Industrial Research

March 15, 2016

2016 US Economic & Transportation Industry Outlook

If you would like to be added to our monthly research distribution list, which we make freely available, please email me at bhartford@rwbaird.com

Benjamin J. Hartford
bhartford@rwbaird.com
414.765.3752

Please refer to Appendix – Important Disclosures and Analyst Certification

Key Focal Points

1. Reviewing 2015's trends: Decelerating growth and transport stock underperformance.

2. Will 2016 be a recession year? A look at what the markets think.

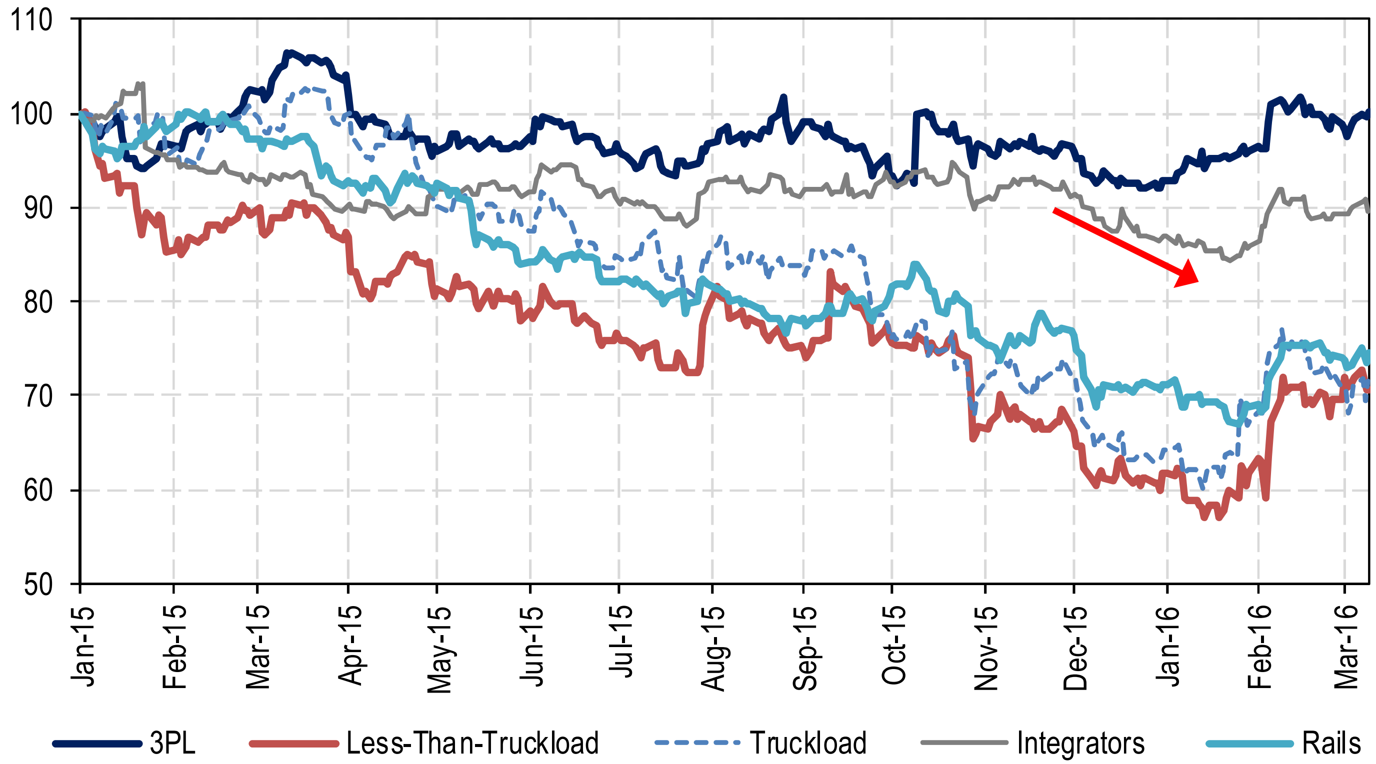
3. Looking to 2016: "It's always darkest before the dawn."

