OCTOBER
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STATE OF THE INDUSTRY

REPORT

FLEET LEASING & MAINTENANCE | DEDICATED TRANSPORTATION | SUPPLY CHAIN SOLUTIONS

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'Calm' before the storm

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Overview

In any other year, it would be inaccurate to characterize this period as "the calm before the storm" — normally tender rejection rates of 24% and national average dry van truckload spot rates near $3 per mile are about as bad as conditions get for shippers and 3PLs.

But 2020 has been different: Consumer demand, industrial activity and ocean freight patterns have all diverged from historical patterns and found their own rhythms in a COVID world. And based on retail inventory data, business sentiment surveys, ocean import bills of lading and the demand currently experienced by parcel integrators, we believe that Q4 will intensify from here.

In particular, Dallas and Atlanta will tighten again, just like Chicago already has. Los Angeles, to a large extent, will be dependent on port volumes and warehouse throughput, but if other major markets consume incrementally more over-the-road trucking capacity, LA could find itself undersupplied.

Volumes will spike, trucking capacity will tighten further, and prices will experience further volatility to the upside. In our conversations with e-commerce shippers, especially, we've found that shippers are securing backup capacity, building resilience, and managing for service and execution rather than cost control. There's a pervasive sense that consumers are establishing new habits, that wallet share is up for grabs, and that securing those customers depends on delighting them with great experiences, service and visibility.

Macro indicators	(y/y changes)
Industrial prod m/m change	-0.6 (-7.3)
Total retail sales m/m change	+1.9 (+5.4)
Sept. U.S. Class 8 orders	32,000 (+154%)
Sept. U.S. trailer orders	52,000 (+179.6%)

Truckload indicators	(y/y change)
Tender rejection rate	24.4% (+1,970 bps)
Average dry van spot rate	$2.89/mi (+36.9%)
Truckstop LAX to DAL	$2.94/mi (+119.4%)
Truckstop CHI to ATL	$3.11/mi (+53.2%)

Tender volumes	(y/y change)
Atlanta	608.71 (+55.94%)
Los Angeles	531.07 (+58.94%)
Dallas	386.55 (+59.68%)
Chicago	307.96 (+53.28%)

Tender rejections	(y/y change)
Atlanta	21.31% (+1,815 bps)
Los Angeles	23.76% (+2,147 bps)
Dallas	18.33% (+1,595 bps)
Chicago	23.01% (+1,840 bps)

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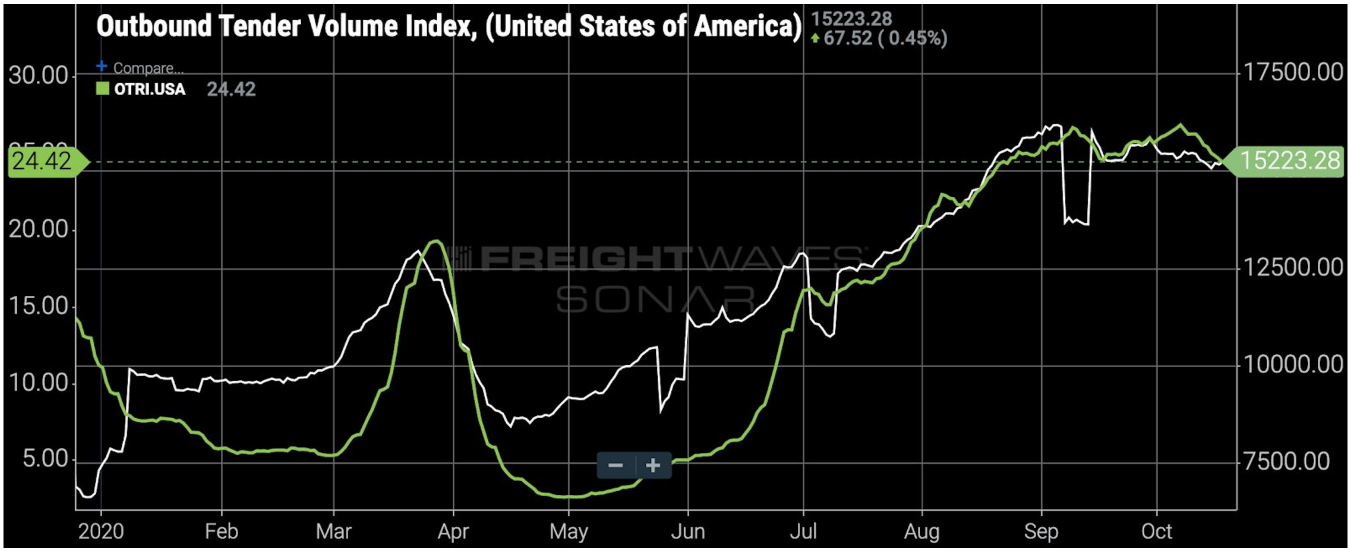
Truckload markets

