Q3 2021 INDUSTRY FORECAST

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AN ECONOMY ON THE BRINK OF RECOVERY

The summer of 2021 has given the country a glimpse into life as it was lived before the coronavirus pandemic lockdowns. As of July 30th, 49 out of 50 states are reopened (only Hawaii remains). Here's another encouraging data point: the week of July 23rd brought more traffic through TSA airport checkpoints than any other week of the COVID era. Better yet, as mask mandates are withdrawn, faces are familiar again. On the other hand, the emergence of a coronavirus variant (the Delta variant) is certainly a cause for concern.

All the same, the American economic recovery proceeds in earnest.

In April, our Q2 2021 Economic Forecast Update observed that "The coming quarter will reveal whether these elevated [freight] rates and volumes will either stand pat through the remainder of the year or taper as a deflationary market takes root." The former certainly appears to be the case: rates have "plateaued just shy of a peak," so to speak. However, as the Delta variant arises from the embers of the 2020 coronavirus pandemic, much remains to be seen. Will the economic recovery be stymied by another wave of cases and hospitalizations? If so, what bearing could such a situation have on freight markets for the remainder of 2021?

Our prior economic forecast update raised three key questions: "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?" In the three months since, some of the fog around those questions has cleared. Incremental gains have been made in truckload capacity. But, a considerable gap still exists between loads and trucks.

With an eye towards a discussion of what lies ahead in Q3 of 2021, let's dig into some of the economic data that's been reported since July 30th.

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. We raised the possibility that we'd see much of the same in 2021, and so far, that prediction has panned out.

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 July 22, 2021) since the release of our Q2 2021 Economic Outlook back in mid-April.

Gross Domestic Product

- On July 29, 2021, the Bureau of Economic Analysis released a report indicating that Q2 2021 GDP increased at an annualized rate of 6.5%. While that figure lagged forecasted estimates of 8.4%, it's an encouraging sign of sustained growth on the heels of a 6.3% increase in Q1 2021 and the 4.3% growth realized in Q4 of 2020.

+6.5% Increase in Q2 2021 GDP

- As of July 30, 2021, the Atlanta Branch of the Federal Reserve Bank's "GDP Now" tracker estimates 6.1% GDP growth occurred during Q3 of 2021.

- The Institute for Supply Management's Purchasing Managers' Index June report registered at 60.6%, a decrease of 0.6 percentage points lower than May's all-time high reading of 61.2%. The June reading, based on monthly surveys of supply chain managers across multiple industries, indicates the 13th straight month of growth for the services sector, which has expanded for all but two of the last 137 months.

Employment

- On June 30, 2021, ADP released the results of its monthly payroll survey. Their latest report revealed payrolls in June increased by 692,000 jobs. The hospitality sector saw appreciable growth with 332,000 new workers. Goods manufacturers saw modest improvement as well: 19,000 manufacturing jobs were added along with 47,000 new hires in the construction industry.

- On July 2, 2021, the Bureau of Labor Statistics reported that total nonfarm payroll employment increased by 850,000 jobs in June as the unemployment rate changed very little at 5.9%.

- For all the progress being made on a jobs front, it's not yet a foregone conclusion that the labor market is out of the woods. On July 29, 2021, the Labor Department released its weekly jobless claims report. First-time claims for unemployment benefits fell by 24,000 from the week before to a seasonally adjusted level of 420,000. Meanwhile, continuing jobless claims increased by a modest 7,000 claims to an ongoing number of 3.27 million for conventional state unemployment programs (that figure swells to 13.1 million if pandemic-era programs are included). These numbers truly demonstrate the depth of the labor shortage.

↓24k Decrease in first time unemployment claims (July 29, 2021)

420k Seasonally adjusted level of unemployment benefits (July 29, 2021)

Personal Consumption

- The July 29, 2021 report by the Bureau of Economic Analysis also revealed that disposable personal income decreased by $1.42 trillion, a 26.1% decline, in Q2. By contrast, personal income increased $2.27 trillion (63.7%) in Q1 2021. Concurrently, personal consumption expenditures increased 11.8% in Q2 and 11.4% in Q1. This recent imbalance between consumer income and expenditures is likely influenced by the recision of pandemic employment benefits across several states.