4. Transports this cycle: regulatory changes, demographics and technology separate winners from losers.

A Look Back at 2015: Where Was The Consumer?

Transports Were Notable Underperformers During 2015…

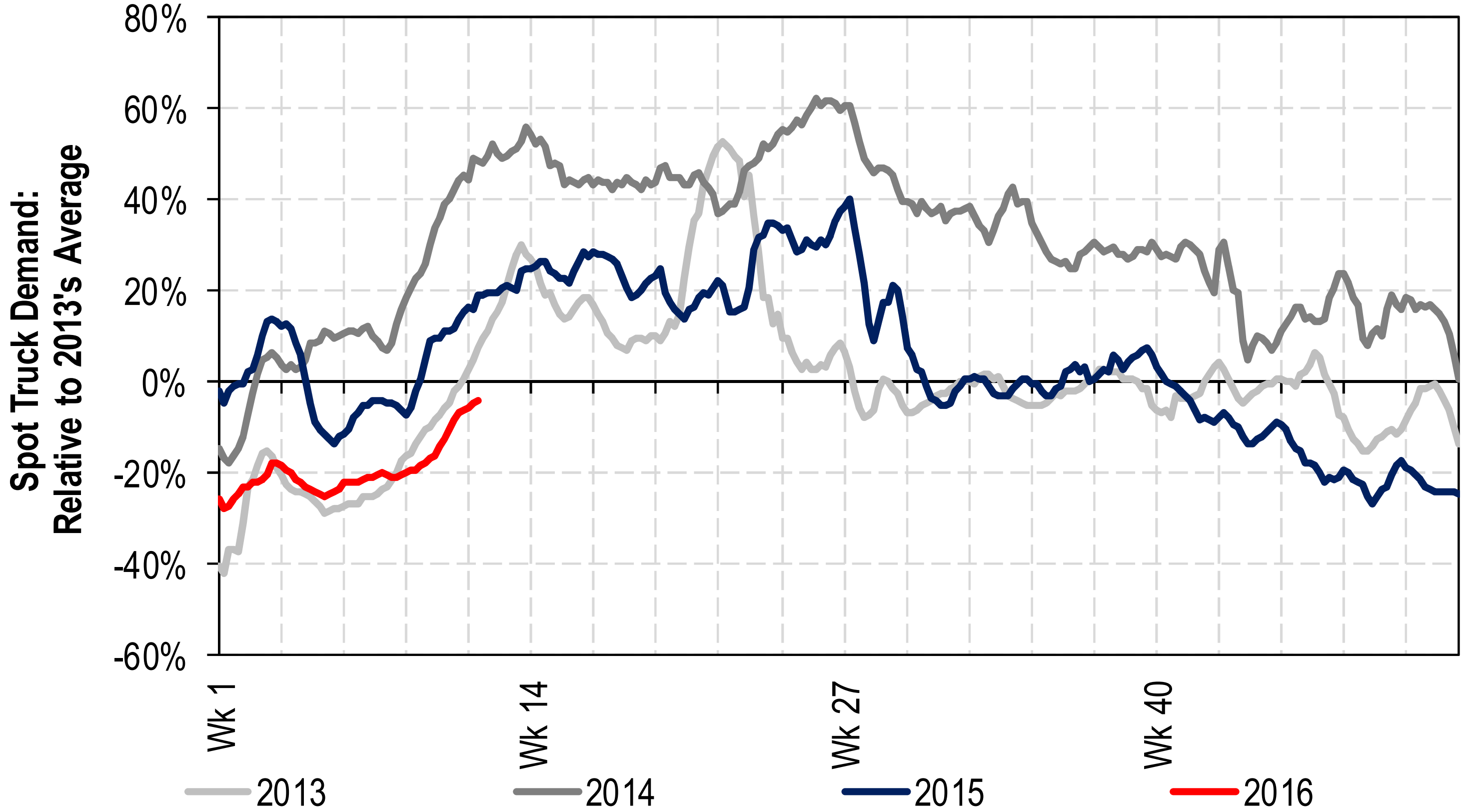
Transports were notable underperformers during 2015, and the underperformance was indiscriminate across subsectors.



