.S. Class 8 net truck orders** during July were the third-lowest monthly total since the pandemic bottom, the manufacturing backlog still sits at nine months of the current build rate while cancellations remain low. As such, and while acknowledging the strengthening macro headwinds, the year-long trend in declining orders still appears to reflect poor supply chain visibility and OEM reluctance to embrace long-range commitments.

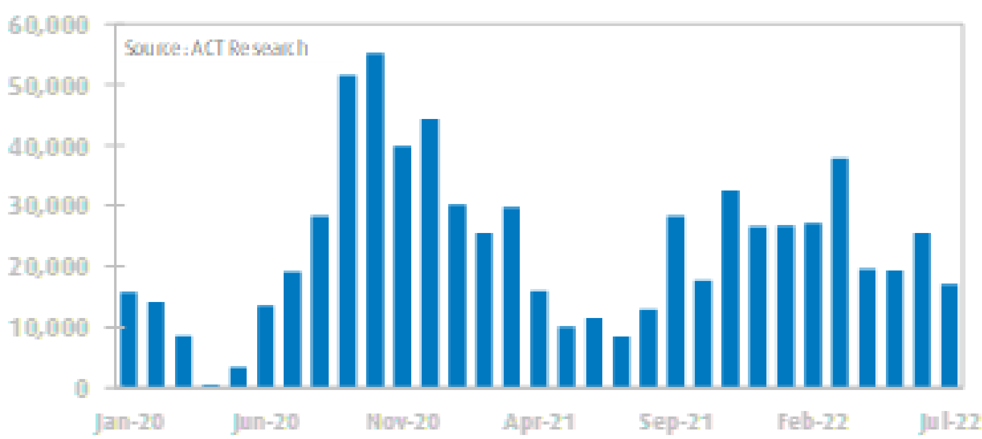
U.S. Class 5-7 Net Truck Orders



Improving Class 8 production seems to be coming at the expense of medium-duty output as sub-optimal supplies of some critical components are directed to the more profitable larger trucks. In addition to factory supply chain issues limiting available build slots, the **U.S. Class 5-7** truck market continues to digest record orders at the end of 2020 and through the first half of 2021.

Despite the lackluster recent order trend and growing headwinds in the construction sector, 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, consistency in vocational sectors, and the durable tailwinds of e-commerce and last-mile delivery.

U.S. Net Trailer Orders



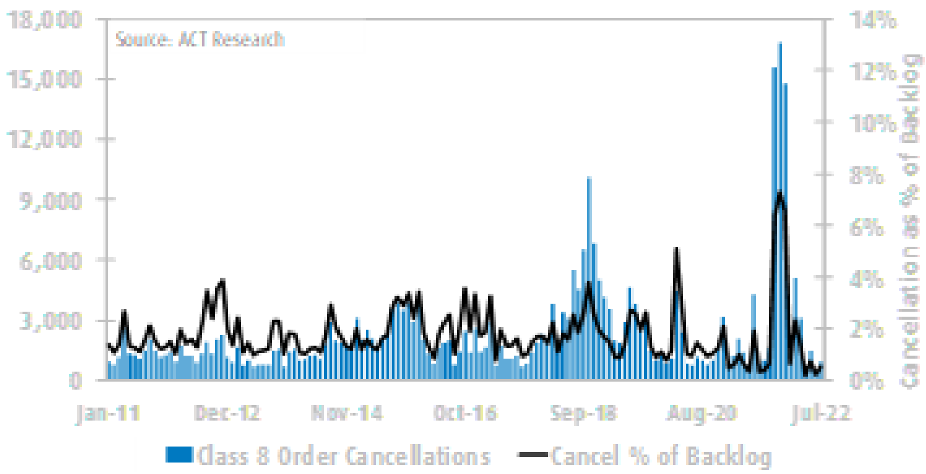
U.S. trailer orders have followed a volatile yet somewhat predictable seasonal pattern over the years, with Fall/Winter the usual timeframe for new capital commitments and Spring/Summer a perfect time for dealers to take a vacation.

Build slots for 2022 have been long sold out, and although supply chain visibility has been improving, OEMs have been more deliberate than usual in opening slots for next calendar year's deliveries. Given the typical seasonal weakness and a still murky supply chain, net trailer orders during July were the lowest since last Summer, albeit more than double last year's low point.

Further, carrier appetite appears intact, given monthly cancelation rates hovering around 1% of backlog compared to the long-run average of 2%.

