BMO | Transportation Finance

Spring 2023

Industry Update

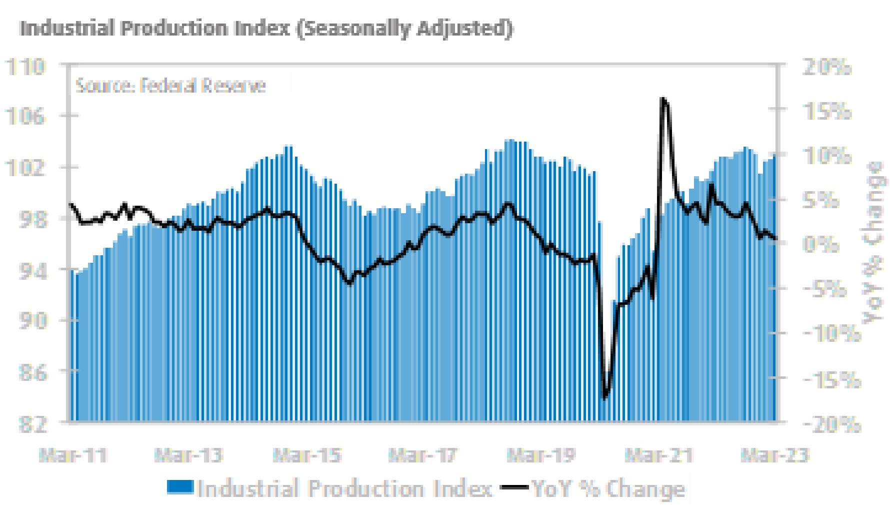
Truck Transportation

Key Developments

- Following the passage of the Advanced Clean Trucks (ACT) rule in March 2021 targeted at OEMs, the **California Air Resources Board (CARB)** recently approved the Advanced Clean Fleet (ACF) rule targeted at fleet operators. In essence, the rule will start banning the sale of new diesel trucks to some fleets beginning next year and entirely by 2036 while retiring diesel engines completely from operation by 2042.
- The **Environmental Protection Agency's** recent proposal for Phase 3 of the Greenhouse Gas Standards for Heavy-Duty Vehicles requires a quarter of new long-haul tractors and half of all vocational trucks sold in the U.S. to be all-electric by 2032. Further, the EPA estimates the upfront retail cost difference, including tax credits, between a model year 2032 electric truck and an internal combustion engine truck would be $582 ($17,335 including charging equipment) higher for an all-electric short-haul day cab tractor and escalates to $14,712 for an all-electric long-haul sleeper cab tractor.
- 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

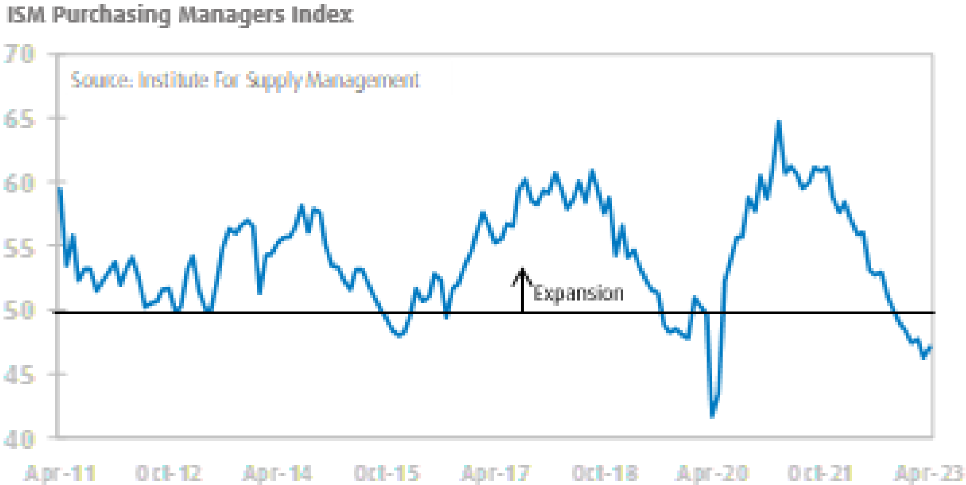
Despite the lagging effects of year-long Fed tightening and increasingly constrained lending conditions, the overall macro environment, while slowing, continues to outperform most expectations. The labor market and, by extension, consumer spending, albeit with a well-documented shift towards services, have been particularly resolute. That said, trucking conditions have been slow to emerge from a winter slumber, with multi-year low freight rates reflecting the age-old equation of volume (not enough) and capacity (too much), with both still firmly in favor of shippers. Persistently low Diesel prices continue to be a silver lining for many spot carriers that purchase fuel at retail, but which has also kept alive marginally viable capacity while slowing the natural re-balancing of the market. As summer approaches, favorable freight seasonality will be welcomed. However, sustainable industry tailwinds will have to wait for further re-balancing and a more relaxed Fed stance on inflation, including a rate reversal, which BMO economists don't see until early next year.



U.S. industrial production defied gravity in March, rising a stronger-than-expected 0.4% despite other indicators pointing to weakness in goods-producing sectors (payrolls, ISM PMI, regional manufacturing surveys). That said, an 8.4% surge in utilities drove all of the strength in the month. Excluding utilities, production fell 0.4%, which aligns with the recent weaker readings in the payroll survey for goods-producing industries.

