Transportation/Logistics

March Freight Flows

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Action

Numerous positive data points in January and February reinforce 2010 as an inflection point for domestic transportation pricing. Above-seasonal demand trends in 1Q underscore early stages of economic recovery. And improving supply/demand truck balance support improving rates over the next several quarters, with a Freight Pricing Renaissance looming if sustained freight recovery materializes.

Our March Freight Flows details our observations of improving freight fundamentals given economic data and industry contacts.

Summary

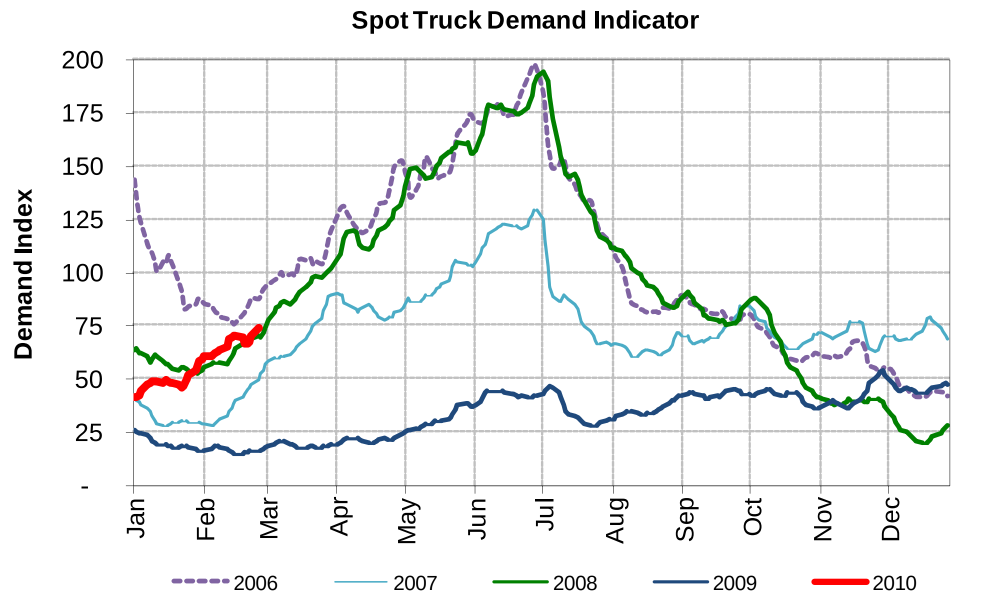
- **Transport stocks outperform in February,** as anecdotes of improving freight fundamentals continue. TL +12%, LTL (excluding YRCW) +11%, Rails +7%, 3PLs +4%, Parcel +4% vs S&P +3%.
- **Trucking supply/demand continues to improve.** Spot truck demand and supply/demand balance tracking 2008 and approaching 2006 levels (two relatively positive freight periods). Anecdotes of tight Midwestern capacity, paid repositioning, and tight intermodal container capacity -- all amid a seasonally weak 1Q -- support our view that industry fundamentals are strengthening at a better-than-seasonal rate.
- **Domestic pricing exhibiting some early seasonal strengthening in 1Q10.** A continuation of the current trajectory through March and into 2Q will be a confirmation of a sustainable recovery; we are encouraged by 1Q's start.
- **International freight demand also tracking above seasonal trends.** Still too early to get a full read on international trends given the Chinese New Year, but both international air and ocean trends appear to be tracking ahead of expectations.
- **Inventories remain lean, supporting future freight growth.** Retail sales growth outpacing inventory growth as shippers tightly control stocking levels into uncertain consumer demand environment. Improving consumer confidence should support sustained inventory build and freight volumes as economic fundamentals improve.
- **Multiple positive domestic intermodal changes** support strengthening fundamentals through 2010. Recently revised legacy UNP deals (PACR, CSX), rate increases among domestic rails ahead of 2010 bid season, tight intermodal capacity during 1Q, and rising truckload rates should support 2H10/2011 domestic intermodal pricing.
- **We remain buyers of asset-based transports.** Stocks had strong moves in recent weeks. We would highlight UPS as a laggard where investors should be aggressive buyers. We continue to like the rails (UNP, CSX). And we would stay with our top truckload and intermodal picks (KNX, HTLD, JBHT, HUBG) and look for pullbacks to be more aggressive buyers. For longer-term value investors, we like UTIW as a turnaround opportunity.