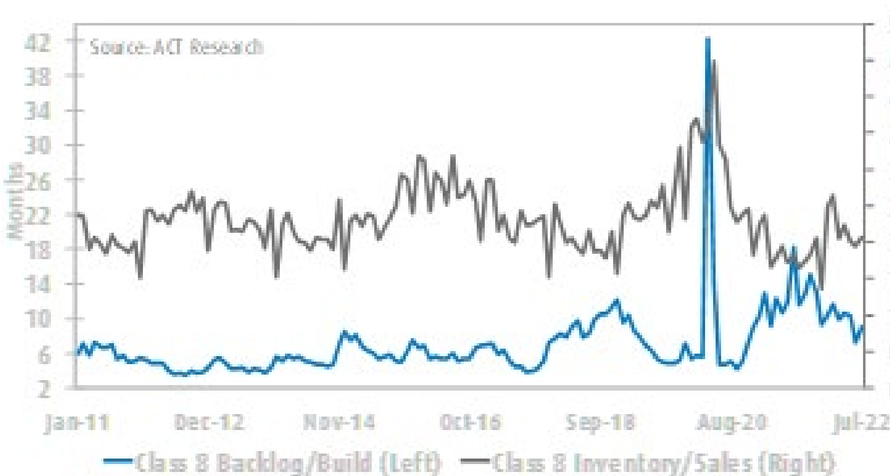
Other Equipment Indicators

U.S. Class 8 Order Cancellations



The 9-month manufacturing backlog has undoubtedly contributed to below-average **Class 8 cancellations** through July. 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.

U.S. Class 8 Backlog/Build vs. Inventory/Sales



OEMs have been managing the order intake to gradually reduce the Class 8 manufacturing backlog, which has declined for nine consecutive months through July. 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 halved over the past year. But at nine months in July, it is still above the long-run pre-pandemic average of six months.

Given the recent improvement in builds, Class 8 inventories were hovering near 18-month highs at the end of July. The **heavy-duty inventory-to-sales** ratio has also rebounded to the low-end of the long-term average range of 2-2 ½ months.

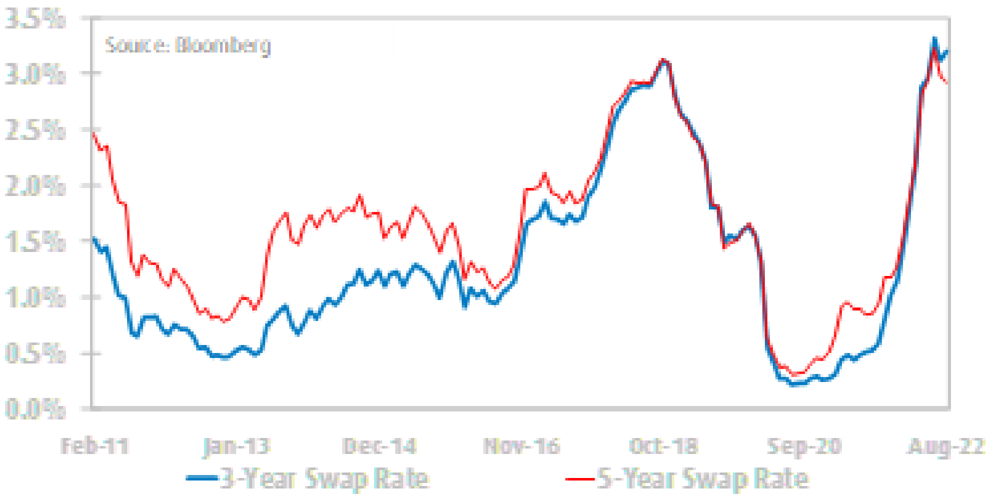
U.S. Class 8 Retail Sales vs Builds

The above replacement pace of **U.S. Class 8 unit retail sales** over the past few months (254k annualized rate from March through July) is an encouraging sign that OEMs are making progress with their supply chains while also demonstrating that plenty of carriers have not lost their appetite for capacity.

Class 8 production struggled to reach a monthly average of 18,000 units throughout 2021. However, throughout the first half of 2022, the materials supply chain and available labor have improved. As a result, monthly builds have been on a choppy trend higher to an average of 21,100 units during the eight months through July, with June production of nearly 26,000 units, the highest monthly total since 2019.

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 has embarked on an unequivocally hawkish path in response to multi-decade high inflation. As of mid-August, BMO's economists were expecting another 125bp increase in the Fed Funds rate by the end of 2022 and then for the rate to remain steady. That said, a recent slight rollback of swap rates reflects a potential peak in year-over-year inflation expectations 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)

U.S. housing starts plunged in July to a far-lower-than-expected 1.45 million units annualized, the lowest since last February. The trend in starts aligns with the plunge in homebuilder sentiment, which in August was at an 8-year low (outside of 2020) of 49 and indicates that more builders view sales conditions as poor than good. BMO economists expect new homebuilding to continue drifting lower and bottom during the 3rd quarter of 2023 at 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 far from normal. Annualized **U.S. sales of light vehicles** of 13.3 million during July improved nearly 5% from a recent low in May but were still down 9% from a year earlier.