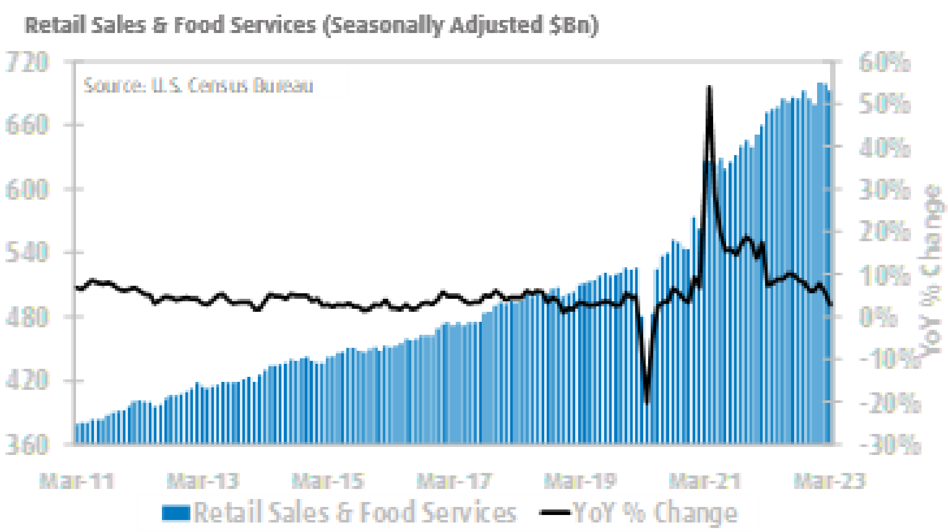
The weakness in manufacturing was broad-based, with construction supplies (-1.8%), business equipment (-1.0%), and durable consumer goods (-0.9%) leading the way. Further, manufacturing **capacity utilization** dipped 0.5 percentage points to 78.1%, essentially in line with the long-run average.

Macroeconomic Indicators



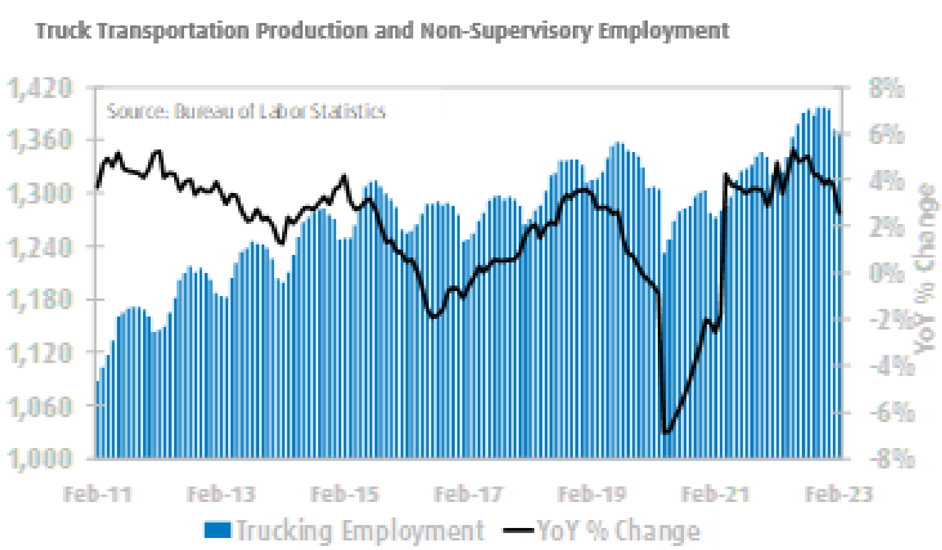
The **Purchasing Managers' Index (PMI)** is a sentiment measure of near-term business conditions in the manufacturing sector. In April, the index rose 0.8 pts to a two-month high of 47.1, beating expectations but still showing the sixth consecutive month below 50 (i.e., contracting) and only the fourth increase in the past year. That said, the latest report had decent support from the main components: new orders +1.4 pts to 45.7, production +1.1 pts to 45.9, employment +3.3 pts to 50.2 (first 50+ reading in 3 months), while inventories fell 1.2 pts to 46.3.

The past relationship between the PMI and GDP suggests that the April PMI corresponds to an annualized GDP growth rate of -0.6%, in line with BMO Economists' current estimate of -0.5% for the second quarter.



American consumers are pulling back, but it's unclear how much of the fade is regular payback from an earlier binge and how much is underlying weakness.

U.S. retail sales sagged further in March, partly due to payback from January's weather-assisted splurge. Sales fell for the fourth time in five months by a larger-than-expected 1.0%, led by sliding gasoline prices (and gas station receipts) and a further reversal in auto sales. Excluding auto dealers and gas stations, sales were down 0.3% after a flat February. The weakness was widespread, with significant furniture, clothing, electronic products, and general merchandise declines. The control measure used to tally personal spending (sales excluding autos, gas, building materials, and food services) also fell by 0.3%.



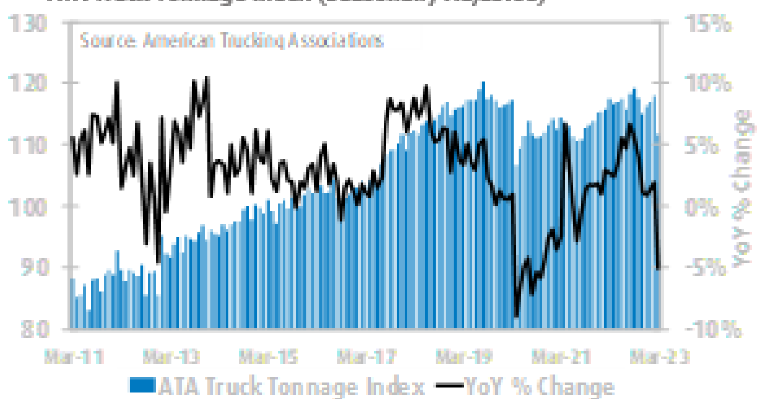
Employment in the truck transportation industry has receded after reaching an all-time high last November. **Production and non-supervisory employment** during February dipped for the third consecutive month and was down -2.1% (~29,700) from the peak but still up +2.6% (~34,700) year-over-year.

