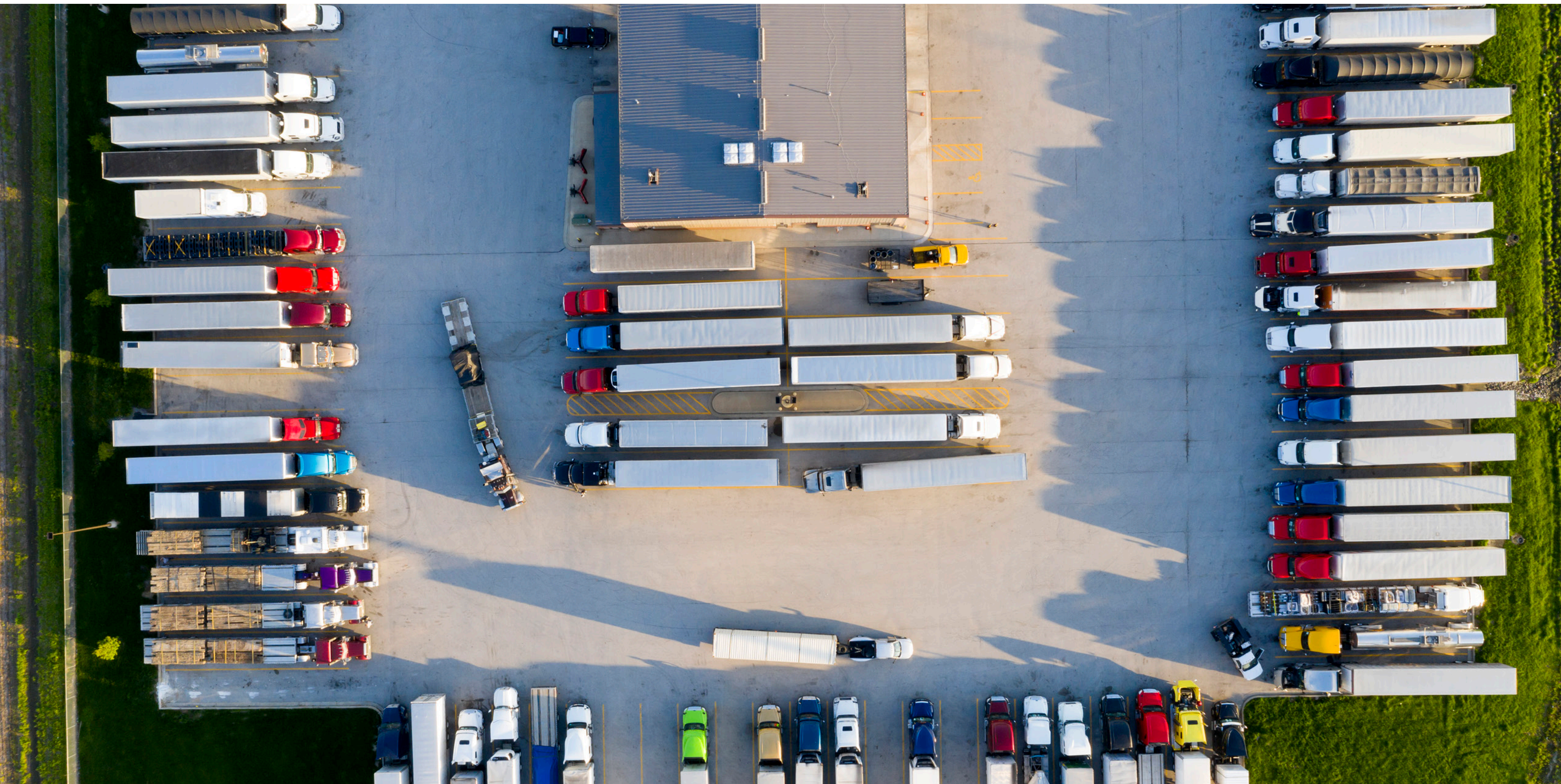
Q2 2021 ECONOMIC FORECAST

Forecast

04/13/21



CHALLENGES, OPPORTUNITIES AND ANSWERS: A PIVOTAL THREE MONTHS

One year ago, a once-in-a-century public health event covered the globe in a fog of uncertainty. Little was known about COVID-19 at the time. The coronavirus was every bit as novel as the mitigation steps taken to control its spread. Communities and entire industries alike modified their day-to-day routines in order to respect social distancing and stay-at-home orders. It was a time of adaptation and anxiety. There was no telling what the future would bring, but a considerable human and economic toll was all but certain.

