



## Transportation/Logistics

### June Freight Flows

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Appendix - Important  
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#### Action

**Recent disconnect between weak stock performance and strong underlying freight trends provide investors opportunity to increase transport exposure,** ahead of seasonally strong June and September/October peak. Positive momentum into June should produce a healthy spot market for capacity, driving pricing acceleration and leading to 2Q earnings upside and improved investor sentiment toward the group.

#### Summary

- **May Transport stock performance** was uniformly weak across modes, though relative performance was mixed. TLs (-4%), 3PLs and Rails (-5%) outperformed market (S&P 500 -8%), while Integrators were in line and LTLs underperformed (-11%).
- **Diverging freight trends, stock performance.** Given recent stock sell-off, investors appear to be discounting a sharper deceleration in freight growth than underlying fundamentals suggest. We recommend investors increase transport exposure into stock weakness and accelerating pricing fundamentals.
- **June freight trends a preview of 2010 peak.** Historically June, along with September/October, one of three strongest months for freight demand. Tightening capacity early in year sets the stage for healthy spot market for capacity in June, which could lead to accelerating pricing growth through 2010's peak season as shippers scramble to secure capacity. We expect domestic asset-based carriers to benefit from this inflection in pricing as early as 2Q earnings.
- **Decelerating ISM not necessarily a transport stock headwind.** Given ISM index is near its 20-year peak, decelerating manufacturing activity expected in upcoming months. Since 1990, Transports modestly underperform broader market in three-month period following cyclical ISM peak with rails historically the notable underperformer; however, solid outperformance occurred in this time period for 3PLs (+7%) and truckers (+2%).
- **Recommend asset-based exposure...** We recommend investors take advantage of recent stock weakness to build exposure to accelerating pricing fundamentals. Top picks remain JBHT, KNX, and CSX.
- **...with an eye toward 3PL rotation.** Strong 3PL outperformance amid ISM deceleration suggests increased exposure to asset-light names. However, solid Truckers performance at similar point in cycle, coupled with accelerating pricing fundamentals, keep us constructive on asset-based carriers.