The growth of the new driver pool has likely slowed as the incentive of solid earnings potential has dissipated with slowing freight growth and the decline in freight rates.

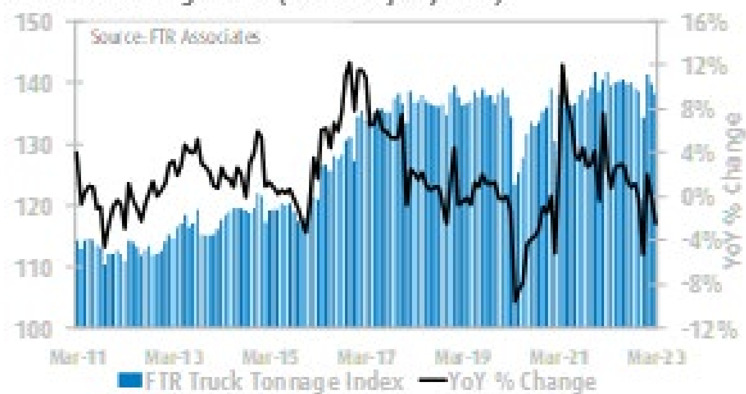
Freight Indicators

The exhibits below show that the freight market is contracting modestly but is not collapsing. Still, the nearly relentless compression in spot rates (and contract rates to a lesser degree) through April reflects a loose environment of lackluster volume and excess capacity. But below the surface, notable modal and market shifts have influenced freight volume in both directions, including trends favoring contract over spot, truckload over LTL and intermodal, and east coast ports over the west coast. Still, the near-term outlook for freight remains mixed. Tailwinds include: improving seasonality, normalizing inventories, resilient consumer spending and durable goods orders, robust energy production, incomplete replenishment of auto inventories, and improving home builder sentiment. On the flip side, headwinds include increasingly limited access to credit, cooling but still high inflation, depressed ocean shipping container volumes, and weak manufacturing output.

ATA Truck Tonnage Index (Seasonally Adjusted)



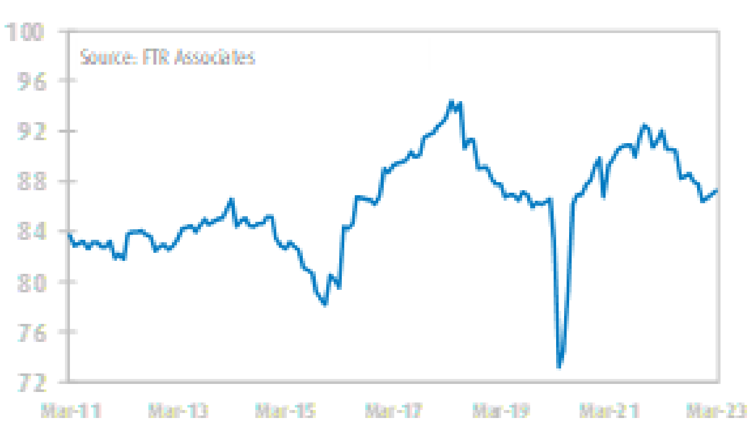
FTR Truck Tonnage Index (Seasonally Adjusted)



Cass Freight Index – Shipments (Seasonally Adjusted)

Transportation Services Index (Freight)

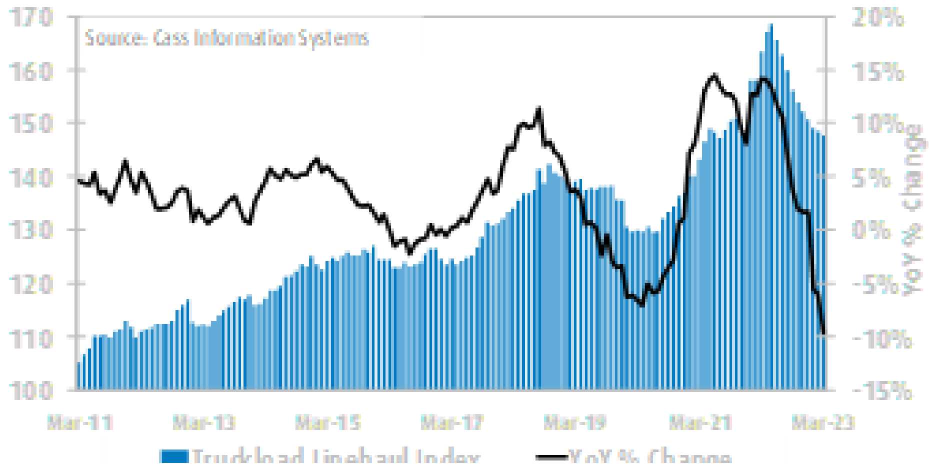
Class 8 Fleet Capacity Utilization



- The **ATA For-Hire Truck Tonnage Index** (primarily contract freight) fell 5.4% (month-over-month) during March, which was the worst monthly drop since April 2020 and the biggest year-over-year decline (-5.0%) since October 2020.
- The **FTR Truck Tonnage Index** has been choppy at a high level while contracting year-over-year in three of four months through March.
- The **Cass Freight Shipment Index** (all modes) has declined (year-over-year) during four of five months through March.
- The **TSI Freight Index** has contracted (year-over-year) for the first time since early 2021.
- The **FTR Class 8 Capacity Utilization Index** has bounced from a 3-year low and is essentially in line with its long-term average.

