Industrial Research
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Transportation/Logistics

December Freight Flows

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Please refer to Appendix - Important Disclosures and Analyst Certification.

Action

Airfreight peak season stronger than expected, reflective of low inventory levels; but ocean freight volumes remain pressured, as broad-based international freight recovery has not yet begun. Domestically, peak season trends have modestly improved since August. Overall stabilizing fundamentals should support 2010 earnings growth among most transports.

Our December Freight Flows discusses freight fundamentals including the current airfreight environment and recent stock performance.

Summary

- **November stock performance mixed.** Rails outperformed on the heels of proposed BNI buyout, while LTLs underperformed given ongoing uncertainty surround YRCW's viability. November performance by mode: Rails +16%, Integrators +10%, TLs +3%, 3PLs +2%, LTLs -8% against +6% S&P 500.
- **Airfreight peak materializing.** Airfreight volumes have improved sequentially since August, with building backlogs each week. Tight capacity and building backlogs driving spot airfreight quotes meaningfully higher. We expect backlogs to persist into early December before sunstantial seasonal weakening develops.
- **Tight air capacity presents challenge for forwarders.** Airfreight capacity down as much as 30% or more to adjust to 1H09 demand correction. Limited capacity availability is leading to higher rates and gross margin pressure among forwarders. Forwarders with access to capacity can capitalize on peak season demand; however, we expect margin pressure to more than offset better-than-expected volumes in 4Q.
- **Improving airfreight volumes not yet indicative of a broad-based international freight recovery.** Better airfreight volumes indicate stabilizing economic fundamentals and tight inventory levels. However, ocean freight volumes, which represent vast majority of non-bulk international freight, still remain down 10-20%. So though firming airfreight volumes encouraging, a broad-based international freight recovery not underway until ocean freight volume growth materializes.
- **Domestic demand showing some signs of seasonality.** Truckload and rail demand has maintained its traditional seasonal trends quarter to date, 4Q. Broader trends remains stable at weak levels with spot market truckload demand seeing some uncharacteristic strengthening in late November, which we see as another sign of lean inventory levels.
- **Best ideas** include KNX, CSX, and JBHT as early-cycle ideas.

Details

Industry Themes Toward the End of 2009's "Peak"

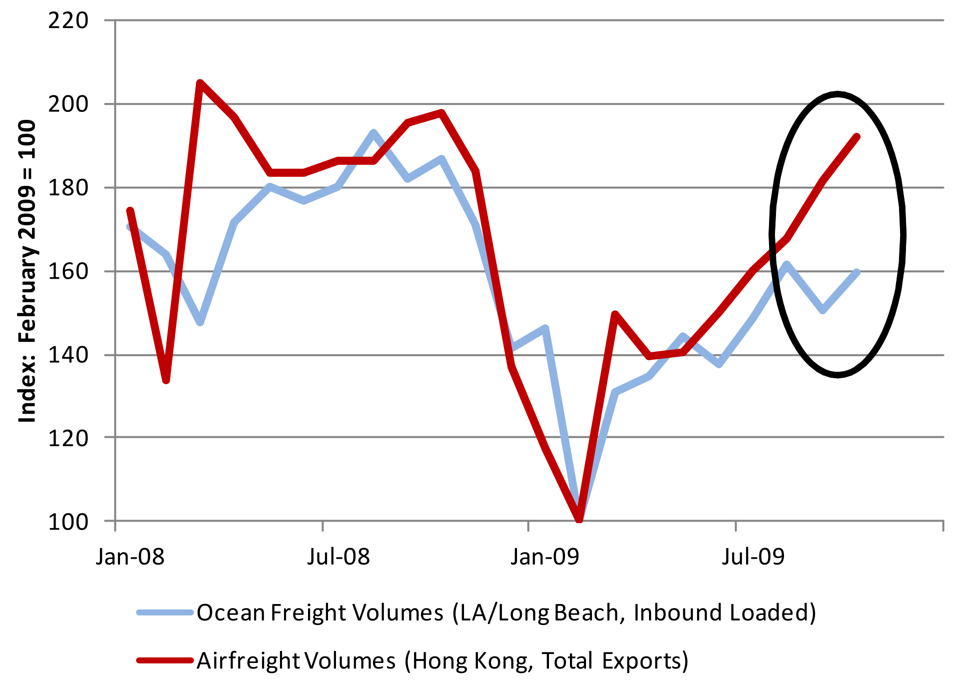
Though peak-season demand was modest, domestic transports did experienced modest seasonal build from August into November, which we view as indication of a stabilizing economy. A strong airfreight peak season belies the tight inventory levels throughout the supply chain, but in our view is not yet indicative of a sustained demand recovery. We recommend investors selectively build exposure to asset-owning domestic transports given that demand fundamentals have bottomed and stock upside in an economic recovery remains attractive.