-26.1%

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- On July 27, 2021, the Conference Board released its monthly consumer confidence survey results. Consumer confidence increased modestly in July to 129.1, up from 128.9 in June. This is the highest level since the onset of the pandemic's first surge in March 2020. However, consumers are taking a wait-and-see attitude towards the short-term labor market outlook: 27.7% of consumers expect more jobs to be available in the months ahead, up from 26.6% from June. On the other hand, 16.8% anticipate fewer jobs will be available in the near term, which is up from June's reading of 15.7%.

- **Economists expect consumer spending to increase by 9% this year. If that prediction comes to fruition, it would constitute the highest growth in spending since 1946, on the heels of the end of World War II.** Child tax credits will soon hit bank accounts across the country, which will have repercussions for not just consumer spending but the labor market for truck drivers as well.

Class 8 Truck Orders

- FTR Transportation Intelligence reports that Class 8 truck orders continued at a strong clip through the spring of 2021 at a pace of 28,500 orders in March, 21,900 in April, and 24,800 in May. Moreover, semiconductors will flow to auto manufacturers in August. However, the semiconductor shortage is still a critical concern – lead times are still more than 25 weeks.

- **However, while Class 8 orders are robust, Class 8 production is another story. Through May of 2021, the 115,328 Class 8 trucks produced to date considerably lag the 155,833 produced through May in 2019.**

Logistics Managers' Index

The Logistic 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.

- Transportation prices, as a component of the index, are down by 3.9 points to 87.3. Although the index remains more than 37 points above the level of expansion, the pressure on transportation prices persisting since the fall months of 2020 does seem to be waning.

- Much of the LMI growth was driven by improvements in inventory levels, which increased significantly to 67.8 (a 9.1 increase from May). However, the metrics around Available Transportation Capacity reinforced the challenges that supply chains are facing in moving goods. For the fifth consecutive month, the Available Transportation Capacity reading remained in the 30s (at 34.5 in June), which indicates extreme rates of capacity contraction.

Freight Market Dynamics

- Recent activity has revealed some softening in spot markets, but most measures indicate spot markets are perched above $3 per mile. Data from Truckstop.com and FTR for the week of July 12th indicates that after a prolonged period of stress, spot freight volumes in dry van and refrigerated freight is beginning to taper off. However, data from DAT shows that spot rates for refrigerated units are still sustaining elevated rates of 38% year-over-year (and 3% month-to-month), while flatbed rates are up 42% year-over-year and dry van hovers at 35% year-over-year (and 3% month-to-month).

Refrigerated units spot rates are up **38%** year-over-year.

Flatbed rates are up **42%** year-over-year.

Dry van rates are at **35%** year-over-year.

- Concurrently, the American Trucking Association's truck tonnage rate reporting has flattened over the past two months: their truck tonnage rate declined 1.5% in June on the heels of a 1% drop in May. However, the ATA's measure of truck tonnage, which is based on contract freight, is still slightly above 2020 levels. Researchers at ATA suspect that tonnage would be much higher if it weren't for the driver constraints facing the entire industry. After all, it's difficult to move more freight with less equipment.

- Along a similar vein, **FTR reports that the share of seated Class 8 trucks actively engaged in hauling freight has hovered near 100% for several weeks. They expect active truck utilization to remain robust through the next quarter before tapering off to 98% during the December holiday season.** FTR also sees their spot rate index tapering off from record highs but remaining well above the baseline of 100 (pegged to Q1 of 2008) – declining to the mid–130s by the end of 2022. Yes, you read that right: the end of 2022.

- On July 6, 2021, the U.S. Energy Information Administration reported the weekly average retail diesel price rose for the 10th consecutive week, coming in at $3.331 a gallon, an increase of 3.1 cents from the prior week.

OUR THIRD QUARTER OUTLOOK

By and large, Q2 2021 proceeded exactly as we expected: sustained rate inflation due to the persistence of heightened freight volumes spread across a diminished driver base. We continue 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. Yet, no matter the degree to which freight volumes stabilize over the course of 2021 and into 2022, freight markets will continue to navigate chronic driver shortages.