The trucking market just exited one of the seasonally weakest time periods of the year. One would've expected truckload volumes to soften and capacity to loosen during September, but historical patterns once again proved obsolete. Unpredictable and volatile divergence from normal historical patterns has become normal in 2020, highlighting the importance of near-time fundamental data.

Truckload tenders ended the month just slightly down from the beginning of September, while capacity, as measured by truckload tender rejection rates, actually tightened throughout the month.



(Chart: FreightWaves SONAR. National Outbound Tender Volume Index [white] and National Outbound Tender Reject Index [green]).

Going forward, we believe that truckload volumes will be driven by two forces: retail spending/inventory replenishment and a recovering industrial economy.

While e-commerce has become a greater percentage of total retail sales over the past decade, we believe that COVID-19 has greatly expedited this process. Consumers have been using services such as Amazon to purchase goods instead of going into crowded public areas, both to avoid possible infection and to save money.

Heading into peak season, we expect holiday spending to be increasingly online, which will in turn fuel parcel volumes and LTL and truckload volumes upstream of parcel. Consumer confidence has been slowly rebounding, which indicates that spending will approach healthy levels, but what's been most relevant this year has been the *kind* of consumer spending, weighted toward goods, rather than overall dollar amounts.

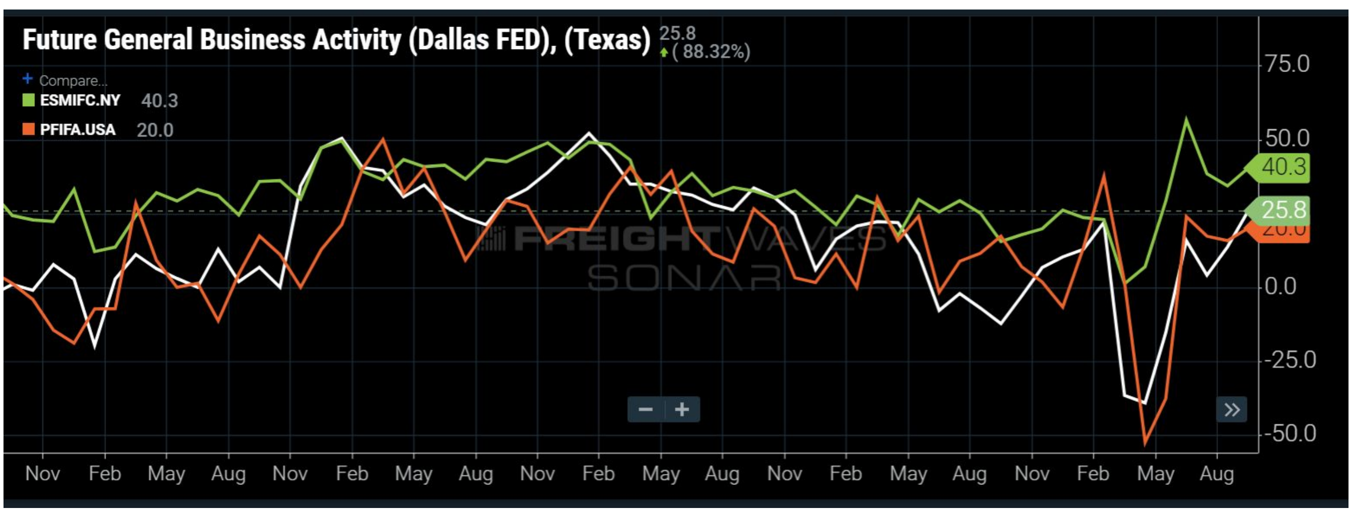
Secondly, as discussed below, the economy is expected to rebound through next year, which will be constructive for all types of truckload transportation. As the industrial economy rebounds, this will benefit flatbed transportation. We read today's announcement of the $9.7 billion sale of Concho

Resources to ConocoPhillips on the back of stabilizing oil prices, the largest oil and gas M&A deal since prices collapsed earlier this year, as positive sentiment toward the industrial recovery.