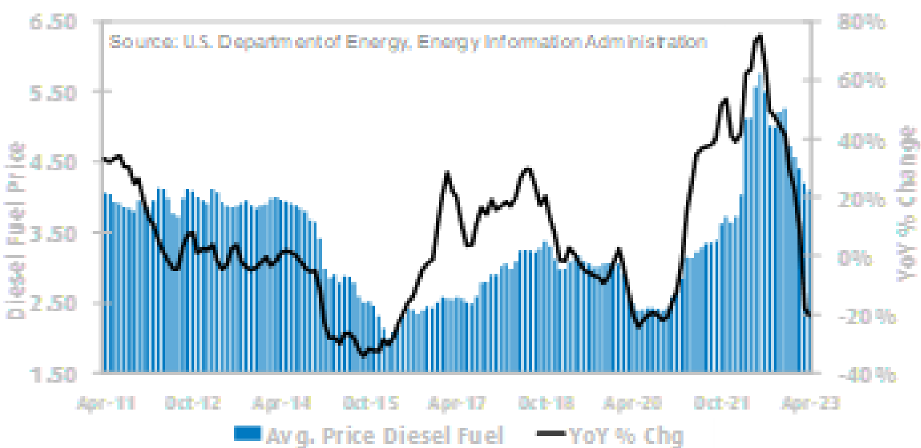
Revenue And Expense Indicators

Cass Truckload Linehaul Index



The **Cass Truckload Linehaul Index,** which reached an all-time high nearly a year ago, reflects a mix of base rate pricing (excluding fuel and other surcharges) in the dry van contract and spot 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 earlier trends in spot freight pricing. With spot rates having seen nearly relentless pressure over the past twelve months, a softening of contract rates is also well underway but still has some catching up.

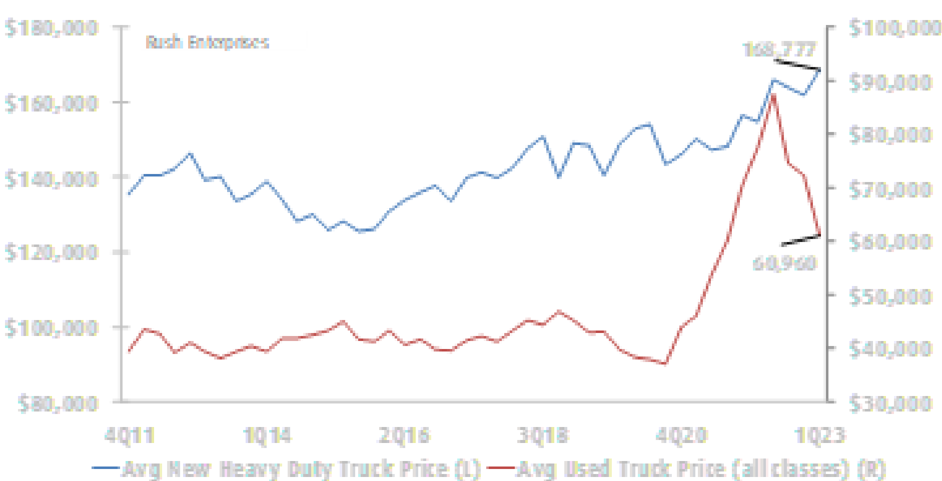
On-Highway Diesel Fuel Price (Monthly Average $/Gallon)



Since the invasion of Ukraine, **Diesel** fuel prices have been on a high-altitude roller-coaster. More recently, however, mirroring a decline in WTI crude prices, the national average weekly Diesel price of $4.08/gallon in late April had declined $1.73 (-30%) from an all-time high of $5.81 last June.

According to the most recent forecast from the U.S. Energy Information Administration (EIA), WTI crude and Diesel prices will experience modest volatility in both directions through the summer and fall before finishing the year near current levels.

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

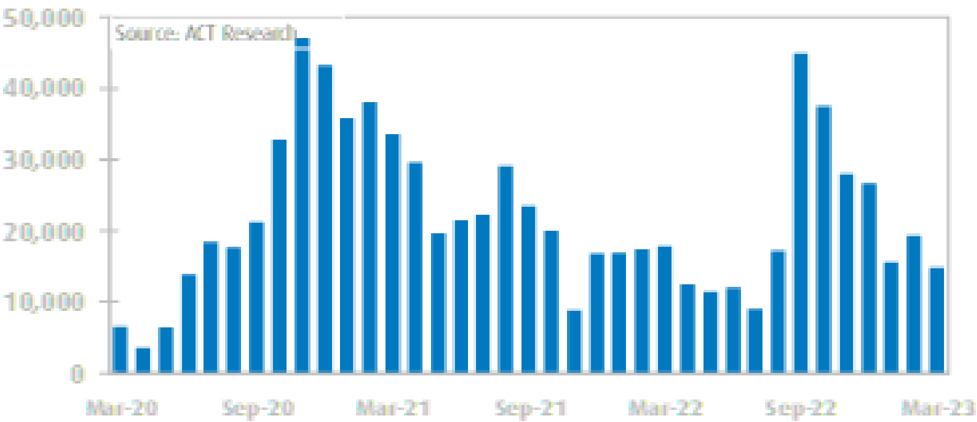


With an improved but still somewhat constrained supply chain coupled with ongoing strong demand from large fleets, the **average price of new heavy-duty trucks** sold by Rush Enterprises during the 1st quarter reached a new high. Heavy-duty ASPs increased by $7,032 (+4.3%) from the 4th quarter and $13,975 (+9.0%) from the year-earlier quarter.

