Transportation Outlook

Looking for the tipping point.

February 2023

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Transportation is a leading indicator of economic health. Upticks and downturns in shipping of materials, components and finished goods reliably lead the market, often by months.

These cycles inevitably pass through an inflection point where supply (capacity) and demand (loads to be shipped) are in equilibrium. Equilibrium, however, is usually just a transitory stop as the market continues in the direction it is already moving.

This movement is either a tightening of capacity as demand continues to exceed supply or a softer market as too much capacity adjusts for weaker demand. Currently, the market is nearing the tipping point where capacity has sufficiently adjusted and rates will start back up from the bottom.

Market Fundamentals

Shippers

Shippers' fears of a collapse in consumer spending remain powerful, not because the indicators are worse, but because no clear resolution is in sight.

- While remaining positive, consumer spending has fallen off its 2021 highs and the likelihood of recession threatens the other side of the ledger for many businesses.
- Shippers are pleased to be operating in a more favorable freight rate environment than last year, but would be even happier with more sales.
- U.S. core inflation remains high at 6.5% and far from the Fed's 2% target.
- January's consumer sentiment is up 8.2% from December 2022, but is still 3.2% lower than January 2022.
- The highest % YoY change in the inventory to sales ratio in the past seven years (excluding the COVID spike) will adversely impact production of new goods.
- The lowest savings rate since 1960 indicates consumer spending is running short on fuel.

Carriers

The current inflation is forcing some carriers out of the market and squeezing those who are still hanging on.

- Diesel prices have recovered from the peak but remain ~90 cents higher than January 2022.
- With waning demand, used truck prices are falling back to normal, but remain two-thirds higher than the long-term average of $60K.
- Driver wages, insurance, equipment and truck parts cost more than a year ago.
  - For example: Trailers that used to be $20-25K now cost $60-80K.
- High interest rates make financing large capital expenses, like truck purchases, even more difficult.
- Additionally, freight rates have fallen nearly 40% since January 2022, reducing carrier income significantly. Combined with higher costs, this has led to the most carriers going bankrupt in 2022 since 2008. 2023 will be worse.

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Analysis 360 | Checking the Record

What we got right in previous Outlooks

- *Consumer Spending: "Overall YoY consumption will likely decline for the rest of the year and Q1 of next year, contributing to softening of freight volumes."*
    - The market finished as predicted and is still on this course.
- *"We forecast that the contract curve will likely experience the first deflationary rates of the cycle in 1Q23 at an average of -2.5% YoY, and rates will continue to decrease until they reach a bottom of the contract rate cycle at -7%."*
    - This is exactly where the market landed.
- *"Take the long view: A long view will help you see more efficient and cost-effective transportation operations in the long run."*
    - Shippers really took this to heart, balancing the network between contractual and spot markets to secure freight with reliable service and balanced cost.

Where we were off the mark

- *"Beon Spot will continue to trickle down until meeting resistance and eventually finding the bottom in 4Q22 around -25% YoY. It is then likely to start upwards, crossing equilibrium in the middle of 2023 with 1Q23 being around -18% YoY."*
    - We went down further than -25% to -34% YoY due to even more muted demand than anyone anticipated during peak season. We'll see what this means for the projected timing of equilibrium come 3Q23.
    - We didn't see the decline going longer and suffering more macro environment drags overall.
    - We should have better defined the word "equilibrium". The freight market is in equilibrium right before rates go up or down and when there is the perfect amount of capacity (supply) in the market to meet the demand, or vice versa. In the case of 2023, we are expecting equilibrium to occur around March and remain at or around equilibrium for a couple of months.

Key Learnings

Forecasting, visibility and proper planning will continue to be critical for supply chain operators. Labor shortages, potential strikes, port or warehouse bottlenecks and weather — among other factors — pose real dangers to supply chains. Contingencies should always be in place.