Details

Numerous data points year to date confirm improving freight fundamentals, which if these trends continue should drive improving pricing momentum across modes throughout the year, leading to improving investor sentiment. Though we recognize that March is always a key driver of 1Q results and weather has influenced the environment, the improving trends in January and February and continued lean inventory levels should lead to favorable March trends. As a result, we expect 2010 to be an inflection point in industry pricing, given improving demand fundamentals as well as sector-specific catalysts. Below we discuss in greater detail the positive developments to domestic fundamentals in recent weeks.

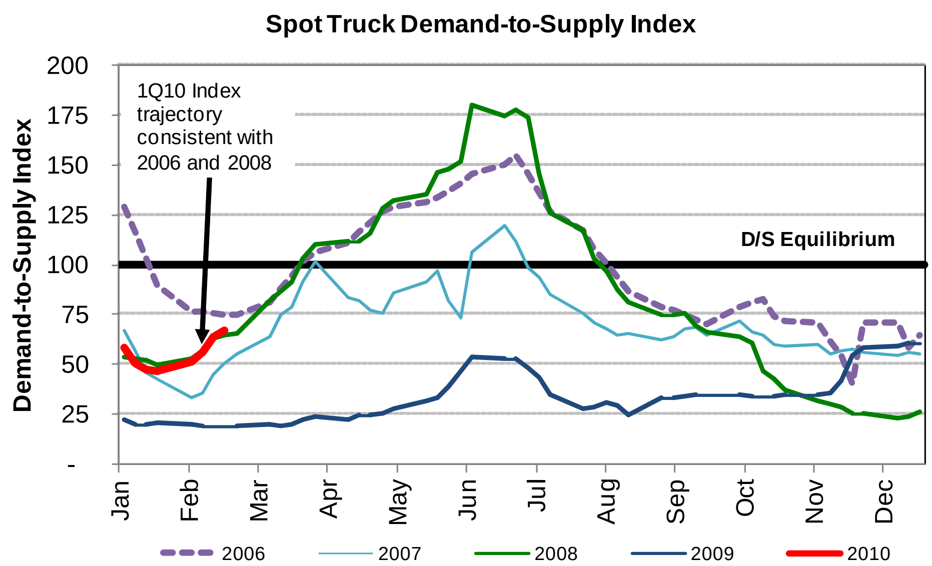
Above-Seasonal Demand Trends To Begin 2010

From the perspective of truckload, spot market demand is tracking 2008's trajectory, as shown in the chart below and if the trend continues, it will be tracking 2006. The trend affirms a healthy start to 2010, consistent with anecdotes from industry contacts. Accelerating volume growth rates were noted by many carriers following 4Q reporting, a function of firming volumes and easing prior-year comparisons.



Source: Industry data, Baird estimates

More important than the spot market demand index is the improving supply/demand truckload balance highlighted in the chart below. Similar to the demand index, the supply/demand index is tracking near 2008 and approaching 2006 levels. With firming demand and the ongoing rationalization of capacity, largely driven by attrition following the underbuy of new truck equipment in recent years, **we expect industry supply and demand to achieve equilibrium at some point in upcoming months, supporting higher truckload rates.** Further, improvement in demand over the next several quarters should drive accelerating pricing growth as shippers struggle to find reliable capacity, which in our view will lead to improved investor sentiment among domestic asset-based transports.