Used truck prices continue to depreciate as inventories increase from trade-ins and the rationalizing of capacity by financially stressed operators. The **average price of all used trucks** sold by Rush Enterprises during the 1st quarter declined 15.5% from the 4th quarter and 21.4% from the year-earlier quarter. That said, Rush has taken a strategically defensive position by holding below-average used truck inventories and expects the depreciation rate to moderate during the current 2nd quarter.

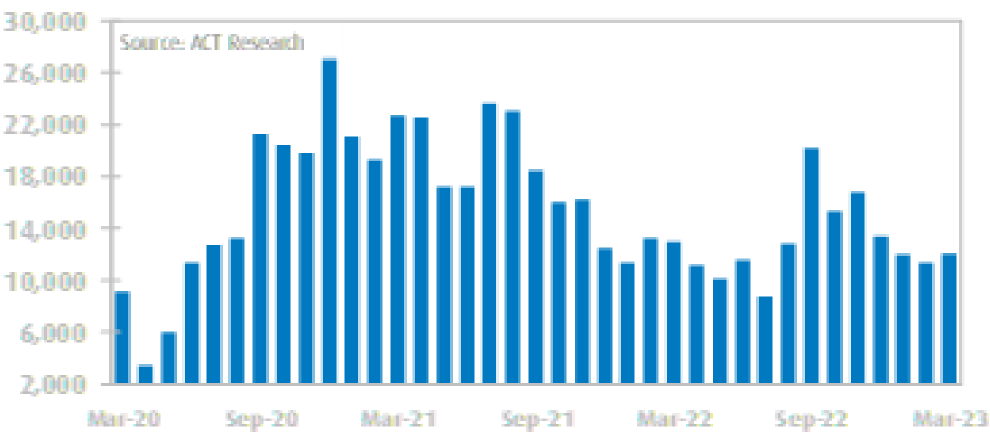
Truck and Trailer Orders

U.S. Class 8 Net Truck Orders



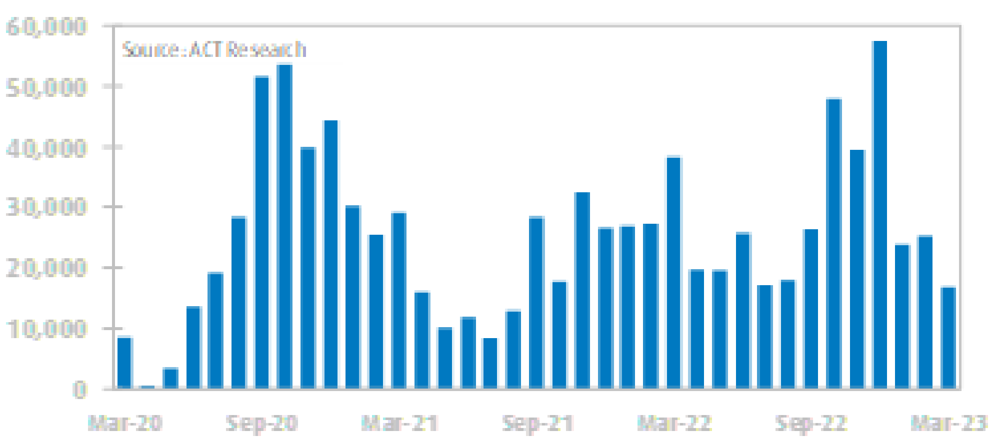
As expected, **U.S. Class 8 net truck** orders experienced typical seasonal weakness at the outset of the year, with much of the demand for 2023 build slots already booked and allocated for delivery as far out as the 4th quarter. Through March, net truck orders had declined five out of six months since peaking last September. Altogether orders during the 1st quarter were down 46% from the 4th quarter and 4.5% from the year-earlier quarter. Based on prior seasonal trends and the ferocity of the most recent surge, the near-term order pace will likely remain at or below replacement into mid-year.

U.S. Class 5-7 Net Truck Orders



Medium-duty orders surged during the fall of last year as OEMs opened more build slots. More recently, orders have downshifted as pent-up demand for build slots begins to wane, and the headwind of slowing macro trends such as residential construction activity takes a toll. Overall orders during the 1st quarter were down 5.7% from the year-ago quarter and 22.2% from the 4th quarter. More positively, cancellations remain relatively benign at 1.1% of backlog, well below the 2.6% pre-pandemic average. The longer-term view remains stable, featuring the usual support of diverse end markets, the secular trend toward shorter hauls, and the durable tailwinds of e-commerce and last-mile delivery.