In earlier forecasts, we anticipated freight volumes to ease off slightly in Q3. Now that Q3 is within our grasp, we believe the next couple of months will function as a continuation of the trends we saw in Q2, but with some incremental gains in truckload capacity as states continue to roll back pandemic unemployment benefits. However, as the economy recovers and the holiday season draws near, the trucking industry will have to reckon with another spate of elevated freight volumes this fall.

Accordingly, we'll pay particular attention to three themes in the months ahead.

1. Truckload Capacity Amidst Driver Scarcity

In our prior forecast update, we talked about frictional changes versus structural changes in the labor market for drivers. To what extent did stimulus checks and unemployment benefits cull 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 are more factors to consider along those dimensions.

- The June 2021 BLS payroll report indicated some progress on a driver hiring front: 1.487 million drivers are presently employed, a gain of 53,900 (3.8%) from June 2020. However, that figure lags the February 2020 driver base by 38,300 (-2.5%).

1.487
Million drivers are presently employed.

+3.8%
Gain from June 2020.

- 2.5%
Loss from February 2020.

- **It makes sense that when rates are high, carriers are eager to grow their fleets. That often entails rolling out new perks and incentives to bring in more drivers. However, a recent ATA survey found that this hard and fast rule doesn't prevail in this current freight market.** So far, in 2021, fleet sizes are down 6% for large carriers and 4.9% for small carriers. Even LTL fleets are slightly down by 0.9%.

- We earlier discussed the most recent BLS data regarding initial claims for unemployment benefits. The continuing claims data is intriguing, as well. The entirety of continuing unemployment claims (both conventional and pandemic unemployment claims) declined 1.1 million two weeks ago. Much of that can likely be attributed to various state governments rescinding pandemic unemployment benefits in order to encourage their residents to return to work. However, the current figure of more than 9 million continuing pandemic claims is triple the amount of conventional state-level unemployment claims. With that much labor sitting on the sidelines, it's difficult to contemplate any quick relief for the driver shortage (and the attendant supply chain disruptions).

- The ATA recently published a report finding that 105,000 additional drivers will be needed by 2023. The report discussed the usual factors behind the driver shortage, ranging from lifestyle issues and the drug and alcohol clearinghouse to the pandemic's limiting effect on the CDL instruction and licensing process. One anecdotal observation in the report resulted from discussions with smaller and midsized carriers who've learned they can pay drivers less as long as home time can be guaranteed every other night.

- Government spending on infrastructure will definitely be a factor in driver recruitment and retention trends. Recently, the Senate voted to close debate on a $1 trillion infrastructure package that will spend $550 billion on roads, bridges, rail, and waterways.

- Capacity diffusion is one interesting trend in this robust freight market. Approximately 51,000 motor carriers have received operating authority through the first half of 2021.

This pace practically guarantees that 2020's record wave of 59,000 new carriers will be eclipsed by a wide margin this year. **Naturally, these numbers aren't being driven by new drivers entering the market but by company drivers electing to run under their own operating authority. This isn't a matter of added capacity; it's more about deeper fragmentation in the industry (and perhaps diminished utilization due to greater coordinating costs).**

2. Supply Chain Integrity, Consumption Trends, and Economic Growth

While the economy has made tremendous progress and shows encouraging signs of sustained growth, the future is far from guaranteed. Inflation, supply chain challenges, and labor market constraints are just a few of the challenges that could stifle recovery.

The scale and complexity of the U.S. economy is a beautiful thing to behold. That's especially true of the supply chains and logistics systems that keep our standard of living afloat. But, when complexity is compounded by chaos and uncertainty, a vicious cycle can develop. Think of how the lockdowns and the attendant changes in consumer behavior have shaken the foundations of our supply chains and distribution networks to their core. Supply chain disruptions have impacted capacity, which impacts fleet productivity, which in turn exacerbates the aforementioned supply chain issues.

Retail inventories are still well below normal for this time of year. Indeed, the Bureau of Economic Analysis' two most recent GDP reports have indicated inventory drawdowns in the face of considerable labor and materials shortages. Yet as more restaurants and experiential sectors reopen, consumer spending could very well shift back to services and experiences. While 2.06 million travelers passed through TSA checkpoints the week of July 23rd, the leisure and hospitality sector is still nearly 2.2 million payroll jobs (12.9%) below pre-pandemic levels.