## Details

### **Examining the Disconnect Between Weak Stocks and Strong Freight Trends**

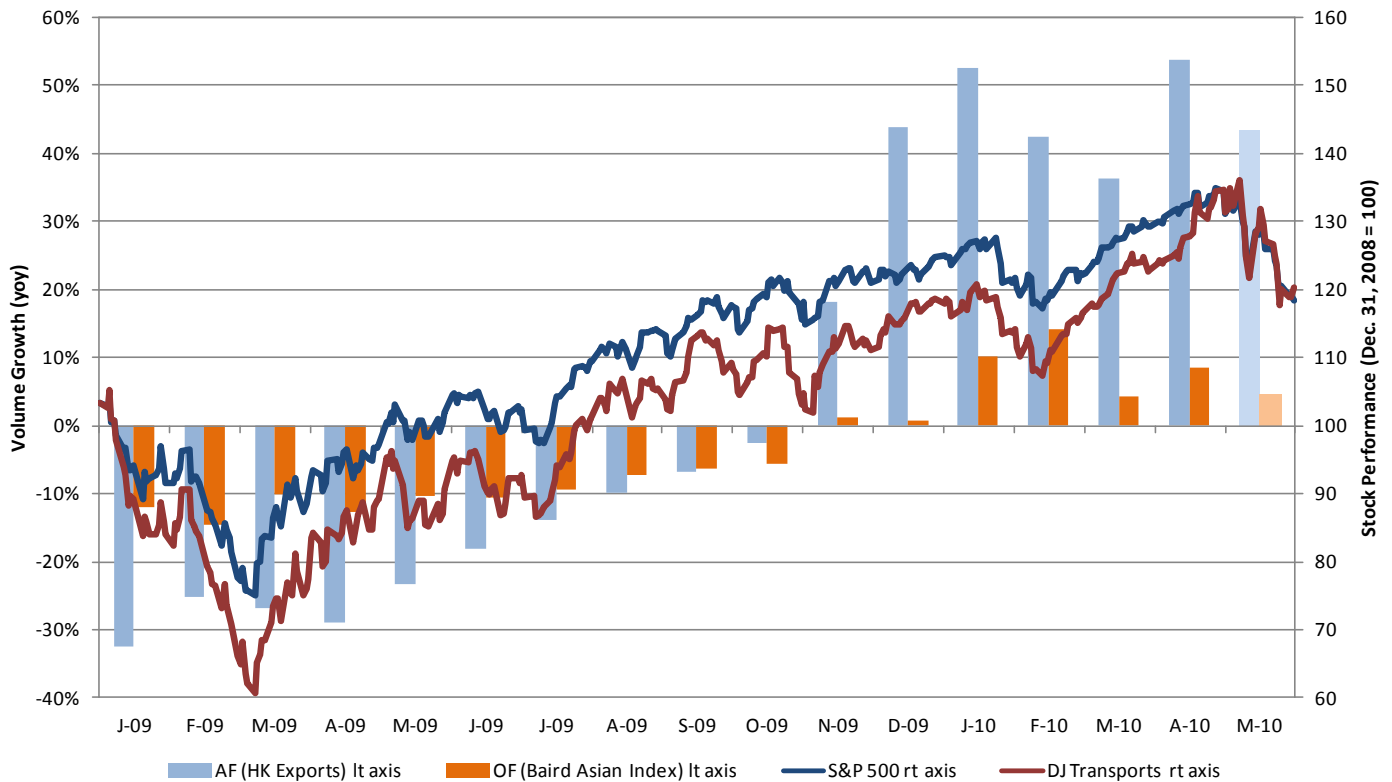
Overall stock performance during the month of May was poor, with concerns over Europe's sovereign debt crisis pressuring the Euro and potentially compromising its economic recovery. Concerns about a ripple effect spreading to the global economy, similar to the impact to economic activity following Lehman Brothers' bankruptcy filing in September 2008, severely pressured equity performance with the S&P 500 losing 8% in May. Similarly, transports were affected, with each mode lower during the month, ranging from -4% TLs to -11% LTLs.

**However, contrary to investors' concerns, underlying freight fundamentals were strong in May.** Capacity remained tight across most modes, most notable in truckload, intermodal, and international air and ocean freight; and incremental tightening was realized in rails and LTLs. Given this favorable supply/demand balance entering into the much stronger seasonal period of June and then September/October, we are constructive on freight demand and pricing. Along with September and October, June is generally one of the three busiest freight months of the year. **Positive momentum into June should produce a healthy spot market for freight capacity, which will drive pricing acceleration and lead to 2Q earnings upside and improved investor sentiment toward the group.**

As such, we recommend investors take advantage of the recent stock weakness to build exposure to accelerating pricing fundamentals. For truckload/intermodal exposure, we recommend best-in-class models **KNX** and **JBHT**. For rail exposure, we recommend **CSX** and **UNP**. And for parcel exposure, **UPS**.

### **Diverging Stock Performance and Freight Fundamentals: An Opportunity for Investors, or A Signal of What's to Come?**

A number of conflicting data points have emerged in recent weeks, causing investors to question the upside remaining in early-cycle stocks. However, as the chart below indicates, May's stock sell-off runs counter to the strong international freight trends to begin 2010. **So which outlook is correct? Is the market correctly forecasting a sharp decelerating in freight growth, or should investors take advantage of the pullback to gain exposure into accelerating pricing fundamentals?** Our thoughts are outlined below.



