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Is the Party Over?

Shippers are benefiting from excess capacity in the truckload market, but analysts say this condition is temporary. The driver situation, increasing regulations and inventory sell-offs all point to a tighter capacity situation in 2017 and beyond.

By John D. Schulz, contributing editor

It's a buyer's market right now in the trucking industry, particularly in the $320 billion truckload (TL) sector. Excessive inventory and a less-than-robust overall economy are causing excess capacity, which is resulting in some carriers straining to keep their trucks somewhat full by aggressively cutting rates.

According to John Larkin, the veteran trucking analyst with Stifel Inc., the current freight market "remains weak," with "soft volumes" and very little evidence of the seasonal uptick that we tend to see during the normally robust second and third quarters. The situation is even causing some shippers to press their carriers for further rate discounts. But a confluence of factors, including what Larkin calls a "cavalcade" of pending federal trucking regulations, may cause financial headwinds,

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particularly for smaller, lesser-capitalized truckload carriers.

"Some fear that we may be approaching the limit on how far down prices can be pushed without harming the supply of capacity from the smaller carriers," Larkin warns. Those smaller TL carriers continue to suffer negative setbacks of such price wars due to their higher unit cost structure when compared to the larger, better capitalized carriers.

However, there are already signs that the inventory oversupply is being burned off. The American Trucking Associations (ATA) truck tonnage index climbed 5.7% on a year-over-year basis in May, an increase from April that was helped by stronger consumer demand and the long-awaited drop in inventories. So, the current pressure on trucking rates may be fleeting. The influential "2016 State of Logistics Report" warned of just that scenario. The report concluded that TL rates and demand for transportation are "soft, and continue to fall," but proclaimed that these market conditions are likely to be temporary.

There are basically three drivers right now in the trucking market: the overall economy; increasing regulations that are resulting rising carrier costs; and the e-commerce market that's also referred to as the "Amazon effect." To help put context around these challenges, we spoke with more than a dozen top analysts and carrier executives to get their insights into where the trucking market is headed for the rest of this year and into 2017. Here's why they believe the current buyer's market in trucking may be fleeting.

It's the economy, stupid

Trucking is a derived demand industry. Trucks can haul only what the U.S. and world economy makes and, increasingly, trades. Carrier executives describe current demand levels as "soft," but not the kind of market that foretells any type of economic recession.

"It's a little soft, but not horrible," says John White, chief marketing officer for U.S. Xpress (USX), the nation's 7th-largest TL carrier. Excluding its dedicated unit, USX runs about 3,000 trucks. White says that those trucks have about 2% to 3% excess capacity, or about 100 trucks less capacity network-wide. "It's not what it was like if you compare it to early 2014," White explains. "In the peak of that year, we were turning down 600 loads to 700 loads a day. Now it's maybe 60 or 70."

While TL executives have largely written off this year as a repeat of 2014 and 2015, they're hoping for some pickup in demand in 2017 once inventories correct, the U.S. dollar weakens relative to foreign currencies, and energy prices more fully rebound. Then, there's what we'll call the "Clinton-Trump effect." A palpable unsettledness concerning the November 2016 election has permeated trucking, analysts and executives say. "The current presidential election has created a cloud of uncertainty," says Phil Pierce, senior vice president of sales and marketing for Averitt Express, the nation's 12th-largest less-than-truckload (LTL) carrier.

Republican candidate Donald Trump has certainly not helped to cut the fog that has engulfed this election. He has pledged to undue the 22-year-old North American Free Trade Agreement (NAFTA), and to "get tough" on China, among other nations. Such isolationism and protectionism flies in the face of burgeoning world trade, contend fellow Republicans and Democrats. Besides, it will cost this nation an estimated 3.5 million export-related jobs "even under a best-case scenario," according to an estimate from the U.S. Chamber of Commerce.

Even talk about such protectionism causes uncertainty in the marketplace, carrier executives say. Chuck Hammel, president of Pitt Ohio, the nation's 17th-largest LTL carrier, says that LTL demand has been soft for more than a year "and it's worse in the TL space." Asked if he expects a turnaround this election year, Hammel replied: "Well it's been a year of soft market conditions so far, so I really don't expect the next 12 months to be much better."

In the $36 billion LTL market where Pitt Ohio operates, the top 10 LTL carriers control nearly 75% of the market, and barriers to entry are significant. LTL shippers say that they're still enduring contract pricing increases, but these are largely offset by lower fuel surcharges.

Old Dominion Freight Line (ODFL), the LTL market leader, released its mid-year update, disclosing a 0.2% year-over-year increase in shipments per day, a 1% year-over-year decrease in LTL tons per day, and a 1.3% year-over-year decrease in LTL weight per shipment in May. Analysts noted that the decline in tonnage may be voluntary, as well-disciplined ODFL is choosing to walk away from some freight rather than haul it at a loss. Such discipline may explain ODFL's stunning 85 operating ratio last year.