Source: FactSet

...Given Normalizing Capacity Conditions...

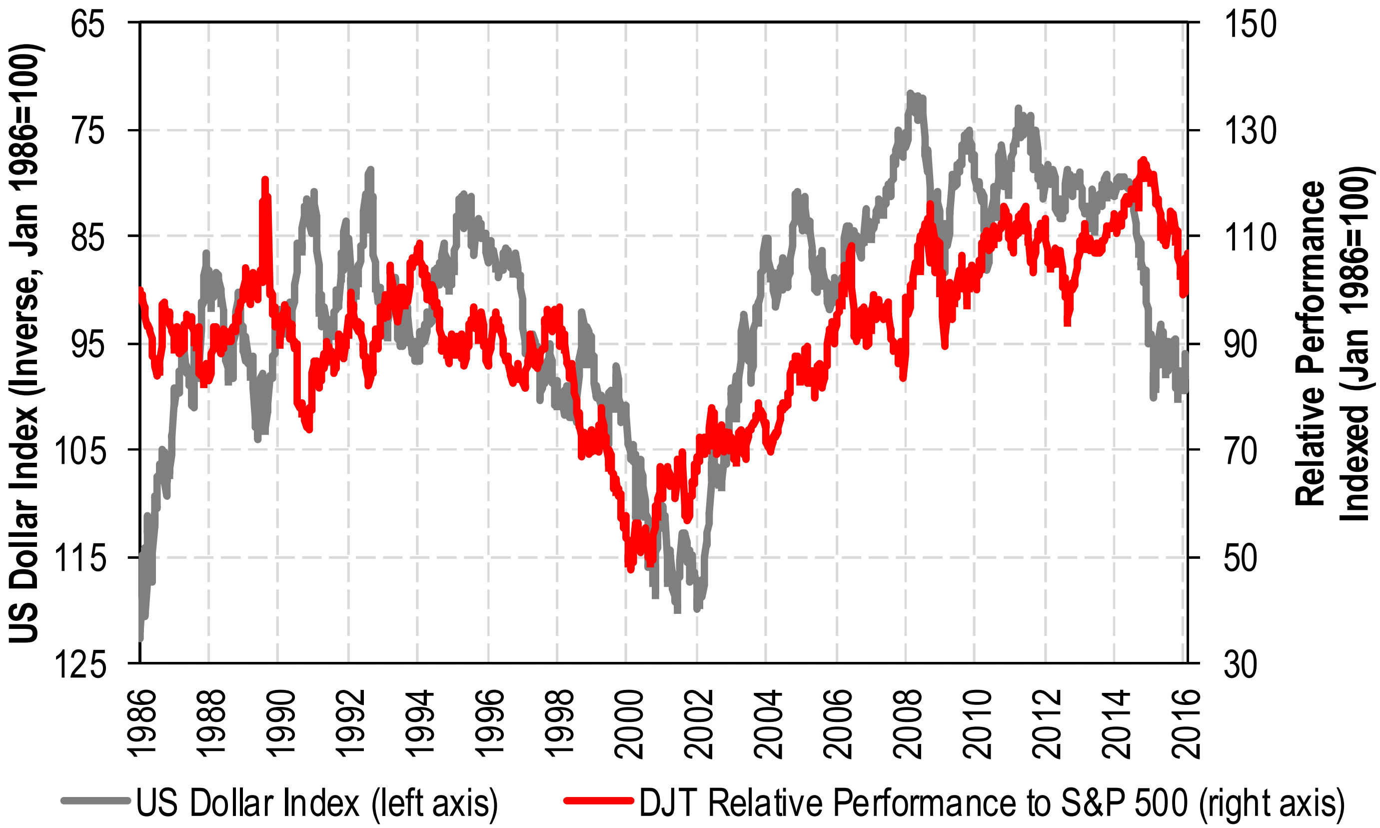
Spot demand was muted, falling below 2013 levels after a weak 4Q15.