Yet what a difference a year makes! After 13 months in the throes of a global pandemic, it finally seems that the haze is beginning to clear. Long-shuttered public spaces are reopening. The U.S. economy maintains momentum amidst a decline in cases, an increase in vaccinations, and warmer weather. Another round of stimulus spending is being rolled out as an ambitious infrastructure program waits on the horizon. The key economic indicators suggest a V-shaped recovery continues unabated.

In our 2021 economic outlook, we observed that "an array of economic factors – from new housing starts to industrial output, inventory stocking and consumer demand – will determine how freight markets behave amidst the ongoing pandemic. The key question in most observers' minds will be: 'How long will the current freight peak linger?'"

Here are a few more questions that are surely on the mind of freight market stakeholders: How long will it take for truckload capacity to catch up? Moreover, how deep does the driver shortage go, and for how long will it persist? And, of course, how much longer will this inflationary rate environment last?

As we said earlier this year, 2021 will be a year of contending headwinds and tailwinds. Several analysts expect this heightened truckload rate environment to crest in Q3 of 2021. But, around this matter exist a wide array of opinions; consensus and certainty are in short supply these days. How you feel about the future of the freight market likely hinges on whether you believe the pandemic-influenced changes in consumer behavior are a trend or a structural realignment in preferences.

The same can be said for one's appraisal of the labor market for drivers. A recent study revealed that 76% of CDL drivers prefer local jobs to over-the-road hauls. Further, how many drivers have bowed out from the industry in response to the pandemic? A good deal of evidence exists that the supplemental income from stimulus and other government programs has encouraged many workers to stay at home; drivers included. Will the jobs created by a robust infrastructure program exacerbate the systemic shortage of CDL drivers willing to go over-the-road? The answers to those questions will likely be revealed over the coming quarters.

With an eye towards a discussion of what lies ahead in Q2 of 2021, let's dig into some of the economic data that's been reported since March 31st.

WHAT'S HAPPENED RECENTLY?

Throughout the coronavirus pandemic, two common themes have characterized our outlook on the freight market. The first theme is that the pandemic accelerated many of the dynamics that were already in play in the early days of 2020: carrier exits in 2019 foretold an inflationary environment in 2020. The pandemic economy intensified those underlying factors, and freight rates surged accordingly to record levels. It also defied the typical conventions around annual seasonality in freight movements. In many respects, 2020's "peak season" comprised most of Q3 and Q4. It's quite possible that we'll see much of the same in 2021.

The second key theme in our outlook is this: the lockdowns have motivated sweeping changes in consumer behavior that are greatly contributing to this heightened rate environment. **A broad shift to e-commerce has left many retailers and manufacturers scrambling to keep up. Supply chain integrity has become every bit as pivotal as marketing to success.**

With those two themes in mind, here are some numbers that have piqued our interest (as of April 5, 2021) since the release of our 2021 Economic Outlook back in mid-January:

<u>Gross Domestic Product</u>

- On March 25, 2021, the Bureau of Economic Analysis revised Q4 2020 GDP figures up to 4.3% (from 4.1%). Better yet, even faster growth is expected in the months ahead. Economists polled by Dow Jones and The Wall Street Journal predict GDP will increase at a pace of 4.9% in the spring and 7% in the summer.

- As of April 1, 2021, the Atlanta Branch of the Federal Reserve Bank's "GDP Now" tracker estimates 6% GDP growth occurred during Q1 of 2021.

- Goldman Sachs is especially bullish about the U.S. economy. On March 15, 2021, the investment bank revised their 2021 GDP growth expectations from 6.8% to 8%. If that forecast pans out, 2021 would usher in the largest economic expansion in decades.

8% **Goldman Sachs revised their 2021 GDP growth expectations from 6.8% to 8%.**

- The American Trucking Association recently updated their prediction for annual GDP growth in the United States in 2021 – they revised their forecast from 5% to 7%. They see this year as a rising tide for carriers of all stripes. ATA's Chief Economist, Bob Costello, remarked, "I think the parts of trucking that have been strong will remain strong and the weak parts of trucking will get strong. It's going to be good for pretty much everybody."