Our best ideas include:

- **CSX Corp.** (CSX—large-cap, cyclical value) is our top pick within the railroad sector; attractive valuation on depressed earnings. CSX's earnings potential not fully realized in the last cycle, given its turnaround efforts were cut short by the recession. Margin upside surprise, continued positive pricing, and early-cycle attributes provide an attractive backdrop for the stock and meaningfully higher peak earnings potential.
- **Knight Transportation** (KNX—small-cap, cyclical growth) is the best-in-class truckload carrier and is well positioned to benefit from the eventual turn in the pricing cycle, which we expect to begin in 2010. Fundamentals have bottomed, and given KNX has done an excellent job of diversifying its business and protecting its base (volumes off only 5% from the peak), KNX is positioned to obtain meaningfully higher peak earnings.
- **JB Hunt** (JBHT—mid-cap, cyclical growth) is an attractive growth story. Intermodal is one of the only transport sectors that will grow as fast or faster in the next economic cycle compared to the last. Intermodal volumes are 20% higher than when JBHT achieved peak earnings, positioning JBHT for materially higher earnings this cycle.

Of our Neutral-rated stocks, we believe **Heartland Express** and **Hub Group** represent an interesting position for long-term holders. Though HTLD lacks a near-term catalyst and has lost market share in 2009, the company maintains best-in-class margins and stands to benefit from improved industry pricing power. And we like HUBG in the low $20s given its indirect exposure to stabilizing truckload trends, solid exposure to the long-term intermodal growth, and recent relative underperformance.

Airfreight peak season materializing. The airfreight market has strengthened noticeably from August into November, leading to backlogs and spot market rates out of Asia. Backlogs are as much as two weeks deep out of Hong Kong and are expected to persist into mid-December, and backlogs are beginning to develop in smaller regional China airports. Given these backlogs, forwarders are quoting outbound rates as high as $6/kg, up from $2.50/kg in August and from $1.50/kg in 1H09. The chart below demonstrates the sequential build in airfreight volumes since February against the moderating ocean freight volumes in recent months.



Source: Port of LA/Long Beach, Hong Kong Air Cargo Terminals Limited

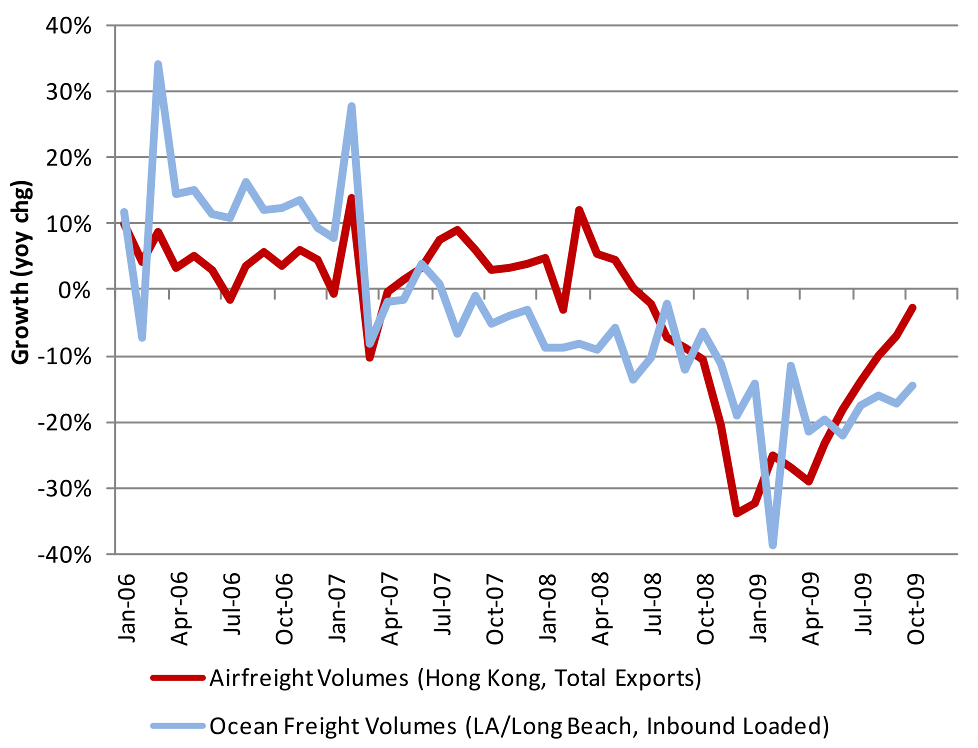
Tight capacity conditions present challenge and opportunity for forwarders. Typically, periods of tight airfreight capacity and peak season surcharges are a positive for forwarders, particularly large forwarders with access to capacity. The tight capacity conditions and high spot market rates have driven an uptick in chartering activity during 4Q, leading to charter rate premiums of up to 50% above previous peak season rates. Numerous air cargo operators have noted an increase in charter flights and demand for wet-leased aircraft in recent weeks.