Source: Industry data, Baird estimates

...And a Strong USD...

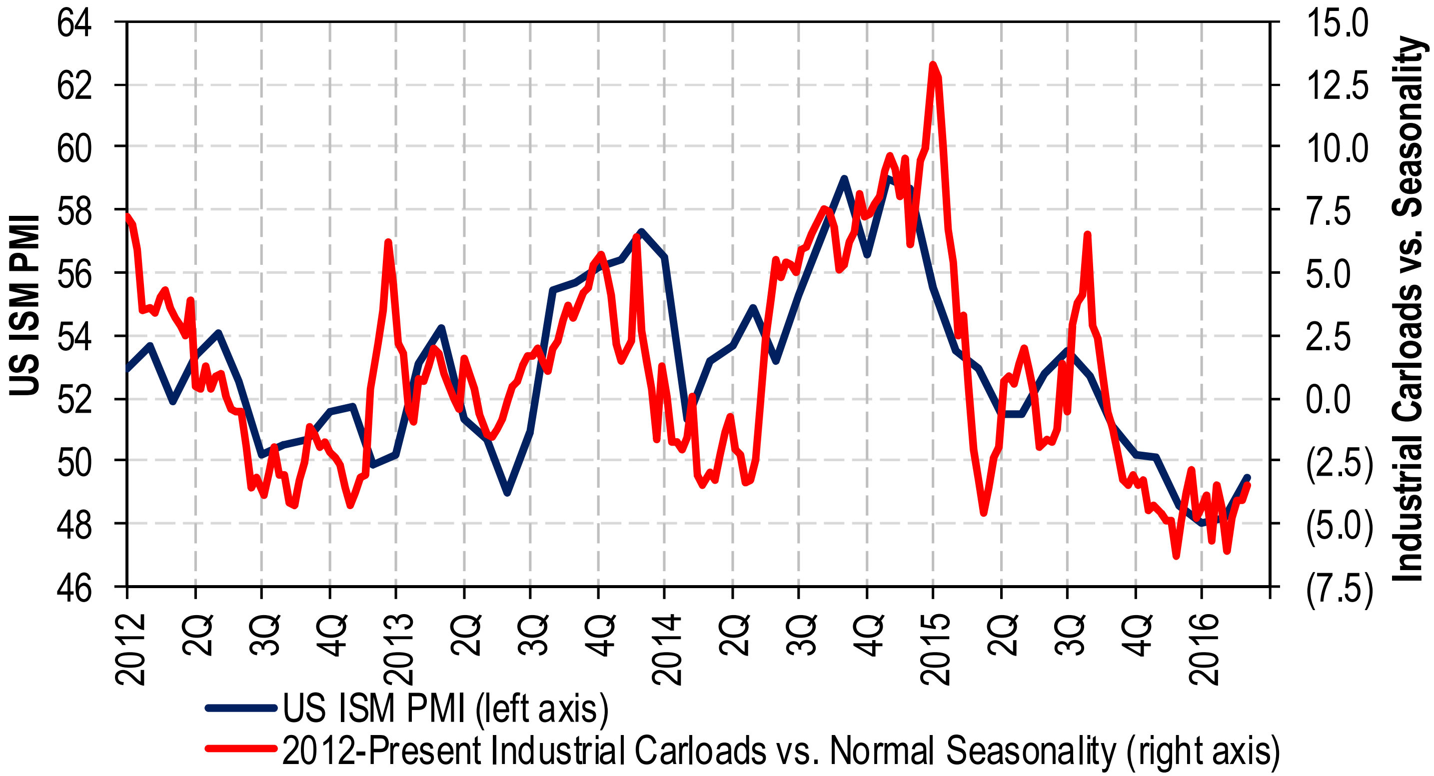
A strong USD correlates with relative underperformance of transport stocks.



Source: FactSet

...Driving Weaker-Than-Expected Volumes...