Other statistical measures are warning shippers as well. The closely watched Institute for Supply Management (ISM) Manufacturing Business Survey recently beat the consensus estimate of 50.8, registering a 51.3. Truckers say anything over a 50 is positive for them. While typically a positive indicator for the manufacturing-heavy LTL sector, there are countervailing factors such as continued declines in weight per shipment, persistently high inventories and rising regulations.

Bob Costello, chief economist at the ATA, said recently that he thought the overall U.S. economy was in better shape than trucking, which is affected as a whole by the industrial sector of the economy. He said that while inventories are high, they don't have to come down too much in order to be considered normal. According to Costello, jobs are becoming as much of a supply issue as a demand issue, as the U.S. is near full employment. This should mean wages move higher, leading to greater consumer spending—which should mean more freight.

Capacity and relentlessly rising costs

Trucking is a thin-margin business in the best of times. Operating ratios (a company's operating expenses as a percentage of revenue) are around 95% for the industry during bullish times. In hard times, ratios of 98% to 99% are more common.

A trucker's best weapon to achieve a lower operating ratio is to keep a close eye on controlling costs along with keeping overall capacity rational to avoid the inevitable price wars started by the less well capitalized carriers. "The market is getting a little less rational," says USX's White, noting his company's rates are up 2.5% in contract renewals. "We're seeing single-digit reductions by other carriers, and there's nothing that justifies that. Our equipment and driver costs are up, not down. Fuel is neutral."

"None of the large TL carriers are talking about expanding their fleets," White says. May Class 8 heavy truck sales fell a whopping 19.5%, the 26th month out of the last 27 when Class 8 sales fell. Capacity reductions initiated by carriers should begin to gain meaningful traction by late 2016 or early 2017, analysts say. Those capacity reductions could occur near the eventual full implementation of the federal electronic logging device (ELD) mandate, although that law is currently being challenged in court by the Owner-Operators Independent Drivers Association (OOIDA).

"The regulatory headwinds are real, but timing and magnitude of industry supply reductions are still the biggest question mark," says Larkin. Analysts and carriers are predicting a 2% to 4% overall reduction in truck capacity when ELD use is mandated on the nation's trucking fleet. Bottom line: Freight demand should bottom out soon, perhaps in the third quarter.

The "Amazon effect"

Brad Jacobs, chairman and president of XPO Logistics, which operates the 2nd-largest standalone LTL carrier in the country, says that he's "very bullish" on trucking right now. Part of the reason for his optimism is the rising growth of e-commerce. But, not everyone in the trucking industry shares

Jacobs' bullishness on what some industry insiders call the "Amazon effect." They see the vans with the lower-case "a" in their neighborhoods and immediately wonder how much freight Amazon is siphoning off.

Amazon, notoriously quiet, is not talking publicly about its transportation system. However, rumors are rampant. Some have it challenging UPS and FedEx, which many contend is doubtful. Others have it siphoning off the most profitable chunks of business while leaving the high-cost, difficult-to-deliver freight to the for-hire sector, which is more likely.

"The biggest driver in the marketplace is what is currently going on at Amazon and potentially what's next to come," says Pitt Ohio's Hammel. "They're going to fundamentally change the supply chain in the retail space."

Carriers will need what Hammel calls "tremendous capacity" for such changes. This could affect downstream demand for such traditional retailers as Target, Walmart and many others. However, the question remains: Will Amazon start dictating who controls the ever-important "final mile"?

Whatever Amazon decides, carriers will have to remember that price discipline is key to their survival. After all, it's a lot easier to make up lost volume than lost pricing. Some, but not all carriers remember the toll the 2009 price wars took. Today, the fear in trucking is that the longer the current lull persists in demand the more carriers may give in to the urge to cut rates.

The carriers with the longest memories may fare the best. "In a cyclical industry, there are always periods of capacity surplus and shortage," says Rick O'Dell, president of Saia, the nation's 10th-largest LTL carrier.

The pendulum moves back toward carriers

The bottom line for shippers is this: Enjoy this brief pricing power because the pendulum is swinging back toward carriers, perhaps quickly. Inventory is being sold off, capacity is not being added, new truck sales are off by double-digits, compliant drivers are harder to find and cost more than ever, and the export market will recover. In the meantime, hiring is up and so are wages, which means more robust consumer spending.

Barring a recession, which no economist is predicting, the worst of the trucking oversupply situation may be over for carriers. In the meantime, the oversupply in the market is self-correcting as fewer new trucks are being produced and sold and more used trucks are being shipped overseas.

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