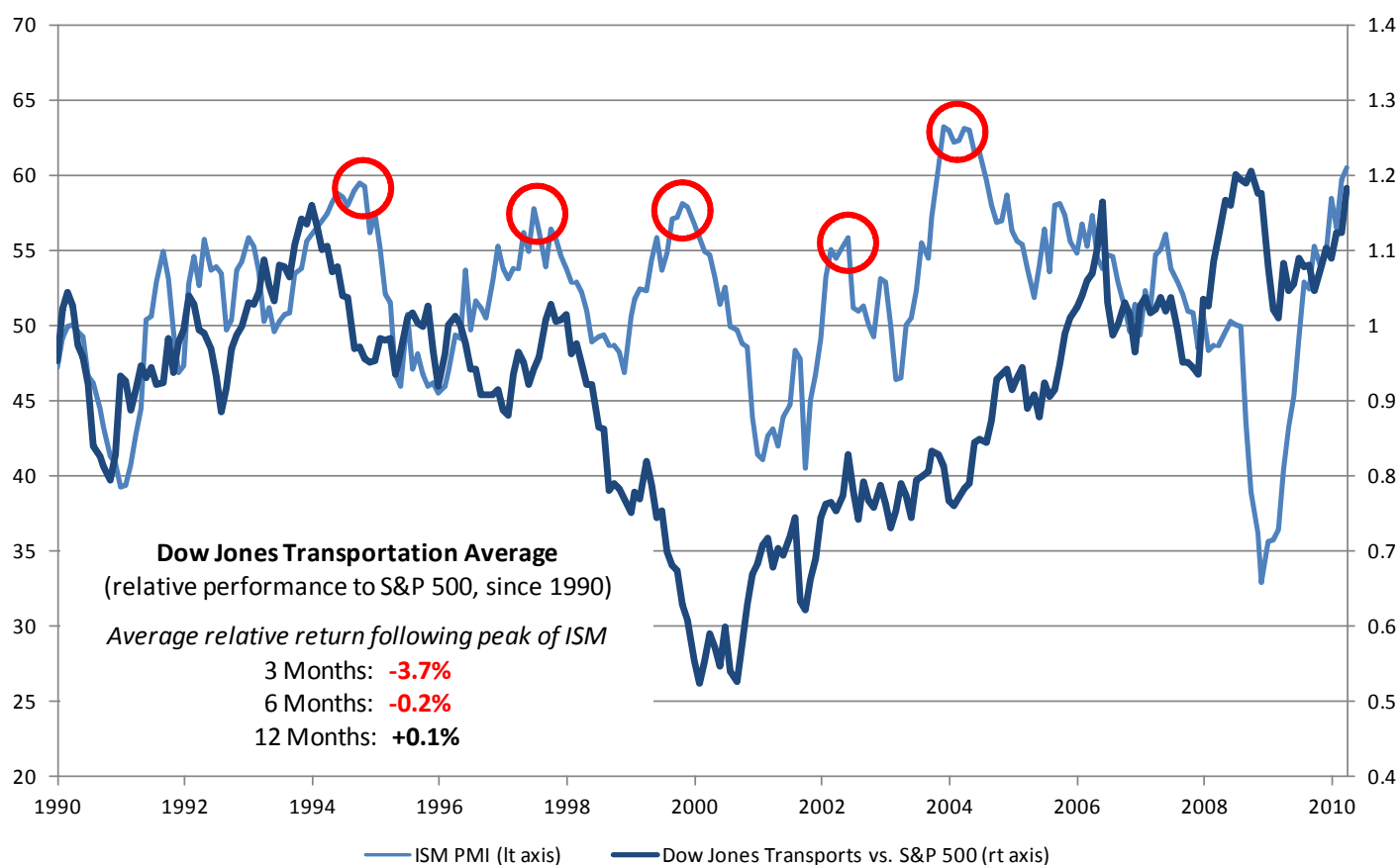
Source: FactSet, HACTL, Baird estimates

Given May's sharp contraction in both the S&P 500 Index and the Dow Jones Transportation Average, it appears investors are discounting a meaningful deceleration in freight demand trends. Though some deceleration is inevitable given the unsustainable levels of monthly growth rates to begin 2010 and firming comparisons through the balance of 2010, anecdotes from industry participants suggest **freight demand remains firm in May and in Europe specifically, despite the noise from May's headlines.**

### Can Transports Work Into A Decelerating ISM?

One near-term headwind to transport stock sentiment is the perceived impact of a decelerating ISM Purchasing Managers' Index – a diffusion index (a reading above 50 is expansionary) based on a monthly survey of 400 purchasing managers. April 2010's ISM reading of 60.4 is 5% below the 20-year peak of 63.2 (December 2003); further, only 4% of the readings since 1990 have been at 60 or greater. So the likelihood is high that the ISM PMI is at the peak for this cycle. And though growth (i.e., ISM > 50) is still likely through 2010, the rate of improvement is poised to slow. Can Transports still work into a decelerating ISM?