The tight airfreight capacity environment is driven by better-than-expected demand, particularly in the technology sector, as well as ongoing capacity reductions by air carriers. Cutbacks in both passenger and cargo flights given reduced demand have reduced scheduled airfreight capacity by as much as 30-50% yoy. Further, carriers have been reluctant to return parked aircrafts to service given the uncertainty regarding the sustainability of demand beyond this season's peak. This confluence of events has driven the increase in spot market rates to record levels.

However, the rapid rise in freight rates, the competitive market pressures among forwarders and aggressive bidding among shippers is expected to limit the benefit to forwarders' margins during 4Q that might arise from building backlogs. Larger forwarders are better positioned than small forwarders to potentially benefit from the tight environment, given the larger forwarders' relationships with the larger-volume shippers and access to capacity among the air cargo carriers. However, given the rapid rise in underlying airfreight rates in recent weeks, many forwarders have been unable to pass through a peak season surcharge sufficient enough to offset the higher underlying rate. And given shippers appear to be aggressively shopping rates during this season's peak at the expense of service, the rate environment between forwarders remains very competitive as many forwarders are satisfied with absorbing some of the higher freight rates to retain the business.

As a result, we believe 4Q will be challenging to many forwarders. Despite the improvement in volumes, we expect the yield squeeze from rising freight rates to more than offset the benefit of additional business, particularly on the Transpacific lane. We maintain our below-consensus 4Q estimates for EXPD and UTIW given our cautious near-term outlook. However, we note that the 4Q environment is temporary and expect yields to normalize in early 1H10, and we would look to take advantage of any related weakness to become more aggressive on both international forwarders.

