Transportation Trends

# Proceed with caution: Logistics Management's 2007 Mid-year Rate Outlook

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Our intrepid economist follows up on our initial 2007 rate outlook and forecasts that shippers will now face increased pricing uncertainty in nearly every mode.

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Here's where we stand six months after our initial forecast: Weaker than expected growth and rising inflation have now settled over the U.S. economy. For carriers, this means the worst of both worlds—falling volumes and rising costs. For shippers, joy over short-term declines in truckload (TL) rates is now being tempered by increased uncertainty in every other mode.

Back in January, the 53 economists surveyed for Randell Moore's *Blue Chip Economic Indicators* newsletter predicted inflation-adjusted gross domestic product (GDP) would grow 2.5 percent in 2007. By April, that consensus forecast had been lowered to 2.3 percent. Chances are that by the time this article is published, GDP will have been revised down to 2 percent.

One reason why: Preliminary government data shows the economy growing at a 1.3 percent annual rate in the first quarter of 2007. In April, not a single economist on the Blue Chip panel expected that, although Robert T. McGee, chief economist at U.S Trust, was close with a prediction of 1.5 percent. In the April 10, 2007 edition of *Blue Chip Economic Indicators*, he stood out as the most pessimistic among the Blue Chip economists, forecasting a 1.7 percent GDP gain in 2007.

"With profits slowing down with revenues," says McGee, "it's not surprising that business caution has already translated into less hiring and capital spending." He notes that durable goods shipments in February showed the same pattern that prevailed in 2000 when the economy was sliding into recession. Now, widespread speculation about recession may gain traction this summer.

## Residual Affects

High fuel prices and a lingering housing slump have already sparked



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consumer and shipper anxiety. In the first four months of 2007, gasoline prices jumped 23 percent as refinery outages reduced the supply of gasoline—and it was getting worse in mid-May. According to James Haughey, chief economist at RBI-US, gasoline prices will top $3.10 in late spring before declining slightly, but will average higher than last summer.

Looking ahead, the U.S. Department of Energy reports that tight oil markets and continued international uncertainty will keep the price of crude oil above $65 per barrel this summer—compared with $70 per barrel last summer. As a result, retail diesel prices are forecast to linger around $2.82 per gallon this summer, down only 6 cents from summer 2006.

"More moderate growth in the economy has resulted in slower demand for rail and truck traffic," says Paul Bingham, a principal at the economic analysis firm Global Insight Inc. In fact, according to the American Association of Railroads, the number of carloads moving freight fell 4.5 percent in the first quarter of 2007 compared to the same period a year ago. At the same time, intermodal rail volume increased at a meager 0.3 percent pace, slowing sharply from a 5.3 percent growth in the first quarter of 2006.

In the trucking industry, meanwhile, truck tonnage fell in all four quarters of 2006, according to the American Trucking Associations' survey. Truck volume increased slightly from the final quarter of 2006 to the first quarter of 2007, but that increase did not lift volumes above levels seen a year ago. In fact, truck tonnage in the first three months of 2007 lingered 1.6 percent below the first quarter of 2006 and 3.1 percent below 2005 first-quarter levels.

"Unequivocally, there's not enough freight out there and drivers are looking for loads to move," says Paul Svindland, a director at AlixPartners in New York. "Rates are dropping now even farther than I had expected six months ago." Less-than-truckload (LTL) rates are falling subtly, adds Svindland, while truckload prices are being reduced 10 percent by incumbent carriers.

A supply/demand imbalance in the truckload market is pushing prices farther down than he had expected as well, says Tom Sanderson, CEO of Transplace, a 3PL owned by some of the nation's largest motor carriers. However, Sanderson predicts that last year's massive overbuying of trucks ahead of stricter engine-emission standards will work out of the system in the second half of 2007. Sanderson adds that the fundamental long-term challenge arising from a shortage of TL drivers remains; so, when the economy picks up, "shippers who think they locked in now may find trucks are not available."

In an April research report, Morgan Stanley stock analyst William J. Greene paints a similar outlook. "There is little reason to believe carriers will add any incremental capacity through the balance of 2007," writes Greene. "Therefore, a faster economic recovery could shift the TL market back into the carriers' favor."

Intermodal rail, meanwhile, hasn't seen as much price erosion, says Sanderson. When truckload prices accelerated in 2004 into 2005, intermodal gained a relative cost advantage—so the freight slowdown hasn't affected intermodal rates as much. That being said, government surveys of U.S. railroads show transaction prices fell 1.3 percent and 1.1 percent, respectively, in the final quarter of 2006 and first quarter of 2007. The U.S. economy hasn't seen average prices charged by railroads fall in two consecutive quarters since 1998-1999.

Meanwhile, volumes at parcel express companies were stable to flat in the first quarter of 2007 compared to the same period a year ago, and yields went up by 2 percent to 4 percent. "That means prices held," says Satish Jindel, president of Pittsburgh-based SJ Consulting Group.

Recent reductions in economist forecasts for GDP and industrial production growth are significant for the parcel and LTL markets, but changes in the industry could mitigate the negative impact. For example, U.S.-based parcel express companies and now larger freight transportation companies—such as YRC and Schneider—are making significant investments to link their transportation services with originators of freight in China.

**Global Wildcard**

Carriers may be more nervous about raising rates now as well since economists are now sounding cautious about the outlook for global trade. "In international commodity trade, especially container trade, we are seeing slower growth in imports," says Global Insights' Bingham. He predicts U.S. containerized imports will grow 6 percent this year, which is down from his previous forecast of 7 percent.

One wild card is emerging in the international political stage which could reduce demand for East-West container traffic. The U.S. is becoming more hostile toward China's huge trade surplus and its exchange rate policy as evidenced by the imposition of tariffs on paper imported from China. "The volume of trade affected was small, but this action could open the door to tariffs on more important products and retaliation by China restricting U.S. exports," says Bingham.

That wouldn't bode well for ocean carriers still recovering from the big hit they took in rate cuts last year. According to the Drewry Container Forecaster report, excess capacity forced weighted freight rates on the East-West trade route down 5.9 percent in 2006. In 2007, however, unlike many other transportation industry forecasters, Drewry has raised its forecast.

Revising the 1.5 percent rate cut forecast from six months ago, Drewry's Neil Dekker now says average rates on this route will likely rise 1.2 percent. He attributes this improvement to three factors: market sentiment has improved; carriers are better equipped to pass along cost hikes to shippers; and the market unsettling caused by Maersk and Hapag-Lloyd mergers and acquisitions in 2006 has leveled off.

While it may take some time to digest all that's happening, let's try to sum up what all this means for the remainder of 2007. We're finding that freight capacity is not abundant, yet pockets of improvement have emerged. As a matter of fact, carriers in some markets are sending requests for loads to fill excess capacity, so the pendulum is swinging back in favor of shippers. No one, however is expecting a return to the good old days when the shipper always held the upper hand.

The yellow light means proceed with caution—good advice for the rest of this year.