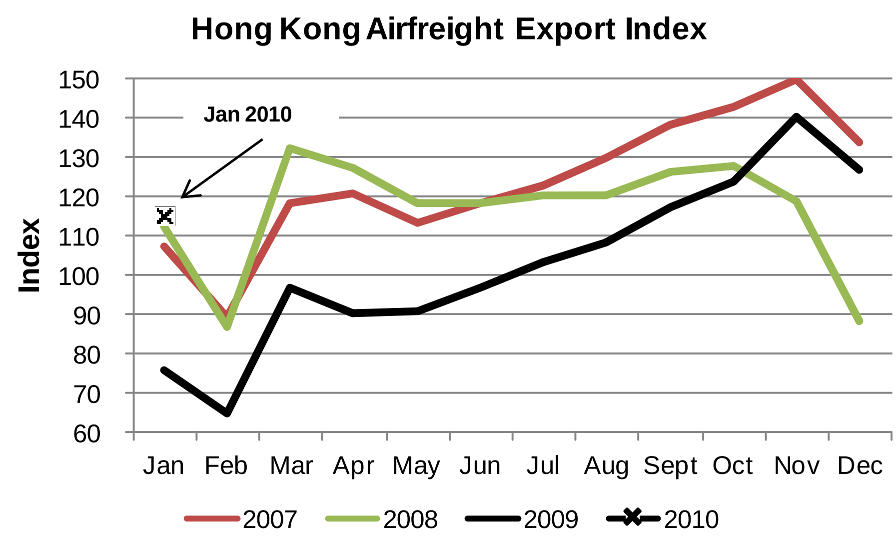


Source: Industry data, Baird estimates

Anecdotes from industry contacts underscore the improving industry supply/demand balance in 1Q. A Midwest US-based truckload broker noted that capacity in the region was scare in January and February, with difficulty passing along the higher purchased transportation rates to shippers. The broker noted that 4Q ended without the usual fall-off in rates in the weeks following Thanksgiving, with 2010 building off the higher rates. Other contacts indicate shippers in certain instances paying deadhead to secure capacity given upside to demand expectations. Further, domestic intermodal container utilization has been unusually high for this time of year. **These trends are reflective of the broader environment, with capacity firming into better demand fundamentals, pushing shippers to start pondering the prospects of higher freight rates in 2010.**

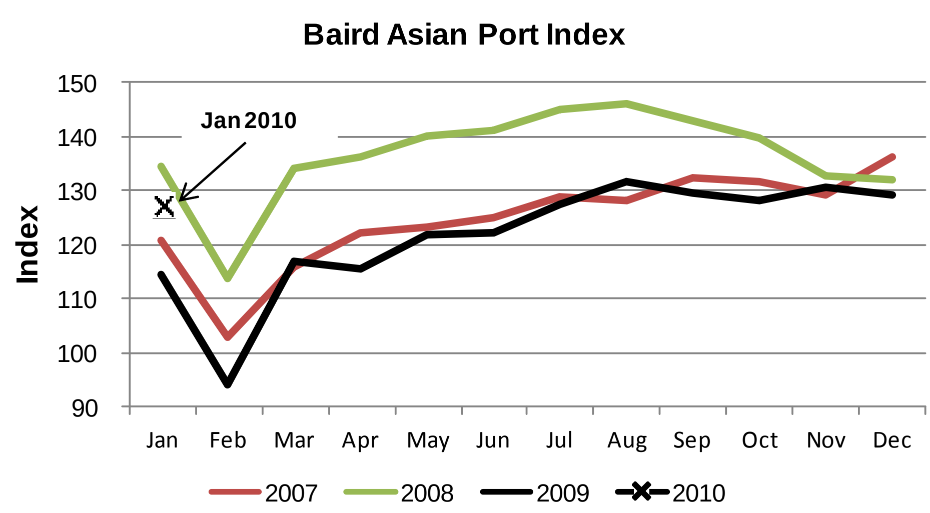
International freight trends have also been encouraging. While 4Q trends showed very strong airfreight demand, year-to-date airfreight trends have continued at an above-seasonal trend. And more importantly, ocean freight, which is a broader reading of economic activity, has shown some signs of life in early 2010.