There are many encouraging signs and reasons for optimism, but growth can't be taken for granted. If businesses must raise wages in order to motivate people to return to work, that could very well fan the flames of long-term inflation. If inflation becomes a serious issue, the Federal Reserve may be forced to move aggressively by raising interest rates in order to tamp down economic growth. Government debt must also be reckoned with. **The next two quarters will reveal a good deal about the upstream, macroeconomic effects that will trickle downstream into the trucking industry by early 2022 (for better or for worse).**

3. Repercussions for RFP Season

The tendency of contract rates to lag trends in spot rates by one to two quarters is a long-observed circumstance in the logistics industry. Tender rejection rates are a key determinant, as well. The FreightWaves tender rejection rate has hovered at around 25% since the fall months of 2020. Simply put, this metric means that for every four loads that have to go out the door on a given day, shippers have to scramble to cover one of those loads due to tender rejections from contract carriers.

In their Q3 2021 market forecast, Coyote Logistics predicted contract rates will continue to climb upwards due to the long-sustained inflationary spot market activity. (Again, spot rate activity in the months leading up to RFP season customarily has the greatest degree of influence over the bidding process.) Coyote also believes that spot rates are most likely at or near the peak for this freight market cycle. But, low rates and ample capacity most likely remain a distant reality. We tend to agree.

THE GROUND IS SHIFTING UNDER OUR FEET

"What goes up must come down" is more than just a cliché – it's a law of nature. Indeed, freight rates are subject to their own rules of gravity. The distinguishing characteristics that make a freight market cycle distinct from another are the many oscillations they encounter along the paths between peaks and troughs. The pandemic freight market cycle is certainly no exception. It's been a long, chaotic, volatile journey.

Without a doubt, a drop in the spot market is going to come. What remains to be seen is whether it'll happen in the winter, spring, or summer of 2022. Moreover, will the decline in rates come as a result of easing freight volumes or an unanticipated surge of new drivers? Or, will it be rooted in a perfect storm of both factors? Further, will a deflationary rate environment arrive in the form of a sudden, steep downhill grade or a moderate, drawn-out decline?

Further, how deflationary must the next down cycle be in order to restore a sense of normalcy to freight markets? Spot rates have reached the loftiest of peaks, so even a considerable decline could still yield significant contract rate premiums.

Absent a dramatic cooling off of GDP growth or a miraculous influx of drivers and truckload capacity, the post-COVID "trough" during the next rate cycle could still land on rates that, in normal times, freight markets of the past would have considered "peak" rates. After all, carriers across the country have tapped into every incentive imaginable to coax drivers off of the sidelines, to no avail.

Here's another possibility: what if the pandemic economy had a permanent effect on the country in a way that goes well beyond the public health domain? What if the coronavirus pandemic ushered in an entirely new set of rules around consumer preferences, spending habits, and supply chains?
Will the conventional wisdom around freight markets remain intact? If not, how will our industry prepare for sustained rates of high freight volumes as an entire generation of drivers exits the labor market (or retires altogether)? This is a challenge that spans more than just a quarter or two, or even a few market cycles.

The coronavirus pandemic has taught our industry a great many lessons about how to strive in the face of adversity. But, what revelations remain once the country has finally emerged from this public health and economic emergency? Amidst the hustle of moving goods and orchestrating freight during a pandemic, how many of us were able to stop, reflect, and feel the ground shifting under our feet? The industry may very well emerge from this episode only to realize that the usual operating models – the old rules – no longer apply.

For decades since deregulation, freight markets have functioned as a dance between freight volumes and truckload capacity, but with no choreography whatsoever. What if a post-pandemic world - a "new normal" - is an opportunity to do better for shippers, drivers, and 3rd party capacity partners alike?

We've closed our five 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. The contributions from truck drivers, warehouse and retail workers, logistics and supply chain managers, and a host of other contributors have sustained 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.

It goes without saying, but we're in awe of the diligence and strength on display in our shippers and peers alike. You've sustained our nation's supply chains amidst forces and uncertainties never before seen. You've tirelessly navigated one challenge after another on a daily basis. Our industry's work has never been more crucial – our decisions have never been more meaningful – than right now.

Thank you for rising to the occasion. It's been a privilege to be on this journey with each and every one of you.

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