7% **The American Trucking Association revised their 2021 GDP growth expectations from 5% to 7%.**

- This year is sure to bring welcome economic growth as the country recovers from the pandemic. However, several economists are sounding alarms about inflation.

- The overall manufacturing sector continues to show signs of life – the Institute for Supply Chain Management's Purchasing Managers Index swelled to 64.7 in March – the highest reading since December 1983.

Employment

- On March 30, 2021, ADP released the results of their monthly payroll survey. Their latest report offered much to be optimistic about; payrolls in March increased by 517,000 jobs, the fastest pace since September. The hospitality sector saw appreciable growth with 169,000 new workers. Goods manufacturers saw modest improvement as well: 49,000 manufacturing jobs were added along with 32,000 new hires in the construction industry.

- On April 2, 2021, the Bureau of Labor Statistics reported that total nonfarm payroll employment increased by 916,000 jobs in March as the unemployment rate dropped to 6.0%. March's employment figures were preceded by a February of encouraging improvement (nonfarm payroll employment rose by 379,000 jobs).

- On April 1, 2021, the Labor Department released their weekly jobless claims report. First-time claims for unemployment benefits increased to 719,000 from the prior week's 658,000 – a figure well ahead of economists' expectations. However, there are a few silver linings: the four-week moving average of first-time claims fell to its lowest level since March 14, 2020. Moreover, the overall number of those receiving unemployment benefits declined.

Personal Consumption

- A March 26, 2021 report by the Bureau of Economic Analysis revealed that personal income decreased by $1,516.6 billion, a 7.1% decline, in February. Moreover, personal consumption expenditures decreased $149 billion (1%). Several analysts attribute that decline to not only the bouts with cold weather across the country but dwindling government transfer payments.

- On March 30, 2021, the Conference Board released their monthly Consumer Confidence survey results. Consumer confidence increased in March to 109.7 from 90.4 in February – the sharpest increase in almost 18 years and the highest since July 2019. Better yet, 36.1% of survey respondents expect greater job availability within the next six months. These are encouraging signs that household spending may pick up even more in the near future.

+19.3 Consumer confidence increased in March to 109.7 from 90.4 in February.

36.1% Survey respondents expect greater job availability within the next six months

Class 8 Truck Orders

- FTR Research has reported six consecutive months of at least 40,000 Class 8 tractor orders (and 372,000 orders over a 12-month period to date). ACT Research believes the current pace of new tractor orders is not only well above replacement rates for the industry but also anticipated economic growth rates.

6 CONSECUTIVE MONTHS

Six consecutive months of at least 40,000 Class 8 tractor orders (and 372,000 orders over a 12-month period to date).

- A recent report by BMO underscored the issues that manufacturers are facing in fulfilling orders for new equipment. **Many OEMs are struggling to build new trucks due to component shortages plaguing suppliers (ironically, truck manufacturers are having a hard time securing semiconductors due to… the shortage of trucks available to move freight for their semiconductor suppliers).** Consequently, fleets are running on older trucks longer than they otherwise would in order to accommodate delays in new truck order fulfillment.

- As such, average prices for used Class 8 vehicles increased in February by 17.9% year-over-year from $41,998 (in 2020) to $49,549 (in 2021) as volumes also increased year-over-year from 20,700 (in 2020) to 22,700 (in 2021). However, used Class 8 sales were flat month-over-month due to dwindling inventories.

Logistics Managers' Index

The Logistics Managers' Index (LMI) is a survey of leading logistics executives that calculates a score based on an array of industry components ranging from warehousing capacity, utilization and prices to transportation capacity, utilization and prices as well. Any reading above 50 indicates expansion while readings below 50 indicate contraction.

- The March index (released April 6, 2021) suggests that the logistics industry is still expanding, albeit at a slower pace. While the most recent LMI reading of 72.2 is slightly up from February's read out of 71.4, it's still well above the all-time average of the index (62.9).

72.2 **The most recent LMI reading of 72.2 is slightly up from February's read out of 71.4, it's still well above the all-time average of the index (62.9)**

- Transportation prices, as a component of the index, are up by 2.6 points to 90.6 – the fifth highest reading in the history of the index and the first reading in the 90s since May and June of 2018. The April report sees the heightened price rate as a matter of constrained Transportation Capacity, which declined 7.7 points to 30.4 – the third lowest reading in the history of the index and the lowest reading since September 2020.

