ENDURANCE TEST

Shippers who survived last year's logistics maelstrom will need both determination and creativity to keep costs under control in 2006.

BY **ELIZABETH BAATZ,** CONTRIBUTING EDITOR

Shippers who didn't adjust well to the challenges of 2005—no-show truckers, bidding wars for railcars, and non-stop fuel surcharges—will get another chance to prove themselves in 2006. That's because U.S. economic growth is holding steady at around 3.3 percent, so demand for transportation services will be nearly as strong this year as it was in the last 12 months.

With fuel prices settling down after Katrina and Rita, shippers may have expected that rates would do the same. But capacity will be as tight as ever in every mode except ocean shipping.

As a result, shippers who weathered the logistics storm of the past 18 months aren't likely to enjoy a respite from rising rates anytime soon. "Rates are going up, and you are not going to negotiate your way out of a rate increase," warns logistics consultant Lee A. Clair of Concord, Mass.-based Norbridge Inc. Indeed, Clair says, any shipper who is asking if rates will go up is asking the wrong question.

The more important question now: What will you do to manage the situation? For even without another devastating natural disaster, the outlook for the logistics market suggests that shippers and carriers alike will be tested again in 2006.

Before looking at how shippers are managing, let's first examine the macroeconomic trends that are driving demand, and why supply-side constraints will take so much longer to lift than in past business cycles.

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MORE STRAIN ON CAPACITY

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Somewhat paradoxically, the positive overall forecast for the U.S. economy also makes the logistics outlook for the coming year appear daunting.

A panel of 50 top economists is predicting that the U.S. gross domestic product (GDP), after growing an inflation-adjusted 3.5 percent in 2005, will register an average 3.3 percent gain in 2006. (See Figure 1.) This consensus forecast from the November 2005 *Blue Chip Economic Indicators* is bounded on the high side by a 3.9 percent prediction proffered by economists at both the National Association of Realtors and at Bear, Stearns & Company. On the low side, Merrill Lynch Economics sees GDP up only 2.7 percent in 2006. The only logistics-related company in the survey sample, FedEx Corporation, calls for a 3.6 percent growth rate.

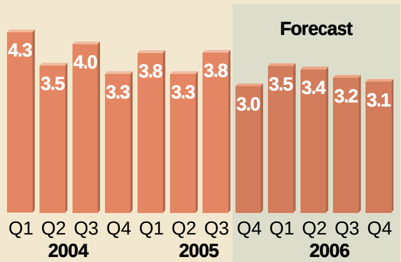
Any weakness the U.S. economy does encounter will come from the consumer side. "We will see a pullback in consumer spending and new housing starts will fall," predicts Randell E. Moore, executive editor of *Blue Chip Economic Indicators* in Kansas City, Mo. In fact, Moore says, the consensus predicts that consumer spending—which accounts for 70 percent of GDP—will be up only 2.8 percent, the smallest increase since 2002. (See Figure 2.)

Business spending, meanwhile, will pick up the slack. Nonresidential fixed investment in plants and

Fig. 1

GDP Forecast to Rise 3.3% in 2006

(Percent change* in inflation-adjusted GDP)



*% change from prior quarter at annualized rate

Source: Blue Chip Economic Indicators (Nov. 2005)

equipment is forecast to grow 7.6 percent this year, after an 8.6 percent estimated gain in 2005.

Furthermore, inventories are very lean, a fact that will influence both economic growth and pressure on shippers. "The consensus forecast assumes rebuilding [inventories] will be a significant contributor to GDP growth in 2006," says Moore. Inventory growth means more production and movement of goods, increasing the strain on already-stretched logistics resources. There will be plenty of competition for what capacity there is: The consensus forecast says faster growth abroad will encourage North American exports.

In a word, this economy is resilient. James Haughey, director of economics for *Logistics Management* parent Reed Business Information, says that resilience became clear when fuel prices quickly returned to equilibrium after the supply shock of Katrina and Rita. "Gasoline prices came down quickly due to surplus supplies from Europe and the Caribbean, and the 40-cent premium that remains on diesel fuel will wind down," Haughey says. The pace of that decline, he adds, will depend on how cold the winter is because diesel and home heating oil use the same raw components. Looking ahead, Haughey expects crude oil prices to drop another $10-plus per barrel in the coming year.

TRUCKLOAD OF WOES

A drop in the price of diesel fuel can't come soon enough for smaller trucking companies, which have a harder time making fuel surcharges stick than their large competitors. For some, though, it's already too late. According to Thomas Albrecht, managing director at investment analysts Stephens Inc., truck repossessions shot up 188 percent in the third quarter of 2005 compared to the same period a year earlier. Also telling is the fact that the number of shipments handled by small truckload carriers in the first three quarters of 2005 declined 2.4 percent from the prior year.