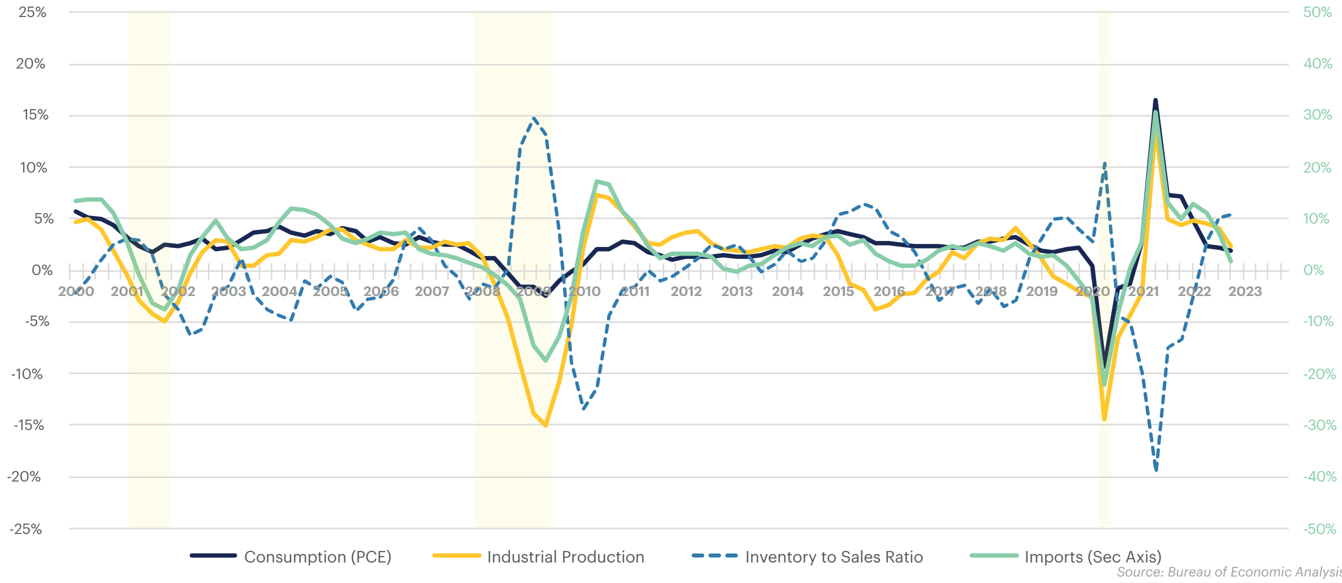
- The spikes are becoming more dramatic, especially since COVID.
    - Carriers have floors to their pricing relative to their operating costs. So we know when supply will have to exit. Demand, on the other hand, is much harder to predict.
    - The cycles are moving faster, accelerated by technology and quicker data exchange.
- The economic climate is especially harsh for owner/operator carriers. The well-resourced operations will do better in both volume and revenue regardless of the market conditions.
    - A broker can be a smaller carrier's best friend in a down market as brokers provide access to freight on lanes where it can be difficult to find a loaded backhaul, effectively helping these small fleets reposition trucks into higher demand markets.
    - Carriers should look at brokers as customers to cultivate long-term relationships that can ride out cycles. Brokerages that provide managed transportation services are especially valuable as a consistent source of freight.

"There are a lot of factors to consider right now: Inflation, war in Europe, an abnormal labor market, recession worries, etc. At the end of the day, costs and service levels are still driven by fundamentals: supply and demand. Finding a balance is key. These shifts don't just show up in the macro data. You must also consider the noisy overlay of current — but transitory — economic factors. These amplify the underlying fundamentals and are where analysis needs to be focused."