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Source: Institute of Supply Management, FactSet, Baird estimates

Over the past 20 years, the ISM has reached a cyclical peak five times. As the chart above demonstrates, the Transports (as measured by the Dow Jones Transportation Average) underperformed the broader market (S&P 500 Index) modestly during the three months following the peak.

Of the various modes, the rails' are the most at risk, with an average underperformance of -9% in the three months following the ISM peak. But the Truckers (+2%) and 3PLs (+7%) both solidly outperformed the broader market three months following the peak. And the broader transport stocks had modest relative outperformance in months four through twelve following the peak. As a result, **there is modest risk of transport underperformance in the upcoming months. However, this risk is offset, in our view, by our constructive outlook on industry fundamentals**, described below. Additionally, the strong outperformance by 3PLs following the ISM peak is also a signal to begin evaluating the appropriate time to rotate into asset-light transport exposure. However, this does not necessarily mean investors must move away from asset-based truckers given that, three of the last five periods, the truckers outperformed the broader market three months following the ISM's peak.

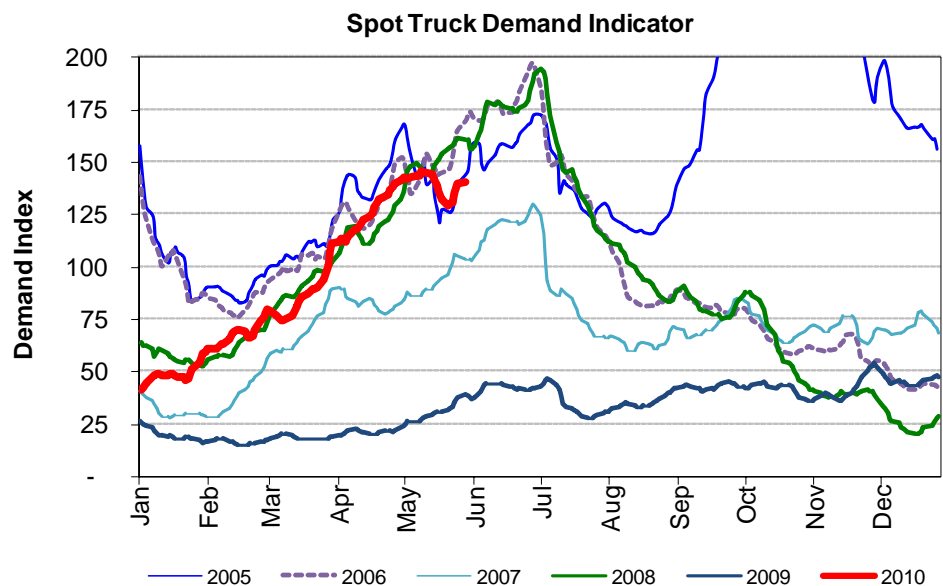
The rails' underperformance immediately following the ISM peak is likely a function of the group's strong volume correlation to the industrial economy. Therefore, we recognize the near-term risk to the group. However, we also point out that the group has not yet endured a cycle in which it possesses both the pricing power and

operating leverage of the current environment, which could mitigate some of the historical precedent of underperformance.