High fuel costs aren't the only thing discouraging new entrants in the long-haul trucking industry. The high cost of insurance has been a big problem, too. Albrecht estimates the average bodily-injury and physical-damage deductible among 12 publicly held carriers stood at only $443,000 per incident in 1999. That figure jumped to $2.7 million in 2004 and $3.2 million in 2005.

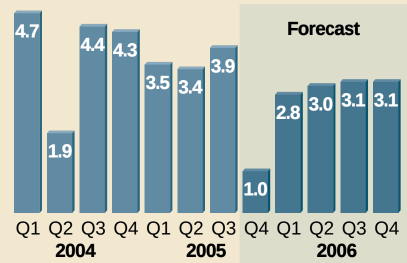
Even if fuel and insurance costs hadn't budged, capacity constraints would persist due to a severe shortage of drivers. According to an American Trucking Associations-sponsored study by economists at Global Insight, the U.S. economy is short 20,000 truck drivers right now. That shortage is forecast to hit 111,000 in eight years as the economy grows and the aging labor pool begins to retire.

These trends will make buying truckload services as difficult in the coming 12 months as it has been over the past couple of years. "Shippers will have to decide: Do I take a chance there will be enough capacity in small

Fig. 2

Consumers Remain Key to U.S. Outlook

(Percent change* in personal consumption expenditures



*% change from prior quarter at annualized rate

Source: Blue Chip Economic Indicators (Nov. 2005)

and medium-sized carriers, or pay now in order to avoid the worst of the spot market?" Albrecht says. "Don't be a sucker for a slow period," he cautions. "We have a multi-year capacity problem, and industry consolidation is still accelerating." He is forecasting that the sharp rise in rates since 2003 will continue in 2006. (See Figure 3.)

Trucking rates are a big concern for 2006, agrees Tom Sanderson, president and chief operating officer of Transplace, the Plano, Texas-based third-party logistics company. "We saw the over-the-road truckload market push through 4 percent to 7 percent rate hikes over the past couple of years, and it's likely we'll see the same in 2006," he says.

If truckload rates see any improvement in the first and second quarters of 2006, it will be due to fuel prices coming back down after spiking abnormally high in the second half of 2005, says Paul Svindland, senior director of the Global Logistics Solutions Group at ICG Commerce, a logistics outsourcing firm in King of Prussia, Pa. Large shippers, though, may be able to keep base-rate increases to 2 percent to 4 percent in 2006 if they are willing to change carriers, he says. That's because a shipper facing a hefty rate hike from its regular provider could negotiate lower rates with another carrier and thereby minimize the percentage increase, he explains.

LTL rates, meanwhile, are unlikely

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—Lee A. Clair, Norbridge Inc.

to experience increases of the same magnitude as truckload, Sanderson predicts. He sees plenty of capacity and enough competitive options in the LTL sector to hold rate hikes in check.

RAIL CAPACITY OUT OF STEAM

The outlook for rail pricing mirrors that of the truckload sector. For the first time in decades the rail industry has run out of capacity. Record international trade volumes, early retirements, general shortages of both labor and equipment, and infrastructure constraints explain why rates have been increasing and aren't likely to fall anytime soon.

Class 1 railroads could hike rates by 8.4 percent in 2006 following an estimated 8.5 percent increase in 2005, says Dr. Leigh B. Boske, economics professor and associate dean at the University of Texas at Austin. Sanderson also expects intermodal rates will rise on par with those for the truckload market, up 4 percent to 7 percent. The main causes, he says, are congested rail yards, shortages of boxcars, and trains "filling up with priority customers like Wal-Mart and UPS, leaving everyone else to fight over the remaining slots."

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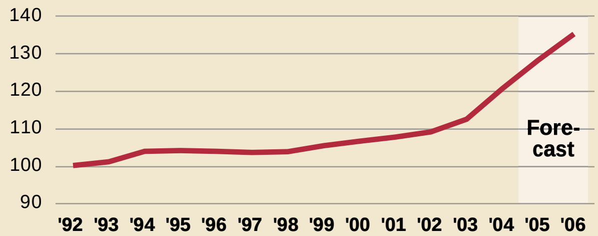
Fig. 3

Truckload* Rates Trend Sharply Upward

(Stephens loaded rate/mile index)



*Dry-van truckload rates, excluding fuel surcharges

Source: Company reports and Stephens Inc. estimates

In the highly concentrated parcel express market, the days when shippers with $10 million or more in business could negotiate deep price cuts may be over—at least for now. When DHL merged with Airborne, the cash-rich company was willing to forego profits to win business away from FedEx and UPS. Now, says Svindland, "DHL is wiser about the business and wants to go after good margins."

With the strong economy boosting shipment volumes, FedEx and UPS are sparring on a market-by-market or account-by-account basis, careful to avoid an all-out price war. In November, UPS announced an average 3.5 percent hike in ground parcel prices for 2006, and FedEx Ground followed with an identical increase. Wall Street analysts say they expect DHL will soon follow suit, but at press time the carrier had not yet done so. In the air express side of its business, FedEx plans an average 5.5 percent price hike for international shipments to or from the United States—the biggest price increase in at least nine years.