Drew Herpich
Chief Commercial Officer

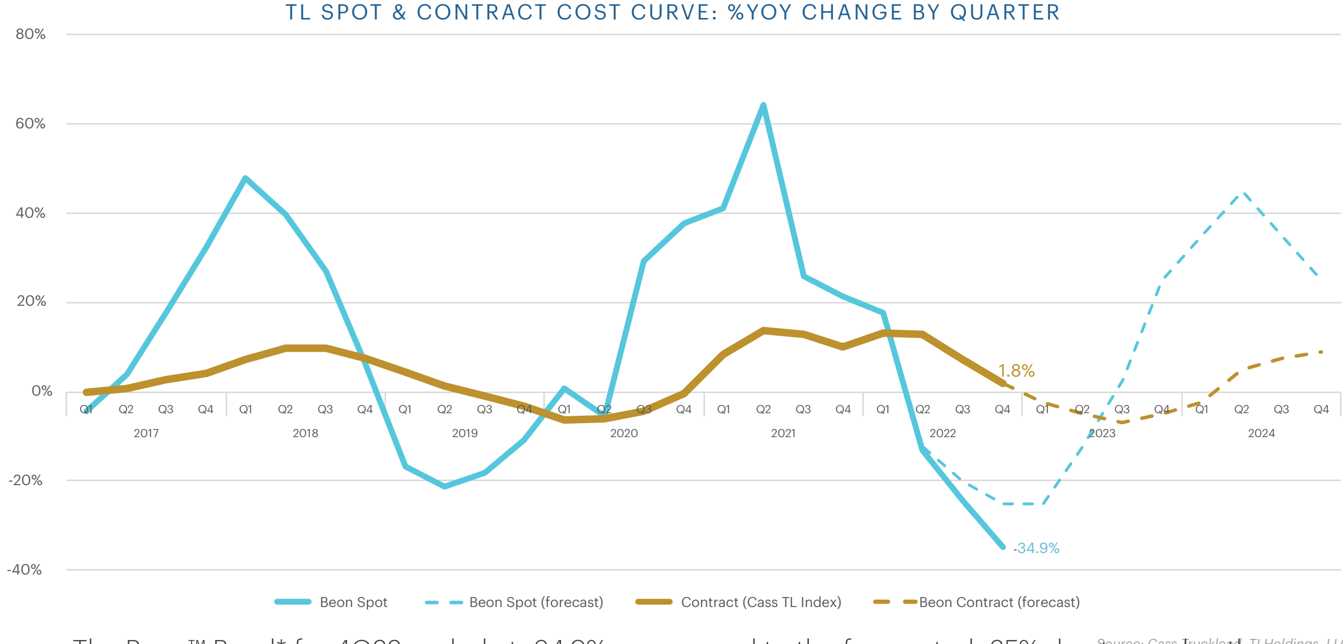
Core Metrics

THE KEY ECONOMIC INDICATORS (% YOY CHANGE BY QUARTER)



- Consumer spending further declined in 4Q22, but is still up YoY.
- Industrial production is stalling. 4Q22 came in ~2% lower than the previous six quarters.
- Imports came down from +7.4% in 3Q22 to +1.7% in 4Q22.
- % YoY change in inventory to sales ratio is the highest it's been in seven years (less a period during COVID).

TL SPOT & CONTRACT COST CURVE: %YOY CHANGE BY QUARTER



- The Beon™ Band* for 4Q22 ended at -34.9% as opposed to the forecasted -25% due to weaker than expected peak demand. We still believe 4Q22 was the bottom of the deflationary cycle. From here we expect our journey upward to the equilibrium with 1Q23 projected at -25% deflationary and 2Q23 at -12.5% YoY. We forecast the Beon™ Band to cross the X-axis somewhere in late 3Q23 of this year and enter the inflationary part of the cycle.
- Contract TL market for 4Q22 ended at +1.8%, close to the forecasted +2.5%. We expect this contract curve to enter the deflationary cycle in 1Q23 of this year at -2.5% YoY and continue to stay deflationary for the entirety of the year.

For a better understanding of the Beon™ Band, see "How to maintain cost/service level equilibrium during extreme market swings" below.