Lastly, trucking capacity is likely to remain extremely tight throughout the end of the year, which will drive volatility back into the spot market. New truck orders are beginning to rebound, but this comes after a dismal 2019, when new truck orders were below replacement levels 11 out of 12 months, and the first three quarters of 2020, when new truck orders have been below replacement levels every month except July, August and September. Trailer orders are outpacing tractor orders, suggesting that the shortage in the total number of available drivers due to driving school closures and new drug and alcohol testing requirements are still hindering carriers' ability to seat their trucks.

Macroeconomic conditions

Future business sentiment continues to improve as we enter the fourth quarter, as the Future General Business Conditions surveys conducted by the regional Federal Reserve banks, which measure business expectations over the next six months, ticked higher in September. The Empire State Manufacturing Index (ESMI) and the Philly Fed posted the first month-over-month increase since June as sentiment waned in July and August, though the levels were still positive. Sentiment in the Southern region of the country has continued to grow as the Dallas Fed has posted higher numbers in August and September after a slight dip in July.



(Chart: FreightWaves SONAR. Future general business conditions, ESMI [white] compared to Dallas Fed's future general business activity [orange], and Philly Fed's future general business activity [green]).

Business leaders in the Philly Fed region are the least optimistic as the Future General Business Conditions survey levels are the lowest of the three Federal Reserve surveys. The survey posted a 4.2-point increase in September, the smallest gain of the year. Within the survey, the future employment rate increased 13 points m/m, and future capital spending increased 8 points m/m.

The survey asked firms how production in the third quarter compared to pre-pandemic levels. The respondents said production was roughly 85% of pre-pandemic levels, and 62% of the firms expect production to increase in the fourth quarter.

The Future General Business survey conducted by the Dallas Fed jumped 12.1 points m/m in September, following a 9.6-point m/m increase in August and extending factory activity expansion for the fourth consecutive month. The employment index improved 3.9 points in September, as 24% of firms surveyed by the regional bank reported net hiring instead of the 10% reported net layoffs. Production capacity utilization rose by over 6.5 points to 17.5, the highest level since September 2018, while future shipments jumped 5.4 points, the highest level since July 2019.

The Dallas Fed asked firms to characterize the current situation among five options: fully operational, temporarily shut down part of operations, temporarily shut down all operations, permanently shut down part of operations, and permanently shut down all operations. 83.2% of firms answered that they were fully operational, up 23.9 points from April, while only 14.7% have parts of their operations temporarily shut down currently, down 18.6 points from April.

The future business conditions reported by the New York Fed via the Empire State Manufacturing Index jumped again in September to 40.3, up 6 points from August and the highest level of the regional bank data within SONAR. The index is led by future capital expenditures, which jumped 12.7 points in September as 30.2% of companies are reporting expected higher capex in the next six months while just 11.5% are expecting lower CapEx.

Future shipments are also expected to jump as 53% of firms in the survey report expected increases while just 14% of firms expect lower shipments in the next six months. The increase in shipments is impacting how firms think of delivery times. 17.3% of firms expect longer delivery times, up 1.3 points from August, while only 11.5% expect shorter delivery times in the next six months.