Though the timing of the Chinese New Year, which began February 14, can skew comparisons, absolute international air and ocean freight volumes from Asia were either near or at all-time highs for the month of January. As shown below, January exports from Hong Kong were up 52% yoy in January; and +3% compared to Jan-08. Relative to December, January's sequential trends were above typical seasonality, which we attribute to tight inventory levels, tight ocean carrier capacity (prompting a temporary switch from ocean to air), and an improving global economy.



Source: HACTL, Baird estimates

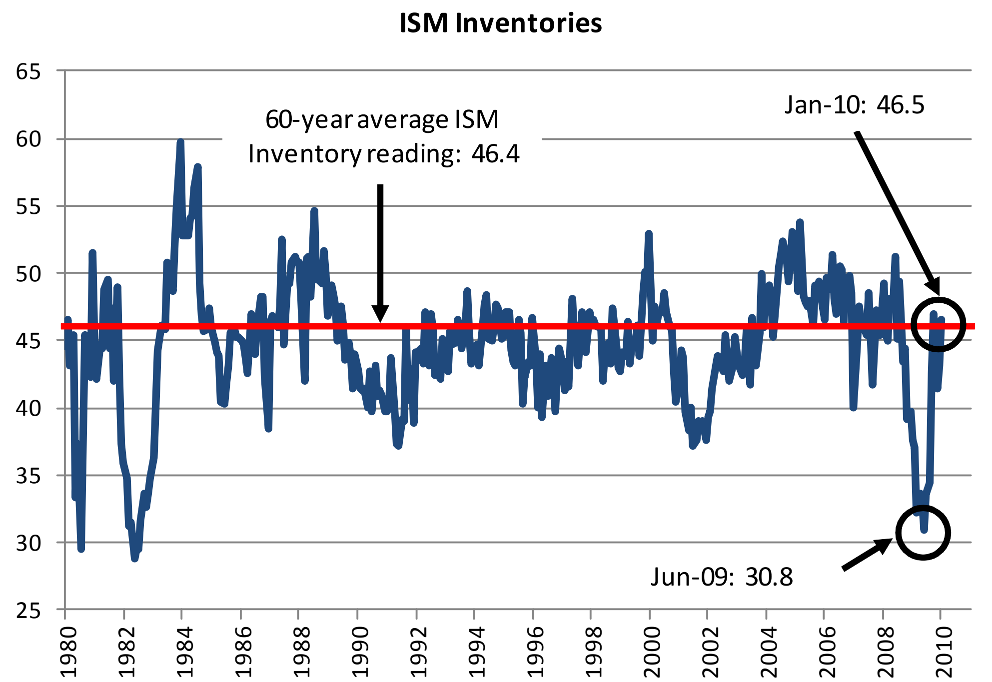
Ocean freight trends also improved in January. Our Baird Asian Port Index, which reflects total Asian ocean freight throughput and serves as a good leading indicator for the broader global economy, turned positive in January for the first time in 13 months. In addition, January's volumes were only 5% below Jan-08 volumes, and represented the second-strongest throughput for the month of January. We view this strength as a healthy indication of the health of the global economy; and sustainability of these trends beyond the Chinese New Year shutdown would be a strong validation of a healthy global economy.



Source: Industry data, Baird estimates

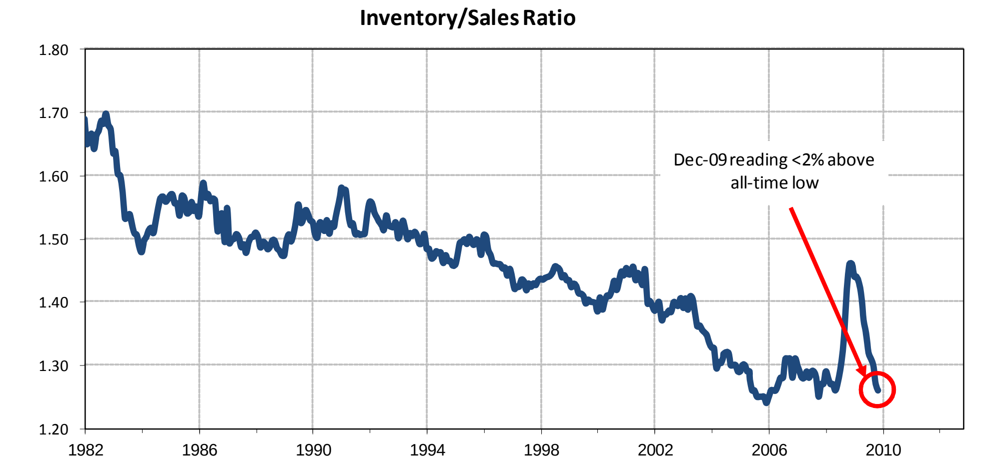
Inventories Remain Lean, Supporting Future Freight Growth