- Inventory levels declined to 61.5 from February's readout of 64. The report writers believe that inventory growth rates are attenuated by port congestions and global delays in consumer goods deliveries.

- Here's one revealing excerpt from the report: "Despite the continued need for more capacity, respondents do not expect much to come online, predicting moderate growth for warehousing capacity at 54.6, and essentially no movement for Transportation Capacity at 49.6. Both of these readings are down from last week, when respondents were slightly more optimistic about the potential for increased supply. They in turn predict continued high rates of growth for costs in inventory, warehousing, and transportation. Demand for logistics services jumped forward by 2-3 years in 2020, and it is currently taking longer than usual to produce new capital equipment. At this point it seems likely that it will take more than a year of building up additional capacity to catch up."

Freight Market Dynamics

- A recent FreightWaves report indicated that tender rejection rates for van loads have exceeded 20% every single day since August (with one exception in February). Rejection rates had been declining incrementally through the first of 2021 until February's winter storms interrupted freight movements and shipper production cycles. Since February 18th, rejection rates have hovered consistently above 25%.

25%

Since February 18th, rejection rates have hovered consistently above 25%

- Moreover, the FreightWaves Outbound Tender Reject Index climbed over 28% during the week of March 20th – a rate on par with the 2020 Thanksgiving season (before pulling back to 26.4% the week of March 27th). This rapid spike is a sure sign that demand continues to overwhelm truckload capacity. According to Truckstop.com, average spot rates increased 20% through the month of February.

- Meanwhile, the Outbound Tender Volume Index did retreat by 4% the week of March 27th, but it's not far from the all-time high of 15,178.

- In a recent trade interview, Professor Dale Rogers at Arizona State University predicted that the ongoing economic recovery will place further strain on an already tight capacity situation. (Rogers and several other economists compile and publish the LMI.) "Trucking is crazy busy," he said. "It's just amazing how transportation pricing is way up, and capacity is way down. The trucking economy is pretty hot." Rogers added, "Regarding the overall economy, I think it will be summer before things really get crazy. The stimulus money is going to be a big thing. There's going to be a lot of pent-up demand."

- By and large, diesel prices have remained stable. But the U.S. Energy Information Administration expects increased average diesel prices of $2.71/gal in 2021 and $2.74/gal in 2022. As a reference point, the average price of diesel on November 30, 2020 was $2.50/gal. Diesel fuel usually represents approximately 1/3rd of a carrier's overall cost. So, a rise or fall in fuel prices can have a considerable impact on profitability. When fuel remains stable in the face of increasing truckload rates, carriers can reap the benefits.

OUR SECOND QUARTER OUTLOOK

As you can see, the metrics paint a picture of an economy on the mend combined with a burgeoning labor market recovery that's punctuated by consumers who are feeling upbeat about their future prospects. Consequently, freight remains abundant as inventories continue to be replenished; and ahead of produce season, no less. But for how much longer will rates and volumes remain elevated?

We tend to agree with those industry observers who believe that this heightened rate and volume environment will persist through 2021 before turning deflationary in Q1 of 2022. As we shared in our 2021 Economic Outlook in January, we still anticipate freight volumes to slightly ease off sometime late Q3 of this year. However, the timing of the inflationary crest (and subsequent market shift) will ultimately hinge on how soon truckload capacity can catch up with freight volumes. The early GDP predictions we've seen for the next two years suggest that even a deflationary rate market in 2022 could yet be characterized by a significant gap between supply and demand; albeit not as pronounced as in 2021. **No matter the degree to which freight volumes stabilize over the course of 2021 and into 2022, freight markets will still have to navigate chronic driver shortages.**

To that end, we believe that the coming quarter will provide several clues as to the state of freight for the remainder of 2021 and early on in 2022. Accordingly, we'll be paying particular attention to four particular categories of metrics.

1. **Truckload Demand: Economic Growth and Consumption Patterns** – The major economic metrics suggest the V-shaped recovery continues apace. GDP is expected to yield big numbers over the months to follow. Consumer spending is up to -3% Y/Y in Q1 2021 from the doldrums of -10% in Q2 2020. Anticipated levels of consumer spending have prompted the National Retail Foundation to predict that imports will set new records this summer.