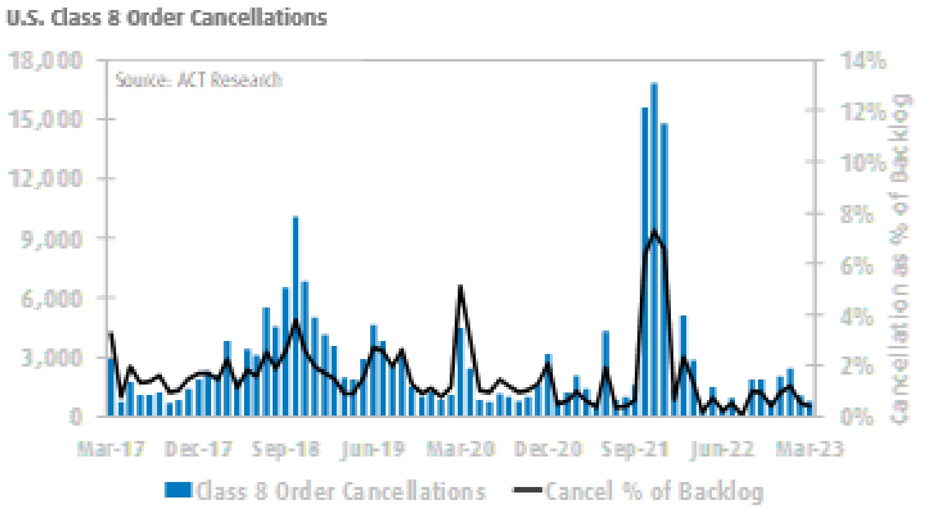
U.S. Net Trailer Orders



Similar to the pattern for heavy and medium-duty equipment, albeit with signature heightened volatility, **orders for trailers** have seen a significant drop-off from a ferocious finish to last year. And given typical spring/summer seasonality, orders will likely remain subdued into the fall.

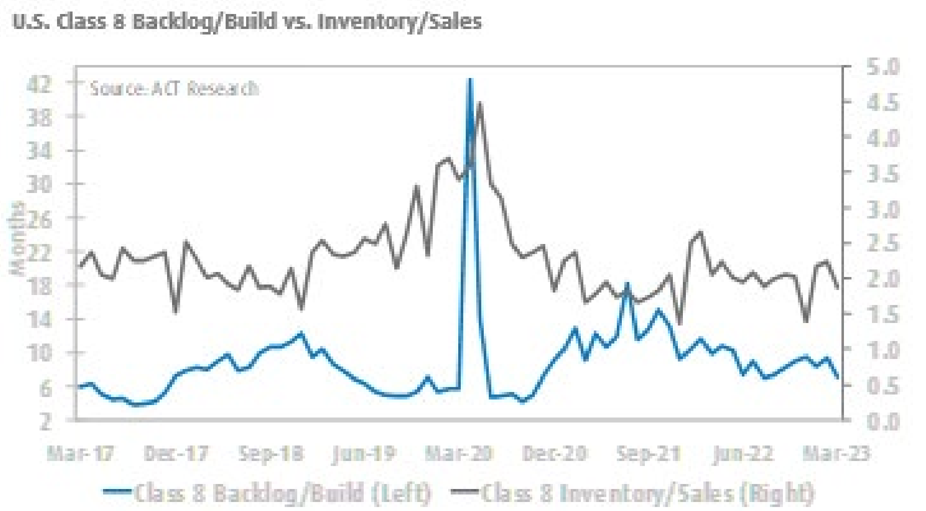
During the 1st quarter, orders fell 54.5% from the 4th quarter and 28.8% from the year-ago quarter. Nonetheless, the monthly cancelation rate of 0.9% during March remains well below the long-run pre-Covid average of 1.9%.

Other Equipment Indicators



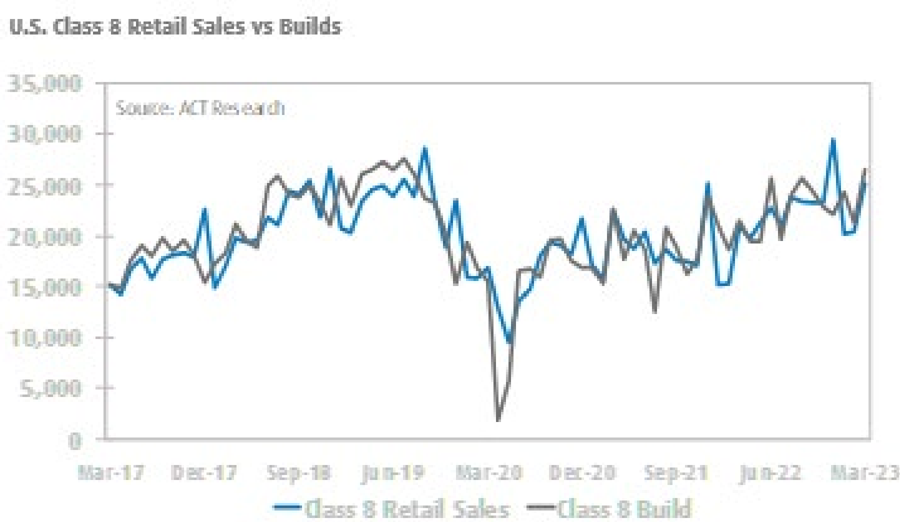
Despite the seasonal decline in orders during the 1st quarter, carrier appetite for capacity appears intact given a trailing 6-month average monthly cancelation rate (as % of backlog) of 0.7% compared to the pre-pandemic 2.3% long-run average.

That said, given sustained stress on cash flows in the spot market, increasing pressure on contract rates, and growing concerns about the durability of the freight market, the rate of cancellations is not likely to remain so far below the long-run average. Still, following two years of limited availability, most fleets will likely hold onto their place in line with a firm grip.