Though the rapid slowing in the rate of inventory depletion during 2H09 helped drive the improved freight environment experienced in recent months, inventory levels remain very lean. The Institute for Supply Management's (ISM) Inventory Index chart below shows though inventory depletion rates have normalized following reaching a generational low in June 2009, inventories remain below 50, which indicate net drawdowns in inventory levels. **Current ISM Inventory level is near the 60-year average, which indicates inventory levels remain lean and inventory replenishment has not yet begun.**



Source: Institute for Supply Management, Baird estimates

Further, despite the rapid drawdown in inventories during late 2008 and 1H09, inventory levels relative to sales activity remains near all-time lows. **This lean level of inventory should support a sustained rebuilding cycle as retailer confidence in consumption improves.**



Source: US Census Bureau

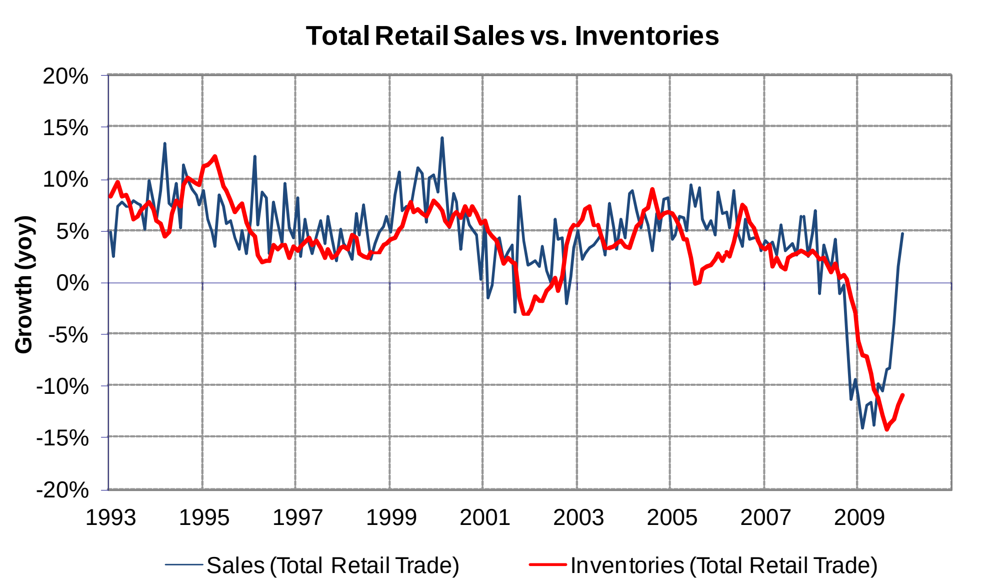
The following two charts highlight the ongoing reduction in inventory levels as compared to prior-year periods. The first graphic displays the difference between the change in retail sales and the change in inventory levels in 4Q09 versus 4Q08, or what we describe as the net inventory drawdown, from selected large retailers. **The consistent theme across retailers is that net inventory reduction actually continued in 4Q as the rate of change in sales is better than the rate of change in inventory, resulting in net inventory drawdown.**