   In mid-March, the Census Bureau reported a declining Inventory-to-Sales ratio of 1.26 in January 2021. By contrast, the January 2020 Inventory-to-Sales ratio was 1.38. This metric means that shippers have fewer warehoused goods (or components for assembly) than necessary to keep up with sales orders.

If consumer spending remains robust throughout the course of the quarter, shippers will have to restock shelves to meet demand. Accordingly, manufacturers will have to create more of the products that will maintain those inventories. This, in turn, means sustained truckload volumes.

-1.26

The Census Bureau reported a declining Inventory-to-Sales ratio of 1.26 in January 2021. The January 2020 Inventory-to-Sales ratio was 1.38

In our 2021 Economic Outlook, we predicted that contract rates will increase by a factor of 8% to 15% over the course of 2021. A recent report by the transportation finance team at a national bank reinforced that view – they predict spot rates will favor carriers through the middle of this year, at the very least. We believe that trend could very well persist into 2022. Either way, data around consumer spending and inventories for the coming quarter will tell us a good deal about the state of freight market demand through the end of the year. If consumption maintains a torrid pace relative to manufacturers' and retailers' abilities to keep up, then rates and volumes will most certainly be elevated for the remainder of the year (even with a mild decline in volumes in Q3).

2. **Truckload Supply: The Height of the Truckload Capacity Ceiling** – The data around driver shortages and backlogs on orders for tractors paints a picture of a truckload capacity ceiling that continues to drop with each passing day. There's a palpable sense of urgency on behalf of carriers, and even industry groups, in identifying new avenues to attract and retain drivers. A recent study revealed that in 2019, more than 14 million truck driving jobs were posted for only 1.9 million jobs available. That figure well-exceeded the average of six job postings per each hire.

14 Million

A recent study revealed that in 2019, more than 14 million truck driving jobs were posted for only 1.9 million jobs available

This study also reported that 57% of current drivers are older than 45 years of age, while 23% are older than 55. If this trend bears out, then almost half of the driver force will be eligible for retirement within 20 years. Further, the average age of a driver hired in 2020 was 46.5. Recruiting tomorrow's drivers is every bit as imperative as retaining today's drivers. This is a difficult challenge, especially

amidst a pandemic. Indeed, the aforementioned study also identified that interest in trucking jobs declined considerably during 2020 (compared to 2019). Moreover, one in two drivers say wages across the industry aren't competitive; 50% don't feel safe on the road. Those data points underscore the prospect of significant wage inflation in order to attract (and retain) more drivers.

"The next three months of reporting around tractor deliveries as well as driver recruitment and retention will answer the pressing questions around truckload supply going into the holiday season. This might strike some observers as an exaggeration, but the coming quarter will likely be one of the most critical periods in trucking in years."

We've discussed the other factors compounding this problem as well: government programs have dissuaded workers in lower income brackets from quickly returning to work, the FMCSA Drug & Alcohol Clearinghouse has sidelined a slew of drivers, and CDL schools aren't graduating newly-minted drivers like they used to. Moreover, once an infrastructure bill is presented to Congress, the impact of $2 trillion in government spending on the labor market for drivers (and the industry at large) will become clearer. Presently, federal law requires trucks to carry $750,000 in liability insurance coverage. There are proposals on the table that would more than double that minimum coverage threshold, which would likely result in a considerable increase in insurance premiums. Accordingly, smaller operators could be driven out of the market.

The coming quarter will present another critical roadblock keeping shippers from accessing expanded capacity: production issues at equipment manufacturers. However, as vaccines are distributed and cases decline, perhaps an unanticipated wave of drivers will return to duty. **The next three months of reporting around tractor deliveries as well as driver recruitment and retention will answer the pressing questions around truckload supply going into the holiday season. This might strike some observers as an exaggeration, but the coming quarter will likely be one of the most critical periods in trucking in years.**

3. **Frictional Changes vs. Structural Changes** - The lockdown economy eschewed the usual demographic distinctions between e-commerce buyers and those who prefer shopping in bricks-and-mortar environments. When stay-at-home orders were issued, consumers of all stripes relied on their computers and phones to buy the bare necessities. They also used money that would have otherwise been spent on dining out, vacations and other experience goods for home improvement projects.