Rate Forecast

Spot Rates

- End of 4Q22, into early 2023 spot rates surged around the holidays, but have begun another descent towards the bottom. Rates will continue to trend downwards, reaching the bottom by the end of 1Q23 when operating costs outweigh profit, causing more carriers to exit the market.
- Starting around 2Q23, expect a sharper than usual bounce back from the bottom of the cycle in reaction to the rapid drop in prior quarters, continuing until the week of July 4.
- YoY TL Spot CPM increases (inflationary) will occur late 3Q23 and continue into 2024.

Contract Rates

- 1Q23 contract rates are dipping into deflationary territory YoY and will likely remain deflationary throughout 2023 and into 1Q24.
- Contract rates will drop more slowly and steadily than spot did through its deflationary cycle.
- Expect to see the bottom of the contract rate cycle around 3Q23.
- Don't expect YoY inflationary rates until 2Q24.

Additional reference you may be interested in:

BLOG

The importance of benchmarking supply chain operations.

Few aspects of business operations are as dynamic and susceptible to macroeconomic forces as your supply chain. Companies that rely on their own historical data have only a narrow perspective on the current status of costs and service levels, much less where things are headed. By tapping third-party data with a wider perspective, decision-makers get a clearer view of how they are doing relative to their competitors and their markets.

Read More

How to maintain cost/service level equilibrium during extreme market swings.

Enterprise shippers — who ship large volumes and contract their capacity — seek to manage costs through their contracts. We know. Some of them are our best customers. But, this is a relatively small portion of all shippers.

TI & NTG are also among the industry's leading providers of capacity for small- and medium-volume shippers, tapping our network of over 80,000 carriers nationwide, predominantly in the spot market. This is where most shippers operate. Our constant analysis of this market has yielded the Beon™ Band.

Contract rates trail the market and lack detail. And every contract is different for each shipper. They're not apples to apples. Spot data feeds a timeline that is current and granular. So, it more accurately reflects the market dynamics for most shippers at any given point in time.

The Beon™ Band rolls up YoY quarterly averages of this data to create trend lines. This band is the outcome of the relationship between freight supply and freight demand, with freight demand being driven by the macroeconomic demand indicators. When we overlay the Beon™ Band with the demand curve in a single chart, we can see demand's influence on the to-the-truck costs.

An analysis of historical trends and the underlying factors—informed by real-time current data—allows us to better forecast overall shifts in market dynamics. This helps predict a shipper's next moves, giving a better idea of when to go to bid and when to contract versus spot.

Supply and demand within the freight cycle is rarely in equilibrium for very long. This makes it hard to accurately understand current transportation costs and predict future costs, especially for those without access to tools like the Beon™ Band. Most recently, dramatic swings fueled by extraordinary world events have also compressed the current cycle. So, we see it being 12 months versus the normal 18-24 months.

But, just because the market spends more time out of equilibrium, your company can achieve better than average results if you know how best to allocate your transportation spend.

For some shippers, contracted freight is your best bet. Finding the appropriate blend between contract and spot will help further optimize your transportation spend and budget.

For a detailed understanding of how to do this, see *"The importance of benchmarking supply chain operations"* linked here and above.

"Shippers want to take advantage of the current market, but not in a way that sabotages a long-term strategy. Negotiate the best possible rates now with the knowledge that by late 3Q23 the spot market will be inflationary. And concessions can work in both directions. You'll need those loyal carriers to manage the pricing and level of service required for your customers over time."

Amit Prasad
Chief Data Science Officer

Market Forecasts

Less-Than-Truckload (LTL)

- Carriers expect 1Q23 and 2Q23 to be soft and hopefully pick up by summer. Instead of dramatically lowering rates, they are cutting operating costs and finding loads they would normally not accept.
- Carrier bill counts are down. However, LTL carrier rates will not decrease drastically due to less fragmentation and more pricing power in the LTL market versus the TL market. The top ten LTL carriers control roughly 75% of the market, giving them more control of rates.
- The rich are getting richer with more consolidation of the bigger LTL carriers.