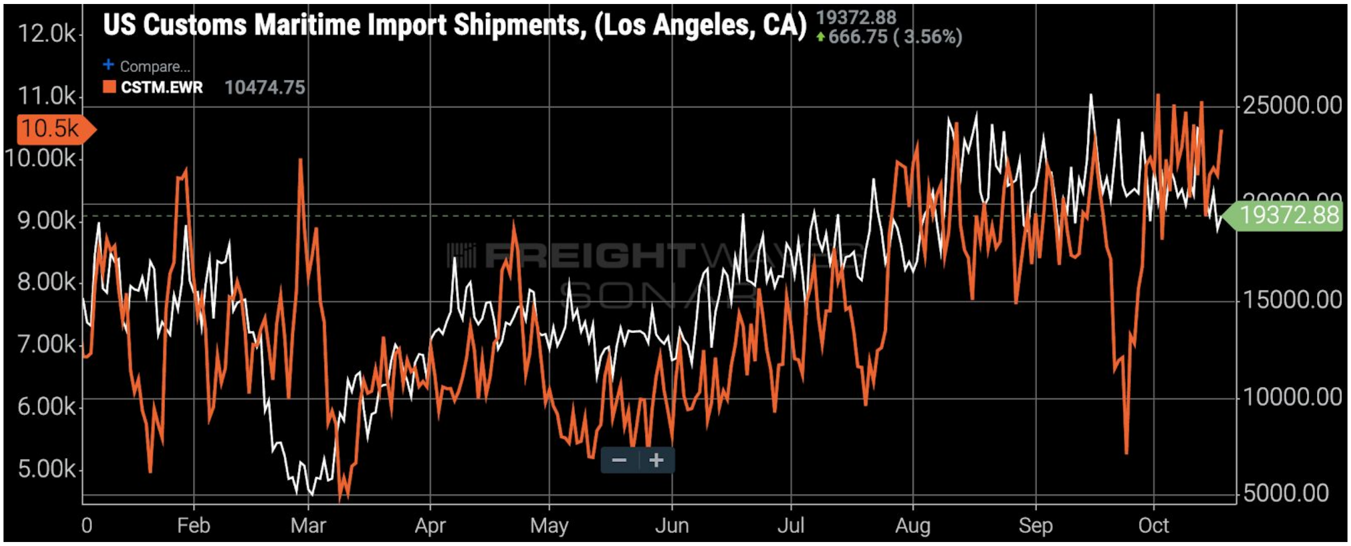
Employment within the transportation industry rose in September, as 74,000 jobs were added during the month. The jobs were led by Warehousing and Storage, which accounted for 32,000 additional jobs in the sector. The 74,000 jobs account for just 11% of all jobs added in September, in which the Bureau of Labor Statistics reported that 661,000 nonfarm payroll jobs were added in September, and the unemployment rate fell to 7.9%.

Imports and exports

United States customs shipments (total bills of lading) are at a healthy level and have rebounded ~87% since the bottom in the middle of March. Our outlook is constructive on national BoLs as we head into the end of the year, due to a strengthening economy and a strong consumer.

In the past month, bills of lading counts at the Port of Los Angeles and the Port of New York/New Jersey have both expanded. The most informative way to analyze import shipments is to look at them on a moving average. Customs officials still mostly process bills of lading manually rather than electronically or automatically, introducing choppiness into the data and putting a ceiling on the number of BoLs that can be processed on a given day.

Going forward, our outlook is constructive. Port volumes were up y/y in August, and according to Susquehanna transports equities analyst Bascome Majors, that should persist through September. Not only is this constructive to the trucking market but also intermodal, where volumes have been on a tear over the past month.



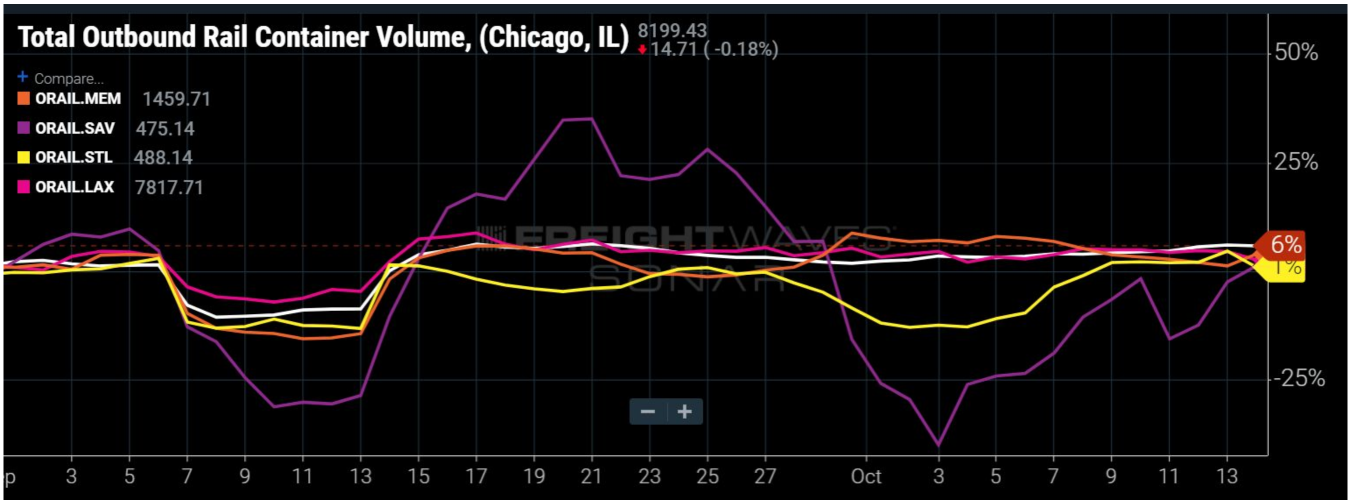
(Chart: FreightWaves SONAR. Import shipments into LA [white] and Elizabeth, New Jersey [orange]).