   Remarkably, the pandemic has compressed several years' worth of e-commerce growth into a 12-month timeframe. In 2020, U.S. merchants raked in $861 billion in sales online – a 44% increase over the prior year (as estimated by Digital Commerce 360). In 2019, e-commerce accounted for 16% of all retail transactions. In 2020, that figure blossomed to 21%.

It makes sense that as the country reopens and vaccines are distributed, travel, hospitality and other service-based, experiential offerings will attract consumer dollars away from online shopping. But what recently formed habits and preferences will remain intact beyond the pandemic? **Are these changes frictional, in the sense that our supply chains pivoted in a makeshift way to keep up with a temporary shift in buying trends? Or, are we seeing a fundamental restructuring in the ways people buy (and retailers sell)? Have clicks finally achieved parity with bricks?** The latter would certainly constitute a structural change in not just supply chains but our way of life in general.

The same can be said for workforce participation in the labor market for drivers. To what extent did stimulus checks and unemployment benefits remove workers from the driver pool for good? Or, in a similar vein, has the past year changed lifestyle preferences in a way that drivers will only consider short-haul and local routes in favor of more home time?

Here's another factor that has the potential to spark widespread structural changes in trucking: autonomous technologies. TuSimple, a self-driving truck startup, is expected to file for an initial public offering in the near future that could value the company at more than $8 billion. US Xpress has partnered with (and invested in) TuSimple in order to test autonomous technologies with select shippers on specific routes. We believe that some routes will operate autonomously as soon as five to ten years from now. Moreover, a widespread rollout of autonomous technologies over a 15-year horizon could enable the freight industry to sustain robust truckload capacity by supplementing the available driver pool – especially amidst driver shortages.

It's worth noting that we'll always have a need for professional drivers. There are no plans to replace human drivers with self-driving trucks now or in the foreseeable future. However, autonomous technologies will have considerable repercussions for not only trucking but other blue-collar industries as well. Imagine a world in which supply chains and freight markets aren't wholly bound by limitations in driver pools. Imagine, also, a world in which blue-collar industries can thrive alongside of one another without cannibalizing their various labor pools. As such, we'll continue to pay close attention to the key players and latest developments in the autonomous space.

4. **Government Spending** – Whether it's an infrastructure program or a supplemental stimulus package, government spending is also worth keeping an eye on. A broad spending initiative, such as an infrastructure bill, could spark economic activity while further exacerbating the driver supply issues. The infrastructure plan that was recently introduced would likely push annual GDP growth above 5% for 2022 and possibly even 2023 if approved by Congress as currently conceived. Additionally, the areas in which the dollars would be allocated would likely drive demand for shipping even higher than the near record levels that have characterized freight markets over the past several months. The job implications could be even more impactful for freight – the unprecedented construction hiring for public works projects would further impede the trucking industry's ability to hire qualified employees.

"The job implications could be even more impactful for freight – the unprecedented construction hiring for public works projects would further impede the trucking industry's ability to hire qualified employees."

CLARITY IS AROUND THE CORNER

In our 2021 Economic Outlook, we stressed that “the trajectory of the 2021 freight market will ultimately hinge on inventory restocking, the available supply of drivers and the overall health of the country’s economy (and its people, as well).” As with our prior forecast, we still expect the inflationary rate environment to persist for most of 2021, even beyond a slight easing in freight volumes late third quarter.

The coming quarter will reveal whether these elevated rates and volumes will either stand pat through the remainder of the year, or taper as a deflationary market takes root. Simply put: it all comes down to whether consumer spending and business purchases continue to thin out inventory levels. On the other side of the coin, the depth and breadth of the driver shortage will be a key determinant as well (particularly as federal infrastructure spending influences the labor market).

We’ve closed our four prior economic forecasts by acknowledging the heroes who have kept our shelves stocked and our economy afloat in the face of adversity, and we would like to do so again here. Their contributions have literally saved lives. We’ve also expressed how proud we are to collaborate with shippers and peers across the industry to sustain our nation’s supply chain amidst struggles and uncertainties unlike any ever seen.

While it’s hard to say when this pandemic will finally come to a close, don’t lose sight of the fact that the end of this harrowing episode draws closer each day. Soon, social distancing will be a distant memory and faces will look familiar again.

As always, thank you for your diligence and strength in rising to the occasion. It’s been a privilege to be on this journey with each of you.

U.S. XPRESS℠

usxpress.com