While truck, rail, and air rates will continue to climb in 2006, ocean freight rates will buck that trend. Mark Page, research director for Drewry Shipping Consultants Ltd. in London, says that the container shipping market is being driven by an oversupply of capacity now. "For the first time since early 2002, a significant quantity of

The Forecast Risk

ECONOMISTS WOULDN'T BE THE MASTERS of their dismal science if they didn't keep a sharp eye out for risks to their optimistic outlook. Stephen Roach, chief economist for Morgan Stanley, sounds the most cogent warning.

According to "Tough Flying Conditions," a recent report authored by Roach, the global economy is soaring along on just two engines: the American consumer on the demand side and the Chinese producer on the supply side. Maintaining altitude could be a problem, he suggests.

America's consumption binge—drawing first from stock-market equity in the latter half of the 1990s and then from the effects of housing-based wealth over the past five years—has been phenomenal, says Roach. The result has been to push the income-based personal savings rate down five percentage points over the last 10 years, "taking it deeper into negative territory than at any point since 1933," he writes.

Halfway around the world, China's GDP growth held above 9 percent in the third quarter of 2005, thanks in part to industrial production that exceeded 16 percent. Those numbers are expected to hold fairly steady this year, and the panel of economists whose forecasts are published in *Blue Chip Economic Indicators* predicts the Chinese economy will grow 9.5 percent in 2006.

The United States probably will account for 35 percent to 40 percent of total Chinese exports in 2005. And therein lies the risk, Roach points out. "Implicit in this extraordinary degree of dependence is a well-established distribution and logistical support infrastructure to U.S.-Chinese trade flows," he writes.

So what will happen if the U.S demand engine sputters or logistics capacity can't keep pace while the Chinese supply engine is going full-throttle?

Answer: Global economic growth will come crashing down.

new vessels is being delivered from world shipyards," he says.

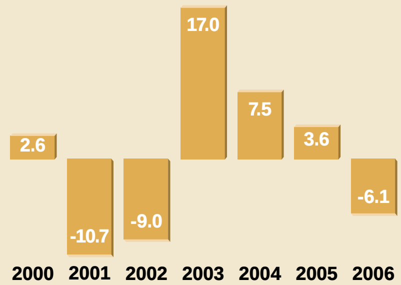
Drewry estimates that total effective capacity in the container market will rise by 14 percent in 2006, while effective demand will weaken from the very high levels of the last three years to a 10.7 percent growth rate this year. For the main east-west trade routes (Trans-Pacific, Asia-North Europe, and Trans-Atlantic), Page forecasts average rates will fall 6.1 percent in 2006. That follows increases of 17 percent in 2003, 7.5 percent in 2004, and 3.6 percent in 2005. (See Figure 4.)

A similar trend on routes from South America to the United States is likely this year. After a brutal marketplace in 2004, when rates surged by up to 40 percent, ocean carriers were disappointed in 2005 that shippers were able to avoid peak-season surcharges.

Fig.4

Ocean Container Rates* to Sink

(Annual percent change)



*East-West trade route composite rate

Source: Drewry Market Forecast (Oct. 2005)

For 2006, Svindland expects northbound rates will slightly decrease for most shippers; small shippers may possibly see minimal rate hikes.

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CREATIVE CONTRACTS

With every mode but ocean shipping looking at another year of significant rate hikes, it looks like the seller's market will prevail again. Of particular concern is the truckload sector: Even if shippers are able to negotiate lower rates, there's no guarantee they'll be able to keep them for long. "[Truckload carriers] will drop you if they see an opportunity for 10 cents more per mile, and then your negotiated rate won't mean much," observes Svindland.

In response to such turmoil, more shippers may be turning to private fleets. "Manufacturers and retailers don't want to be in the trucking business," says Sanderson, "but they have to do something to insulate themselves from high rate increases."

The transportation landscape is indeed changing as buyers become more creative, says Svindland. On behalf of its shipper clients, for example, his company is developing more contracts that include incentives for on-time delivery and pickups.

Norbridge's Lee Clair counsels shippers to be more creative across the board when it comes to managing their costs in the coming year. To take full advantage of cost-saving opportunities, shippers may need to make changes in their distribution networks, in the modes they choose, and in the hours they work, he suggests.

They may even need to change their attitude. Clair cites the example of IKEA, the home-goods retailer. Logistics executives at that company were concerned about the truck-driver shortage and decided that one way to ensure adequate capacity and lower costs would be to become the most attractive customer to its motor carriers.

There's no question that maintaining high-quality service while keeping transportation costs under control will entail plenty of hard work. But shippers that are able to meet that challenge will be well prepared for anything that may come down the road in 2007.

Contributing Editor Elizabeth Baatz, a principal in the economic forecasting firm Thinking Cap Solutions, authors LM'*s monthly Price Trends column.*