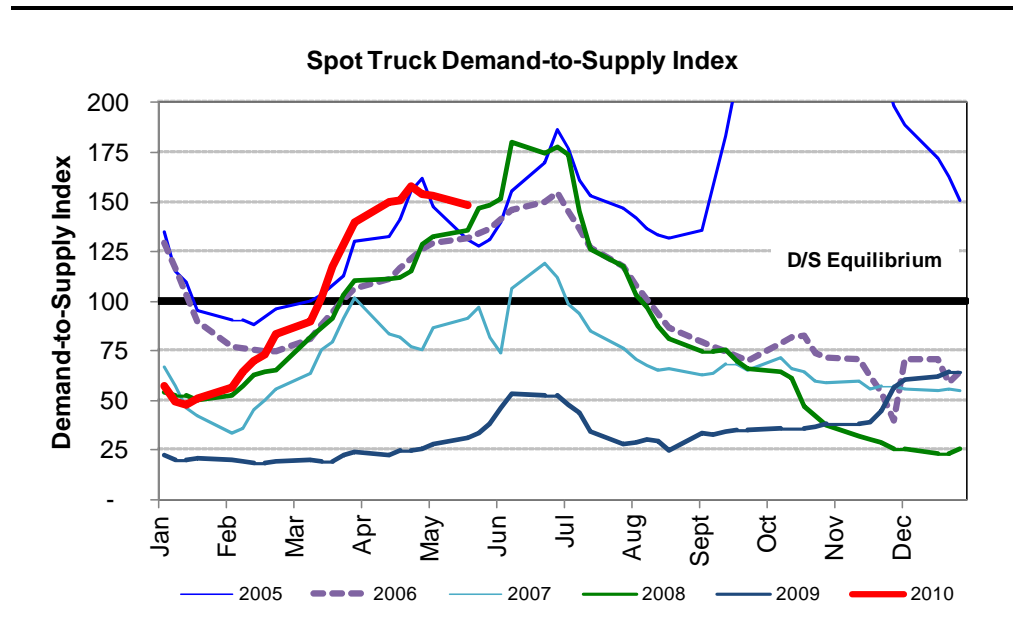
### June: A Preview of 2010's Peak Season

Historically, June is one of the strongest freight months of the year, along with September and October. Positively, ahead of June, the environment has experienced above-seasonal demand strength and tightening of capacity across most freight modes from truckload to intermodal rail to parcel.

Our Spot Truck Demand Indicator and Demand-to-Supply Index shown below demonstrate the above-seasonal truckload demand strength to begin 2010 and the resulting tightening capacity. Given the favorable demand/supply balance, the truckload spot market rates will strengthen further from the already strong spot-market rates (up 20-50%) experienced in recent months. This environment positions capacity owners very well ahead of the 2010 peak season. **Given that inventories remain lean and transportation capacity remains tight, we are expecting a very favorable peak season for capacity owners. The month of June will be a preview of this strength.**



Source: Industry data, Baird estimates



Source: Industry data, Baird estimates

**We are incrementally more constructive on the LTL stocks and would be better buyers on pullbacks.** Encouragingly, LTL demand has remained strong since February. But most importantly, is that despite the industry’s problem with excess capacity, this improved level of demand has absorbed enough available capacity to start supporting modest rate increases. Though we expect LTL rates to continue to lag the other domestic modes, the inflection in LTL rates is a positive for LTL stocks. And given the high degree of operating leverage in LTL models, accelerating pricing growth can have a meaningful impact to near-term earnings power if recent price increases gain traction.

**Mixed seasonal June/July relative performance exists for transport stocks.** Over the past decade, relative transport stock performance has been mixed during the June/July period with a bias toward outperformance. However, we are constructive on the broader transport group given our expectations for a solid seasonal demand acceleration, freight pricing acceleration, and upside to 2Q EPS consensus estimates.

**Weak Transport Stock Performance in May; Mixed Results Relative to Broader Market**

For the month of May, transport stock performance was uniformly weak but mixed relative to the broader market. Tls (-4%), 3PLs (-5%), and Rails (-5%) each outperformed the market, while Integrators (-8%) were in line and and LTLs (-11%) underperformed the S&P 500 (-8%). A complete chart of stock performance is shown below:

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Ticker	Name	Rating	05/28/10 Price	Trading Performance					
				May	Apr	1Q	YTD	2009	2008
<b>Integrator Index</b>				<b>(8%)</b>	<b>3%</b>	<b>12%</b>	<b>13%</b>	<b>13%</b>	<b>(24%)</b>
UPS	United Parcel Service	O	62.78	(9%)	7%	12%	9%	4%	(22%)
FDX	FedEx Corp	N	83.59	(7%)	(4%)	12%	0%	30%	(28%)
<b>Railroad Index</b>				<b>(5%)</b>	<b>4%</b>	<b>9%</b>	<b>8%</b>	<b>35%</b>	<b>(20%)</b>
UNP	Union Pacific	O	71.43	(6%)	3%	15%	12%	34%	(24%)
NSC	Norfolk Southern	N	56.47	(5%)	6%	7%	8%	11%	(7%)
CSX	CSX	O	52.28	(7%)	10%	5%	8%	49%	(26%)
CNI	Canadian National	NR	57.43	(4%)	(1%)	11%	6%	48%	(22%)
CP	Canadian Pacific	NR	55.10	(6%)	5%	4%	2%	61%	(48%)
KSU	Kansas City Southern	NR	38.16	(6%)	12%	9%	15%	75%	(45%)
RA	RailAmerica	NR	11.20	(13%)	9%	(3%)			
GWR	Genesee & Wyoming	NR	35.95	(8%)	15%	5%	10%	7%	26%
<b>Third-Party Logistics Index</b>				<b>(5%)</b>	<b>7%</b>	<b>3%</b>	<b>5%</b>	<b>6%</b>	<b>(12%)</b>
EXPD	Expeditors Intl	N	38.24	(6%)	10%	6%	10%	5%	(26%)
CHRW	C.H. Robinson	N	58.11	(4%)	8%	(5%)	(1%)	7%	2%
JBHT	J.B. Hunt Transportation	O	34.53	(6%)	3%	11%	7%	23%	(5%)
LSTR	Landstar	N	41.94	(5%)	5%	8%	8%	1%	(9%)
UTIW	UTi Worldwide	O	14.45	(9%)	3%	7%	1%	(0%)	(27%)
HUBG	Hub Group	O	30.60	(4%)	14%	4%	14%	1%	(0%)
FWRD	Forward Air Corp	N	27.37	(2%)	7%	5%	9%	3%	(22%)
PACR	Pacer International	N	8.14	23%	10%	91%	158%	(70%)	(29%)
ECHO	Echo Global Logistics	NR	13.12	(3%)	4%	2%			
UACL	Universal Truckload	NR	17.31	(5%)	4%	(3%)	(4%)	28%	(26%)
<b>Leasing</b>									
R	Ryder	N	44.97	(3%)	20%	(6%)	9%	6%	(18%)
TAL	TAL International Group	O	23.99	(8%)	30%	51%	81%	(6%)	(38%)
<b>Truckload Index</b>				<b>(4%)</b>	<b>2%</b>	<b>13%</b>	<b>10%</b>	<b>10%</b>	<b>5%</b>
WERN	Werner Enterprises	N	22.54	1%	(3%)	17%	14%	14%	2%
HTLD	Heartland Express	O	15.55	(6%)	0%	8%	2%	(3%)	11%
KNX	Knight Transportation	O	19.91	(6%)	1%	9%	3%	20%	9%
CGI	Celedon Group	NR	13.64	(9%)	7%	28%	26%	27%	(7%)
MRTN	Marten Transport	NR	22.27	2%	11%	10%	24%	(5%)	36%
USAK	USA Truck	NR	15.04	(18%)	14%	29%	20%	(9%)	(10%)
CVTI	Covenant Transportation	NR	6.88	(7%)	23%	43%	63%	111%	(70%)
<b>LTL Index</b>				<b>(11%)</b>	<b>9%</b>	<b>(3%)</b>	<b>17%</b>	<b>17%</b>	<b>(26%)</b>
CNW	Con-way	N	34.04	(12%)	11%	1%	(2%)	31%	(36%)
YRCW	YRC Worldwide	U	0.36	(37%)	3%	(35%)	(58%)	(71%)	(83%)
ODFL	Old Dominion	N	35.64	(1%)	7%	9%	16%	8%	23%
ABFS	Arkansas Best	N	23.39	(23%)	2%	2%	(21%)	(2%)	37%
SAIA	Saia	NR	14.97	(10%)	19%	(6%)	1%	36%	(18%)
VTNC	Vitrans Corporation	NR	14.12	(7%)	26%	11%	30%	74%	(56%)
<b>SPX</b>	<b>S&amp;P 500</b>			<b>(8%)</b>	<b>1%</b>	<b>5%</b>	<b>(2%)</b>	<b>23%</b>	<b>(38%)</b>

\* Indices are market-cap weighted.

Source: FactSet, Baird estimates

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