Parcel

- Although parcel capacity constraints will subside in 2023, the industry will still feel the impacts of e-commerce volume spikes from 2020-2021. The most evident are the record 2023 rate increases, created by capacity constraints in prior years.
- Published tariffs for 2023 set record small parcel rate increases with FedEx and UPS announcing a general rate increase of 6.9%, up from 5.9% in 2022 and 4.9% for 2018-2021.
- Small parcel carriers continue to extend peak surcharges beyond peak season. Select surcharges are now in effect "until further notice" with UPS renaming them "demand surcharges."
- The record rate increases are coming in a year when we are projecting softening in the small parcel market. As published rates increase at record paces and the market softens, there will be a tipping point where shippers become motivated to renegotiate contractual discounts and carriers will become more competitive for that business.
    - One key factor will be the UPS Teamsters agreement expiring July 31, 2023. The outcome of those negotiations will directly impact UPS's pricing strategy.
- The combination of increased published tariffs and market softening is anticipated to drive negotiations up for parcel contracts in 2023.

Our recommendation is to strongly consider diversifying your small parcel carrier network, especially in a year of uncertainty.

Container Shipping and Dray

Shipper

- It's looking like most factories in China and Vietnam are going to take a long break to start the year. Factories closed around January 7 and will not reopen until about early February. There will be a long shadow afterwards as it takes time to get production up and running. We will likely see some seasonality pick back up in March, April and May. But, given the high inventory to sales ratio, we don't expect volume fully restored until 3Q23.
- According to Bloomberg, "China's reopening is set to provide a welcome boost to global growth, offsetting weakness in Europe and a looming recession in the U.S." However, they claim, "China's rebound won't be linear." We believe that China's pivot from Zero-COVID policy is one of the most welcomed developments for global trade from a volume perspective. But, we are a bit concerned that an "open" China could reinvigorate demand and keep inflation around longer.

Carrier

- We are seeing large asset-based carriers with high monthly overhead quickly getting more aggressive on pricing, while looking for contracted business. Owner operators sticking with higher rates in hopes of better margins are seeing revenue decline and will have to adapt. Capacity seems to be open across the U.S.

Market Forecasts (continued)

Cross-Border

Even before the pandemic struck, shippers recognized the volatility that came with sourcing outside of North America and were exploring nearshoring in Mexico, Canada and the U.S. Now we're starting to see a more diverse group of shippers enter the market as inventory demands shift in the original shipper profile and consumer demand evolves with shippers who normally sourced from Asia.

- **Mexico**
  - While Northbound has been softer than normal recently, expect volumes to ramp up as produce exports from Mexico increase. While most produce ships via reefer, the dry market will also feel the impact.
    - McAllen, Laredo, Nogales and El Paso markets will be most impacted from this over the next couple of months.
  - Many shippers in Mexico take off the last two weeks of the year, and slowly work into the New Year. Now that we're fully into 2023, expect increased urgency from shippers to get back on track, both with inbound raw materials and outbound finished goods.
  - While Mexico in particular is set up to reap the benefits of nearshoring, safety and security for drivers and freight in Mexico continues to be an issue.
  - We're seeing more drivers from southern Mexican states migrate north to handle volume. But, with the inefficiencies and the safety concerns, the number of drivers being added will not keep up with demand until those issues are properly addressed.
- **Canada**
  - Much like the U.S. market, cross-border capacity between Canada and the U.S. has been generally abundant. With a relatively mild winter so far, fewer temperature-controlled trailers have been needed, allowing shippers to continue to use dry vans when they would normally need to switch to reefers. With that, the market has remained in balance with minimal disruptions.
  - As we get deeper into winter and the colder months, expect that to change, with more shippers switching to temperature-controlled trailers, driving up rates.

Feel free to contact us with any specific needs or questions.

Let's Connect