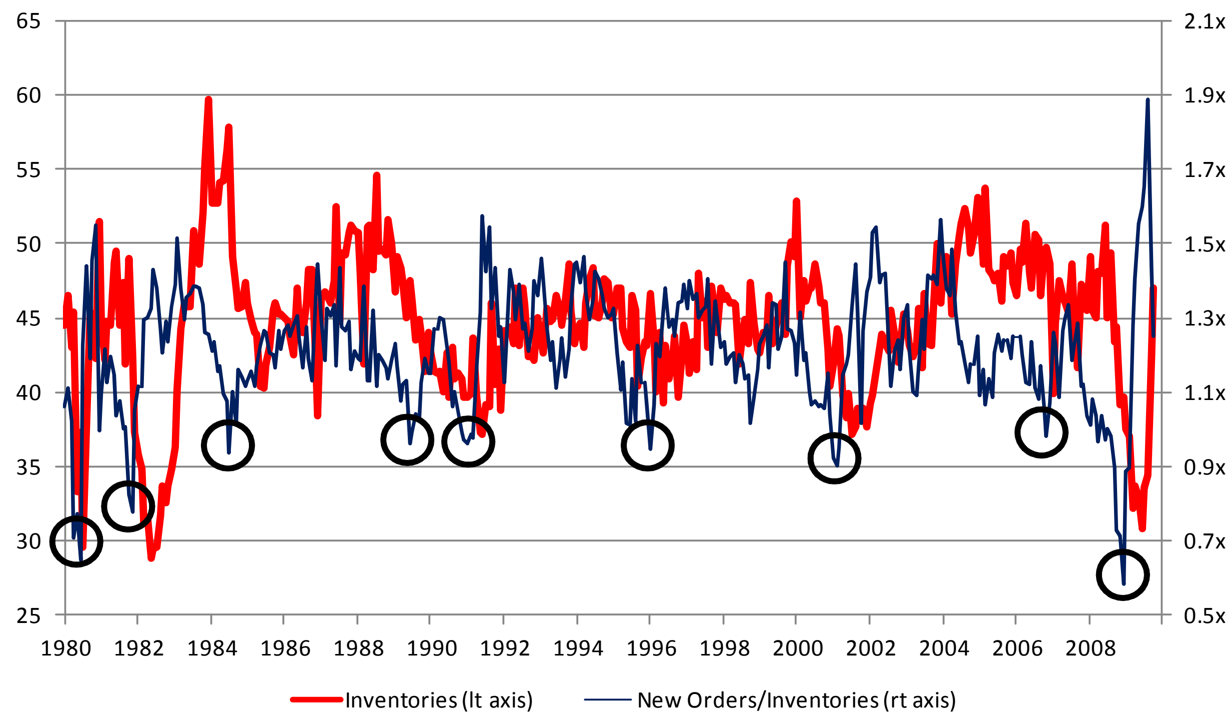
Airfreight peak only the beginning of recovery in international freight trends. Though we believe the recent improvement in airfreight volumes is a harbinger of an international freight recovery, we do not yet believe they are indicative of a broad-based recovery in international freight volumes for two reasons: 1) half of all airfreight volumes is exception freight, and 2) the airfreight market represents less than 1% of all non-bulk international freight moves by volume. Though airfreight volumes have improved sequentially since March into November and are roughly flat yoy, ocean freight volumes remain well below prior-year levels. Ocean freight volumes have stabilized in recent months, and we expect stabilizing economic activity and easing comparisons to drive 0-2% yoy US inbound ocean freight growth in 2010. But until we see a sustained improvement in ocean freight volumes, we do not believe a broad-based international freight recovery has begun. The chart below demonstrates the recent divergence between airfreight and ocean freight volumes.



Source: Port of LA/Long Beach, Hong Kong Air Cargo Terminals Limited

Inventory levels lean, but normalizing. The recent pickup in airfreight volumes has been driven in part by low inventory levels throughout the supply chain, particularly within the technology sector, as better-than-expected demand has driven expedited shipments. The chart below highlights the 30-year history of the New Orders/Inventories ratio using ISM data, which has generally preceded moves in the ISM's Inventories reading. After reaching a 30-year low in December 2008, the New

Orders/Inventories ratio moved sharply higher, as suppliers depleted inventory in response to lower demand levels, and the ratio reached a 30-year high in August. Consequently, after reaching a generational low in June, the rate of inventory depletion has improved over the past four months. And the most recent reading (October, 46.9) still indicates a modest level of inventory depletion but is above the 30-year average of 44.6, implying that inventory levels are beginning to normalize. We do not believe a sustained inventory rebuild will occur until demand fundamentals demonstrate sustained improvement. As such we expect freight demand to remain choppy for the next several months before giving way to a more sustained freight recovery.



Source: Institute for Supply Management

November Stock Performance Mixed

Transport stock performance was mixed in November, with the Rails and Integrators outperforming and the TLs, 3PLs, and LTLs underperforming. Rails led the transport subsectors, with outperformance catalyzed by Berkshire Hathaway's proposed purchase of BNI. Meaningful underperformance in LTLs as uncertainty surrounding YRCW's survival persists, weighing on both YRCW and the broader group. Transport performance by mode was Rails +16%, Integrators +10%, Truckloads +3%, 3PLs +2%, and LTLs -8% against +6% for the S&P 500. YTD, only the Rails (+32%) have outperformed the broader market, with Integrators (+13%), TLs (+1%), 3PLs (+0%), and LTLs (-2%) lagging the market (S&P 500 +21%).