Over the past 20 years, inventory growth trends have tended to lag retail sales growth trends by 4-6 months, evidenced by the second graphic below. This lag effect is evident in the 4Q retail sales and inventory data among the large retailers, as detailed above. As such, given Total Retail Trade Sales (as measured by the US Census Bureau) only returned to positive growth in Nov-09, we expect yoy inventory contraction to continue into 1H10. **If confidence continues to build, inventory replenishment could set the stage for continued improving freight demand into 2H10.**

	4Q growth yoy		
	Sales	**Inventory**	***(difference)***
Big Box/Warehouse Clubs			
WMT	4.6%	-3.9%	*8.5%*
TGT	3.7%	7.1%	*-3.4%*
SHLD	-0.2%	-1.0%	*0.8%*
Department			
KSS	8.5%	4.4%	*4.1%*
JCP	-3.6%	-7.2%	*3.6%*
JWN	10.3%	-0.2%	*10.6%*
Apparel			
ANF	-4.6%	-16.6%	*12.0%*
COH*	10.9%	-17.5%	*28.4%*
Home Improvement/Furnishings			
HD	-0.3%	-4.5%	*4.3%*
LOW	1.8%	0.5%	*1.4%*
Other			
TSCO*	7.9%	-0.4%	*8.2%*
CAB*	3.8%	-15.0%	*18.7%*
RSH*	4.7%	5.4%	*-0.7%*
HGG*	20.3%	15.4%	*4.9%*
OMX*	-3.9%	-15.1%	*11.3%*
Average	**4.3%**	**-3.2%**	***7.5%***

*December quarter-end; others January quarter-end

Source: Company data



Source: US Census Bureau

Changing Intermodal Landscape A Positive For Pricing

Multiple positive domestic intermodal industry events have occurred over the past year, each of which speak to improving intermodal pricing power in 2H10 and beyond.

- *Repricing of legacy CSX/UNP agreement (Mar-10):* Accelerated renegotiation of legacy agreement between CSX and UNP expands the partnership between the two carriers and improves domestic intermodal competitiveness relative to truck, intended to accelerate truckload conversions. Raising CSX's below-market legacy intermodal rate structure to market rates improves broader industry fundamentals by forcing smaller IMCs reliant on subsidized rates to become more price-disciplined.
- *Repricing of legacy PACR/UNP agreement (Nov-09):* Renegotiation ahead of 2011 contract expiration removes PACR from the wholesale domestic intermodal market, removing a subsidy for smaller IMCs and bringing linehaul rates to market prices.
- *Announced rail rate increases by NSC (effective May-10):* Rate increase of 5% for local NSC tariff rates as well as on selected Westbound traffic to California. Importantly, rate increases signaled ahead of 2010 bid season, which should support negotiated intermodal rates during the period and drive better pricing in 2H10.
- *Anticipated UNP domestic rate increase (2Q10) and legacy PACR customer repricing (1Q10):* Rumored rate increases by UNP following migration of wholesale IMC business away from PACR to UNP directly would effectively end the subsidized rates to IMCs from the legacy PACR deal and improve the domestic intermodal industry's pricing fundamentals.
- *Expanded rail carrier/IMC partnerships (2009):* UNP/HUBG's expanded partnership in 2Q09 and JBHT/NSC's enhanced contract announced in Nov-09 improve the competitiveness of both IMCs, which negatively impacts the smaller intermodal competitors.

Each of these changes represents incremental steps taken by the industry that will improve pricing fundamentals in 2010. Tight intermodal capacity to begin 2010 further supports capacity providers into the 2010 bid season, which will experience peak activity in 2Q. Though we do not expect the benefits of these changes to be evident in 1Q, a healthier bid season and improving truckload pricing throughout 2010 should support better intermodal pricing results in 2H10. Given decelerating pricing growth in 2H09 negatively impacted investor sentiment, we believe the recent industry moves and improving demand trends support our view that overall core rail pricing will improve from the 4Q09 trough. Investor appreciation of the building pricing power by the asset-based carriers will lead to outperformance by the domestic asset-based carriers in 2010, in our view. **We believe UNP is clearly best positioned among the rail to benefit from these changes in the industry. JBHT and HUBG are best positioned among intermodal logistics providers**