A typical seasonal deceleration in orders during the 1st quarter combined with a dramatic increase in production has put significant downward pressure on wait times for new class 8 trucks. Specifically, the **heavy-duty backlog-to-build** ratio has been more than halved over the past 18 months to seven months during March, which is still slightly above the long-run pre-pandemic average of six months.

With the improvement in builds met with steady demand, the **heavy-duty inventory-to-sales** ratio during March retreated to slightly below the long-term average range of 2-2 ½ months.

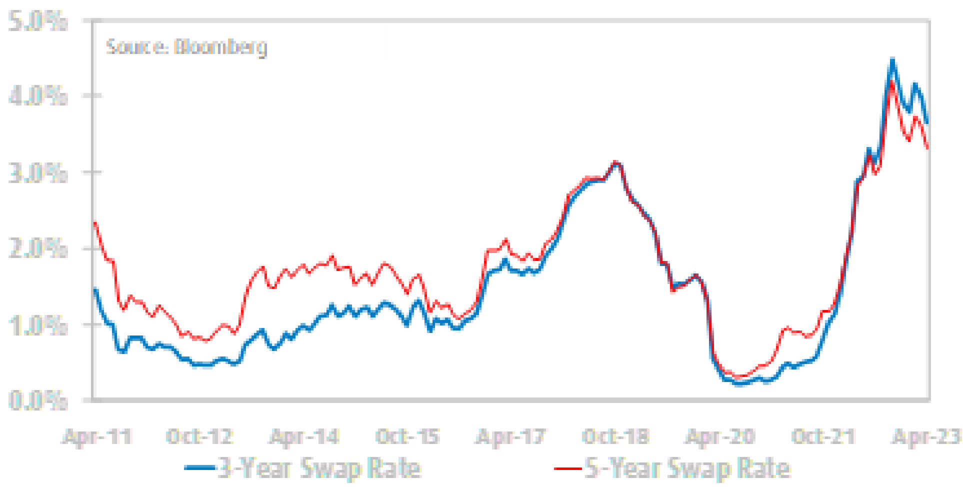


Including a typically sharp early calendar downturn during January, the above replacement pace of **U.S. Class 8 unit retail sales** (263.3k annualized during the 1st quarter and 273.6k over the past twelve months through March) is a clear sign that OEMs have made significant progress with their supply 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 22,000 during 2022 and, more recently, an average of 24,000 during the 1st quarter of 2023.

Other Business Indicators

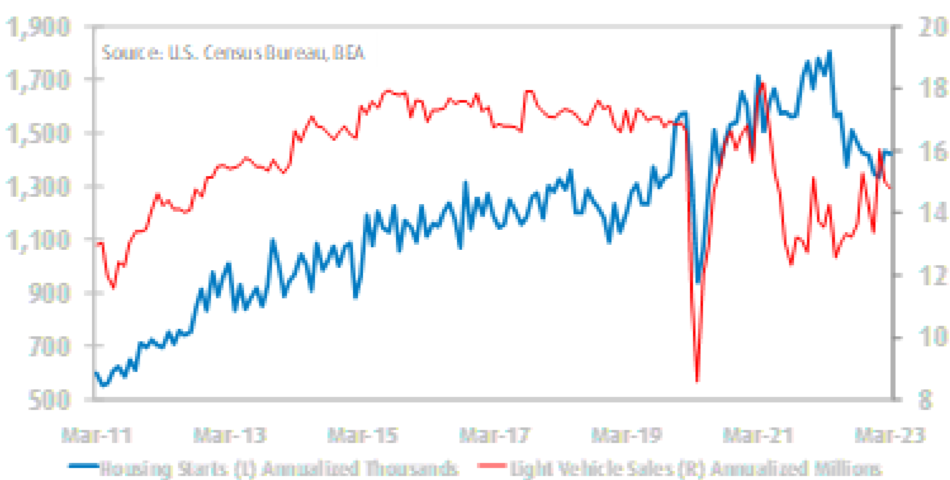
Interest Rates: 3 & 5 Year Interest Rate Swap Pricing



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.

After a brief surge higher early in the year, the yield curve has again reversed course and shifted lower primarily in response to stress in the regional bank sector and cooling inflation data. Likewise, the futures markets reflect expectations of an imminent peak in the terminal Fed Funds rate and a sooner-than-expected initial cut in the Fed Funds rate by September or November. As of late April, BMO's economists were on board with the terminal rate consensus, albeit with the expectation that a rate cut will probably not materialize until early 2024.

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



U.S. **housing starts** and building permits weakened in March. While that was in line with expectations given the affordability challenges in the housing market, the continued improvement in homebuilder sentiment, which improved for the fourth consecutive month during April, suggests that the housing market bottom could be in sight.

Given improvements in component availability and likewise production, inventories of new autos have improved significantly. That said, fragile consumer sentiment and higher financing costs have also dampened some of the pandemic-induced pent-up demand. Annualized **U.S. sales of light vehicles** of 14.8 million during March were down for the 2nd consecutive month and down 12% from January 2020, immediately before the pandemic.

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

The **total business Inventories-to-sales ratio** bottomed at an all-time low at the end of 2021 but has now recovered to the pre-pandemic long-term average. A closer look reveals that manufacturing (up) and general merchandise inventories (down) have progressed toward normalization. Inventories of motor vehicles and parts have also made progress toward replenishment but remain somewhat below historical norms.