Last report we mentioned one of the risks to export volumes was a deterioration in China-U.S. relations. While this relationship is often volatile, there hasn't been any further deterioration since our last report. We believe that it isn't likely that there will be further escalations as we head into the election out of fear of what the reaction could be by the public and financial markets.

On a relative basis, we expect that the West Coast will outperform the East Coast for the intermediate term. SONAR has a new function where you can see which ports different companies utilize for their freight over the past 30 days. Over the past month, ~78% of Amazon's total TEUs have gone through the Port of Los Angeles and the Port of Long Beach. As long as current trends hold, this will be very constructive to West Coast volumes as we head into the end of the year.

Rail intermodal

Intermodal volumes reported by the Association of American Railroads have sustained growth throughout September and early October as intermodal volumes are up 3.4% y/y the past four weeks and 8.4% in the most recent week. Volume growth has been widespread across the country as all five U.S. Class I railroads have reported year-over-year volume growth, led by the smallest Class I rail, Kansas City Southern, which has four-week moving average volumes up 18.8% y/y.



(Chart: FreightWaves SONAR. Outbound intermodal containers from LA, Chicago, Memphis, Savannah and St. Louis on a relative basis over the past month)

The largest intermodal markets have held up the best over the past month while the smaller markets have struggled. Total Outbound Rail Container Volume (ORAIL) shows that Los Angeles, Memphis and Chicago have posted volume growth over the past month, though growth only amounted to approximately 1% in the LA and Chicago markets. Smaller markets like St. Louis and Savannah have struggled as both ORAIL.SAV and ORAIL.STL are up only 1% since the beginning of September.

As volumes recovered for the rails overall, reported service metrics such as terminal dwell times and train velocities have worsened. The average Class I railroad dwell time is up 4% year-to-date, and only one rail has improved dwell times since the beginning of the year. BNSF has improved dwell times by 12% since the beginning of 2020 and nearly 20% since the beginning of July when volumes started recovering.

Average train velocities have slowed since the beginning of the year. The Class I average intermodal train is 2% slower year-to-date, pulled down primarily by Norfolk Southern, which was 7% slower YTD, and CSX, 4% slower YTD. Kansas City Southern is the outperformer in velocity as its intermodal trains run 3% faster than at the beginning of 2020. The implementation of precision scheduled railroading has allowed for longer, faster trains to move across the rails. Still, due to speed restrictions in portions of the rails and how speeds are reported, train speeds may improve only gradually compared to the improvements made when PSR was first implemented.

What we're watching

Complex negotiations in Washington over the next round of coronavirus relief/stimulus are bogging down. There is an assortment of parties involved, including Democratic House leadership, Republican Senate leadership, Treasury Secretary Steven Mnuchin and White House Chief of Staff Mark Meadows. There are also multiple issues still at stake: the status of enhanced unemployment benefits, which were at $600 per week but which Senate Republicans want to reduce to $200 per week; and the thorny subject of liability protection for employers.

In our view, aggressive fiscal stimulus is propping up consumer demand; additional rounds of stimulus will be necessary to avoid further economic damage as states and cities struggle to control new outbreaks.

Last week the Federal Motor Carrier Safety Administration (FMCSA) extended coronavirus relief waivers for commercial driver licenses and commercial learner's permits until Dec. 31, which helps free up trucking capacity and improve driver productivity, especially for reefer carriers at food and beverage distribution centers. Those adjustments to capacity have been marginal; in large cities with high rates of infection, tender rejections are rising amid a flurry of short-haul reefer movements.

In most years, West Coast port TEU volumes are flat to down in October; 2018 was an exception to that historical pattern, in part because shippers were building inventory in anticipation of further U.S.-China tariffs. Today, shippers are still building inventory but for a different reason: the COVID-19 pandemic altered consumer buying patterns in unpredictable ways. Now retailers are playing catch-up. It's unclear whether October's TEU volumes will be higher than September's, but we expect generally elevated levels to hold this month.

One rarely-discussed trucking capacity bottleneck is the reduced throughput at commercial driver schools due to COVID-19. In an October 20 client note, Stephens analyst Jack Atkins discussed survey data from 28 commercial driving schools across the country. Of those schools surveyed, ~22% are still closed either temporarily or permanently due to the pandemic. ~82% of the surveyed commercial driving schools reported capacity constraints, putting the entire cohort of schools at roughly 57% pre-pandemic capacity.