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

The **total business Inventories-to-sales** ratio bottomed at an all-time low last fall 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 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 U.S. economy. For more: https://economics.bmo.com/en/

U.S. Economy: Skirting Recession
Sal Guatieri, Senior Economist and Director August 19th, 2022

The data releases this week suggest the **U.S. economy may still have one foot out of the murky recession waters.** While most of the indicators landed on the soft side, notably for housing, a few others showed glimmers of resilience. The latter included a surprising **retreat in initial jobless claims** after a one-way trip northward since April. As well, **industrial production popped 0.6%** in July, led by a surprisingly large gain in manufacturing. However, regional factory surveys for August are mixed: the Empire index plunged to pandemic levels while the Philly Fed measure returned to expansion.

Amid a busy summer travel season, real **consumer spending could pick up** to a 2% rate in Q3 after a soggy first half of the year. Lending a hand are lower pump prices and some retail discounting to clear out excess inventories. **Retail sales were flat** in July amid sliding gas station receipts and minimal advances (after inflation) at most other stores. But retail sales largely measure the demand for goods, which are now out of vogue as people travel, dine, and do other fun things. And, so far, there is little sign of a pullback in these areas.

One sector that has no ambiguity about its direction is the **housing market, as nearly every indicator is pointing due south**. This week brought a 10% dive in housing starts, a sixth straight decline in existing home sales to below 2019 levels, a further drop in mortgage applications, and a slide in homebuilders' confidence to the lowest level since 2014 (apart from the early pandemic days). Median resale prices have fallen 2% (seasonally adjusted) in the past two months, and are likely headed for at least a 10% retreat amid the worst affordability since 1989.

Nicely summarizing the U.S. economy's current and prospective status were the **composite and leading indicator indexes** for July. The former is still marching forward, suggesting the economy is not currently in recession. However, the latter fell for a fifth straight month, pointing to at least a mild downturn in the year ahead. Meantime, based on data in the first half of the quarter, the **Atlanta Fed's GDP Nowcast** sees 1.6% annualized growth in Q3. That's one percentage point above our call, suggesting some upside risk. While neither estimate is worth celebrating, they sure beat a third straight quarterly contraction. Still, the economic outlook remains grim until we know whether the Fed can avoid using a sledgehammer to beat down inflation.

U.S. Economy: Hard Core Problem
Doug Porter, Chief Economist and Managing Director August 19th, 2022

We may be past the high-water mark for inflation, but there is still a long slog ahead in bringing it anywhere close to the comfort zone. That, in a nutshell, is the takeaway from this week's round of economic data, remarks from central bankers, and market action. Partially in recognition of the hard inflation fight ahead, bond yields generally pushed higher, even with a further moderate pullback in oil prices to around $90. Stocks initially held firm, but eventually succumbed in some late-week softness amid the re-rating in rates. After getting as low as 2.6% at the start of August, the 10-year Treasury yield is now back close to the 3% threshold for the first time in a month. Two-year Treasuries remain stubbornly stuck almost 30 bps higher, keeping the curve inversion alive and well.

"Voice of the BMO Economics Team" Continued

U.S. Economy: Hard Core Problem (cont.)
Doug Porter, Chief Economist and Managing Director August 19th, 2022

The 5%-to-6% range of core inflation measures in Canada and the U.S. are matched in Australia but are well above the latest 4% reading for the Euro Area and in a different league than the 1.2% in Japan. However, **Britain** now takes the cake for high inflation in the advanced economies, with core at 6.2% and the headline rate topping double digits in July at 10.1%. Peak inflation in the U.K. is less a reality than Peaky Blinders, with fuel prices still raging and further hikes on the way—some are now looking at inflation topping out above 13% later this year. But Britain may be the exception that proves the rule, as gasoline prices are poised for another sizeable drop in August for North America at least, potentially pointing to a further small step back in overall inflation next month.

The key point is that even if gasoline does provide some further modest relief, and even if food prices relent in the months ahead, **we are still facing underlying price trends of around 5% (or more) in much of the industrialized world.** Reinforcing that point, a variety of wage measures are now drifting into that zone as well in both the U.S. and Canada. And while the summer rally in financial markets may be gratifying for investors, the strengthening in overall financial conditions will make the job of central bankers that much more challenging. Some have deemed the recent market rally as "self-defeating", since it could indeed imply that central banks will need to tighten even further—or keep rates restrictive longer—to ultimately rein in core inflation.

A major source of friction between the market and central bank communications has been around the issue of **how long rates will need to stay relatively high to corral inflation.** We tend to side with the Fed speakers on this issue, and markets are gradually pulling back on the degree of potential rate relief in 2023. With a light data calendar ahead, next week's headline event may focus on this very issue—Chair Powell's address at the annual confab at Jackson Hole, Wyoming. This year's theme for the symposium is "Reassessing Constraints on the Economy and Policy". Sustained strength in underlying inflation would be a meaningful constraint on both the economy and the room to maneuver for policy.

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