Transport Stocks Outperformed in February

Due in large part to the last two weeks, transport stocks outperformed in February, with improving domestic fundamentals driving improving investor sentiment. From best to worst, TLs (+12%), LTLs (+11%), Rails (+7%), and Integrators and 3PLs (+4%) outperformed the market (S&P 500 +3%), with LTLs (-1%) the lone underperforming segment in February. A complete chart of stock performance is shown below:

Ticker	Name	Rating	02/26/10 Price	Trading Performance Feb	YTD	2009	2008
Integrator Index				**4%**	**2%**	**13%**	**(24%)**
UPS	United Parcel Service	O	58.74	2%	2%	4%	(22%)
FDX	FedEx Corp	N	84.76	8%	2%	30%	(28%)
Railroad Index				**7%**	**(0%)**	**35%**	**(20%)**
UNP	Union Pacific	O	67.37	11%	5%	34%	(24%)
NSC	Norfolk Southern	N	51.43	9%	(2%)	11%	(7%)
CSX	CSX	O	47.46	11%	(2%)	49%	(26%)
CNI	Canadian National	NR	52.66	5%	(3%)	48%	(22%)
CP	Canadian Pacific	NR	48.18	3%	(11%)	61%	(48%)
KSU	Kansas City Southern	NR	34.30	15%	3%	75%	(45%)
RA	RailAmerica	NR	11.84	(6%)	(3%)		
GWR	Genesee & Wyoming	NR	31.85	8%	(2%)	7%	26%
Third-Party Logistics Index				**4%**	**0%**	**6%**	**(12%)**
EXPD	Expeditors Intl	N	36.47	7%	5%	5%	(26%)
CHRW	C.H. Robinson	N	53.33	(6%)	(9%)	7%	2%
JBHT	J.B. Hunt Transportation	O	35.48	16%	10%	23%	(5%)
LSTR	Landstar	N	39.89	10%	3%	1%	(9%)
UTIW	UTi Worldwide	O	14.91	9%	4%	(0%)	(27%)
HUBG	Hub Group	O	26.97	12%	1%	1%	(0%)
FWRD	Forward Air Corp	N	24.46	4%	(2%)	3%	(22%)
PACR	Pacer International	N	4.82	61%	53%	(70%)	(29%)
ECHO	Echo Global Logistics	NR	11.31	(6%)	(11%)		
UACL	Universal Truckload	NR	17.79	6%	(2%)	28%	(26%)
Leasing							
R	Ryder	N	35.29	(3%)	(14%)	6%	(18%)
TAL	TAL International Group	N	18.23	29%	38%	(6%)	(38%)
Truckload Index				**12%**	**6%**	**10%**	**5%**
WERN	Werner Enterprises	N	22.31	13%	13%	14%	2%
HTLD	Heartland Express	O	15.31	10%	0%	(3%)	11%
KNX	Knight Transportation	O	19.75	9%	2%	20%	9%
CGI	Celedon Group	NR	12.22	24%	13%	27%	(7%)
MRTN	Marten Transport	NR	18.84	7%	5%	(5%)	36%
USAK	USA Truck	NR	13.25	7%	6%	(9%)	(10%)
CVTI	Covenant Transportation	NR	4.59	28%	9%	111%	(70%)
LTL Index (excluding YRCW)				**11%**	**(9%)**	**29%**	**(10%)**
CNW	Con-way	N	32.49	14%	(7%)	31%	(36%)
YRCW	YRC Worldwide	U	0.46	(50%)	(45%)	(71%)	(83%)
ODFL	Old Dominion	N	30.74	12%	0%	8%	23%
ABFS	Arkansas Best	U	26.24	16%	(11%)	(2%)	37%
SAIA	Saia	NR	12.66	5%	(15%)	36%	(18%)
VTNC	Vitran Corporation	NR	9.59	7%	(12%)	74%	(56%)
SPX	**S&P 500**			**3%**	**(1%)**	**23%**	**(38%)**

** Indices are market-cap weighted.*

Source: FactSet, Baird estimates

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