"Voice of the BMO Economics Team"

With macro conditions slowing but outperforming the expectations of most economists and yet with the lag of Fed and credit tightening not yet fully reckoned with, 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: U.S. Still Headed For Recession? Yes, No, Maybe, Think So
Sal Guatieri, Senior Economist and Director April 28th, 2023

The U.S. **economy isn't going down without a fight**. It slowed to a 1.1% annualized rate in the first quarter, but the expansion continues. After the most aggressive rate increases in four decades, this is about as soft a landing that anyone could hope for. And, if inflation continues to ebb, the Fed just might pull off a feat worthy of Houdini's praise.

But that's a big 'if' given that **core PCE inflation is proving sticky** at above 4%. The glue comes from a tight labor market. The employment cost index sped up to a 4.7% annualized rate in Q1, not much below the yearly rate of 4.8%, which itself is not far behind the 33-year high of 5.1% reached earlier this cycle. Together with a likely decline in Q1 labor productivity, **unit labor costs could accelerate to over 6% annualized** in next week's release. This means that inflation's biggest driver is revving three times faster than what would be required to sustain price stability.

Next week's releases also include the first set of key April indicators, notably payrolls and the ISM surveys. In addition, preliminary auto sales data flag some acceleration, suggesting consumers might be catching a fourth wind. They took a breather in February and March after bolting out of the gates in January to take advantage of milder winter weather. Households are buying fewer goods, while spending somewhat less on services. Even if they stand perfectly still through the spring, real personal spending will register a slight decline from the prior quarter's average. And, with businesses also pulling back, **real GDP could contract modestly this quarter**.

Or not. **Real-time indicators suggest flat rather than contracting activity in April.** Both air travel and hotel spending are holding at a steady cruising altitude. Credit and debit card use, retail and restaurant spending, and theatre outings also are stable, albeit with a slight downside tilt. Indeed's job postings continue to ebb, though from high levels. The Fed's Weekly Economic Index has faded to around 1% y/y, while the OECD's Economic Activity Tracker is holding somewhat firmer. The economy might not be growing much, but it doesn't appear to be contracting, either.

But just because GDP isn't contracting doesn't mean it won't. The Fed's staff, perhaps influenced by its own leading indicator, now expects a mild recession to unfold later this year. Its indicator is derived from the spread between the 3-month Treasury forward rate 18 months ahead and the current rate. The latter is well below the former because investors expect the Fed to slash interest rates, presumably to address a recession. In fact, this indicator is placing higher odds (99%) on a downturn in the year ahead than before the Great Recession. Similarly, a year-long slide in the Conference Board's Leading Economic Index also signals trouble. Based on a stellar track record over the past six decades—it has never flagged a recession that didn't happen—the LEI's 8% plunge in the past year lines up with a 2 ppt rise in the unemployment rate to around 5.5% this summer. While that timeline seems iffy, the end result may only be delayed by the unusual nature of this business cycle owing to excess savings, pent-up services demand, and labor hoarding.

Bottom Line: The U.S. economy is losing steam and remains at high risk of stalling or contracting. Much will depend on whether higher borrowing costs and tighter lending conditions overcome lingering support from excess savings. We continue to pencil in a shallow downturn for this spring and summer… but note I said pencil, not pen.

"Voice of the BMO Economics Team" Continued

U.S. Consumers: Flat Is The New Up

Sal Guatieri, Senior Economist and Director April 28th, 2023

American consumer spending stalled in March amid still-elevated underlying inflation, higher borrowing costs, and perhaps the first signs of tighter lending conditions. Personal spending was flat in both nominal and real terms. In fact, apart from the big 1.4% jump in January (inspired by warm weather and a spike in Social Security payments), real consumer spending has fallen (taken to the second decimal place in March) in four of the past five months. A decline in goods spending volumes in March was mostly offset by a slight increase in services. The **soft starting point sets up a possible mild decline for real consumer spending in Q2**, though preliminary figures for new unit auto sales flag a decent upturn in April.

Personal income rose 0.3% for a second straight month, allowing the saving rate to trend higher at 5.1%. However, it remains below pre-pandemic levels, suggesting that households are still tapping excess savings to support spending, albeit less so than last year.

It's rare to see the Fed's favorite price and wage metrics out on the same day. **PCE prices rose 0.1%,** slicing the yearly rate to 4.2% from 5.1%. However, **core prices landed as expected, up 0.3%** for a second straight month, allowing the yearly rate to edge down to 4.6% from an upwardly-revised 4.7%. The yearly rate is bracketed by a higher 4.9% 3-month rate and a lower 4.3% 6-month rate, suggesting stickiness at a rate not far below the cycle high of 5.4% reached early last year. Our measure of **Powell's 'supercore' metric (services prices excluding energy and housing) rose 0.24%,** down slightly from the prior month. The yearly rate eased to 4.5%, while the 3-month pace fell to 4.7%...right direction, wrong level.

Keeping services inflation aloft was brisk wage growth due to the tight labor market. **The employment cost index rose a larger than expected 1.2%** (or 4.7% annualized) in Q1. The yearly rate slipped to 4.9% after tracking slightly above 5% for the past three quarters, which was the fastest pace since 1990. It's hard to see services inflation moderating quickly with that kind of wage pressure and a likely decline in labor productivity last quarter.

Bottom Line: American consumers appear to be taking a breather after bolting out of the gates this year. Whether they catch a second (or is it fourth?) wind will determine the fate of the current expansion. We still look for a mild downturn in spending and real GDP in the next two quarters, but uncertainty remains high. Much will depend on whether households are challenged not just by higher borrowing costs but by restricted access to credit stemming from the banking stress.

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