BULLISH ON TRANSPORT

THE U.S. ECONOMY has undergone major changes in last few decades. In 1950, goods-related activity was 40 percent of GDP. The Dow Transport Index, which includes major transportation companies, was rightly viewed as a strong predictor of the direction of the broader U.S. economy. At that time, the service sector-driven economy was 26 percent of GDP.

By 2010, the goods-related economy had dropped to only 23 percent of total GDP, while the service sector economy expanded to 47 percent of total GDP. Furthermore, there were other changes in the GDP over last few years, such as decline in net exports from 0 percent in 1980 to minus-4 percent in 2010, and the gross domestic investment fell from 18 percent in 2000 to 12 percent in 2010, amounting to a 33 percent decline in domestic investments in just 10 years. Meanwhile, the government segment expanded from 16 percent of GDP in 1950 to 21 percent in 2010.

These figures describe a changed U.S. economy away from the goods-related sector in ways that are not favorable to transportation companies.

By Satish Jindel

As a result, Dow Transport companies now are moving only 22 percent of GDP, and as such these companies may not experience any negative impact from a very low growth rate of GDP, which could come just from the service sector or other components of GDP. That suggests economists, financial analysts and reporters must be cautious in using the Dow Transport Index as an indicator of broader U.S. market direction.

The world and the U.S. economy are sluggish largely because of

problems in the financial, banking and other service-related sectors. However, with the goods segment a much smaller component of GDP, and the need for consumers to meet certain basic needs for support, transportation companies are likely to experience a better financial outcome in 2012 than one would expect purely on the basis of projections for the broader GDP.

Global economic development will be affected by the debt crisis in European countries such as Greece and Italy, political unrest in the Middle East and strong domestic demand from the growing middle class in China and India. The growing number of natural disasters in various parts of the world and the rapidly growing economy of Brazil create other challenges for global transportation companies, including ocean carriers, global integrated carriers and air freight forwarders.

As a result, the volume and revenue growth prospects for such international transportation service providers are more difficult to forecast and will vary even though they face a similar economic environment in their core coverage areas. UPS, FedEx and DHL are likely to experience middle to high single-digit volume growth in U.S.-centric international lanes because of growth in the electronics sector, and high double-digit growth rate in intra-Asia lanes supported by strong consumption by a growing middle-class population in China and India.

On the U.S. domestic front, the parcel carriers could experience a repeat of the modest single-digit volume growth rate of 2011 in the new year, with their value proposition supporting a yield increase in the mid-single-digits. One bright star is a high double-digit increase in parcels generated by growth in online retail sales. However, these packages tend to be lightweight, travel a shorter distance and often have rate pressures from large online retailers that have to offer free shipping to promote sales. They also face strong, yield-challenging competition from niche carriers and the U.S. Postal Service. Moreover, uncertainty about the future of the USPS and its efforts to cut costs and raise revenue may result in the elimination of Saturday delivery, which will be a mixed blessing for parcel carriers.

Although GDP growth in the U.S. and other countries will affect the demand of transportation services, pricing in 2012 should be favorable because external factors will limit the addition of capacity by transportation carriers. As such, the trucking segments (truckload and less-than-truckload) should fare well. External factors such as the higher cost of new trucks and the acute shortage of qualified and "good" drivers with safe driving records will collectively limit the carriers from adding capacity.

Within the truckload segment, flatbed carriers could experience the tightest capacity, and that will result in shippers either paying higher rate increases or facing unpredictability of capacity when required. Truckload carriers with dedicated services also should see growth opportunity from increased private fleet conversions because of the growing awareness and attention to CSA scores by carriers, shippers and trial lawyers.

These developments favor continued tightness in capacity, and this will support rate increases in the mid-single-digits. Truckload rates were up more than 4 percent in 2011 and should continue the mid-single-digit rate increase into 2012.

A wild card that could change this forecast for

rate increases in 2012 is the end to further extension of unemployment benefits. Since some of the driver shortage seems to be triggered by the competition faced by generous unemployment benefits, an end will push some qualified drivers back on the employment path and could help offset the tight driver market.

Capacity will further tighten as a result of the recent trend at some large truckload carriers (J.B. Hunt Transport, Knight Transportation, Werner Enterprises) to favor meeting customer needs with brokerage services that use hundreds of smaller carriers to provide truck capacity. Smaller carriers have a bigger challenge adding trucks and drivers because of a lack of capital and ability to screen for safe drivers, which means we are unlikely to see an increase in the number of trucks provided by these smaller operators.

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The LTL segment, while much smaller in market size than many other trucking segments, should have its best year since 2007. The industry has been blessed with many developments that are coming together for rate increases and margin improvements. A few of these developments include tight capacity as a spillover effect from the truckload segment, a driver shortage that will keep even variable capacity tight, and an increased effort by LTL carriers to charge for accessorial services and become more vigilant in reweighing shipments and making corrections for smaller variations.

As a result, LTL base yields increased about 5 percent in the first three quarters of 2011 from a year earlier, with margins up 2 to 4 percent during the same period. Rates should continue their mid-single-digit increase in 2012 and drive further margin expansion. Although Old Dominion Freight Line is widely considered the best-in-class LTL carrier, Saia and Vitran are LTL carriers to watch in 2012. Both carriers have the lowest yielding freight per hundredweight and thus are positioned for increases in yield and margin in this favorable market.

Intermodal is another attractive segment for 2012. It should continue its middle to high double-digit revenue growth. Because of the tight driver market that limits capacity addition by truckload carriers, coupled with increased capacity created by railroads with years of capital expenditures and their environmental advantages, intermodal has all the stars aligned to boost volume and yield for next three to five years. J.B. Hunt Transport is the best-in-class in this segment.

Ocean carriers, however, are unlikely to see increases in revenue or match the margins of 2011 because of overcapacity and declining rates. Furthermore, the more traditional lanes (Asia to U.S. and Europe to U.S.) in which the ocean carriers operate aren't likely to benefit from the growing segments of global trade.

Although China's rapid growth has fueled domestic consumption within the country, it also has increased wages for many manufacturing and assembly jobs, leading some companies to add new production capacity in Mexico and closer to the U.S. market. These changes will mean declining growth for some segments and increased growth for others based on their focus by geographic coverage area such as truckload carriers (Celadon, for example) and railroads (such as Kansas City Southern) that operate in the Mexico and cross-border lanes.

Additionally, greater cooperation with labor unions at companies such as General Motors is resulting in new manufacturing facilities in the U.S. and will further increase domestic transportation demand.

Even if sluggish GDP growth continues into 2012, most transportation companies, and the Dow Transport Index, still should see an improvement from 2011 because of tighter capacity and a favorable rate environment. JOC

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