A complete chart of stock performance is shown below:

			11/30/09	Trading Performance				
Ticker	**Name**	**Rating**	**Price**	**Nov**	**3Q**	**1H09**	**YTD**	**2008**
Integrator Index				**10%**	**20%**	**(11%)**	**13%**	**(24%)**
UPS	United Parcel Service	N	57.40	7%	13%	(9%)	4%	(22%)
FDX	FedEx Corp	N	84.20	16%	35%	(13%)	31%	(28%)
Third-Party Logistics Index				**2%**	**9%**	**(4%)**	**0%**	**(12%)**
EXPD	Expeditors Intl	N	31.88	(1%)	5%	0%	(4%)	(26%)
CHRW	C.H. Robinson	N	55.73	1%	11%	(5%)	1%	2%
JBHT	J.B. Hunt Transportation	O	31.72	6%	5%	16%	21%	(5%)
LSTR	Landstar	N	37.28	6%	6%	(6%)	(3%)	(9%)
UTIW	UTi Worldwide	O	13.19	6%	27%	(21%)	(8%)	(27%)
HUBG	Hub Group	N	26.29	6%	11%	(22%)	(1%)	(0%)
FWRD	Forward Air Corp	N	22.51	5%	9%	(12%)	(7%)	(22%)
PACR	Pacer International	N	2.82	(1%)	73%	(79%)	(73%)	(29%)
UACL	Universal Truckload	NR	15.11	(8%)	5%	11%	7%	(26%)
Leasing								
R	Ryder	N	40.53	(0%)	40%	(28%)	5%	(18%)
TAL	TAL International Group	N	13.26	12%	30%	(23%)	(6%)	(38%)
Truckload Index				**3%**	**0%**	**1%**	**1%**	**5%**
WERN	Werner Enterprises	N	18.57	(1%)	3%	4%	7%	2%
HTLD	Heartland Express	N	14.65	8%	(2%)	(7%)	(7%)	11%
KNX	Knight Transportation	O	16.93	6%	1%	3%	5%	9%
CLDN	Celedon Group	NR	9.30	(5%)	35%	(2%)	9%	(7%)
MRTN	Marten Transport	NR	16.82	(4%)	(18%)	9%	(11%)	36%
USAK	USA Truck	NR	11.40	2%	(6%)	(2%)	(17%)	(10%)
CVTI	Covenant Transportation	NR	4.31	(14%)	(11%)	175%	116%	(70%)
Less-Than-Truckload Index				**(8%)**	**6%**	**17%**	**(2%)**	**(27%)**
CNW	Con-way	N	30.13	(9%)	9%	33%	13%	(36%)
YRCW	YRC Worldwide	U	1.13	(69%)	157%	(40%)	(61%)	(83%)
ODFL	Old Dominion	N	26.34	1%	(9%)	18%	(7%)	23%
ABFS	Arkansas Best	N	24.40	(6%)	14%	(12%)	(19%)	37%
SAIA	Saia	NR	14.14	(4%)	(11%)	66%	30%	(18%)
VTNC	Vitran Corporation	NR	9.15	7%	(9%)	58%	46%	(56%)
Railroad Index				**16%**	**14%**	**2%**	**32%**	**(20%)**
UNP	Union Pacific	O	63.32	15%	12%	9%	32%	(24%)
BNI	Burlington Northern	O	98.28	30%	9%	(3%)	30%	(9%)
NSC	Norfolk Southern	N	51.39	10%	14%	(20%)	9%	(7%)
CSX	CSX	O	47.47	13%	21%	7%	46%	(26%)
CNI	Canadian National	NR	52.63	9%	14%	17%	43%	(22%)
KSU	Kansas City Southern	NR	28.60	18%	64%	(15%)	50%	(45%)
GWR	Genesee & Wyoming	NR	30.72	6%	14%	(13%)	1%	26%
SPX	**S&P 500**			**6%**	**15%**	**2%**	**21%**	**(38%)**

** Indices are market-cap weighted.*

Sources: FactSet, Baird estimates

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