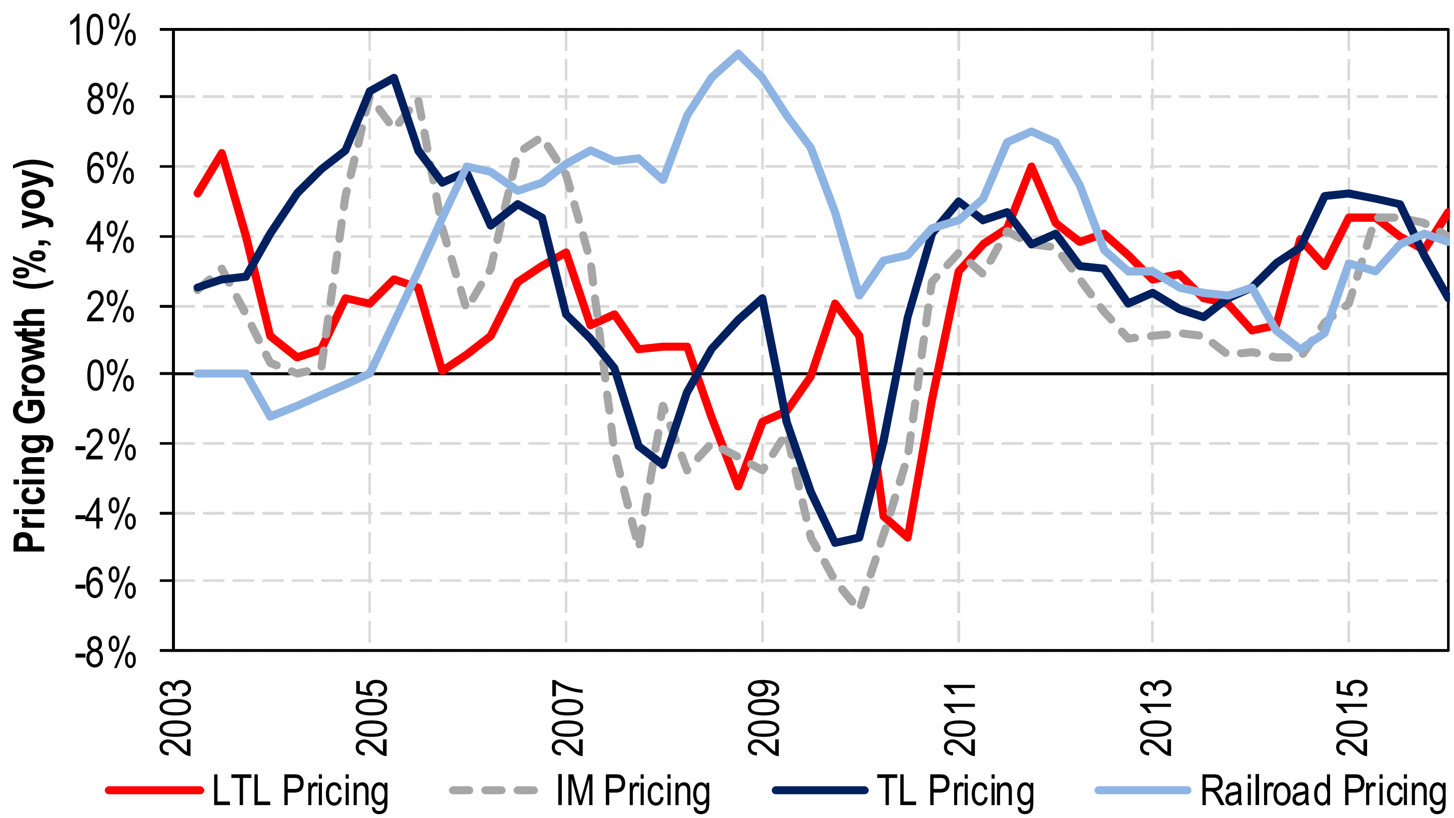
Weak US industrial activity and lower crude oil prices/a stronger USD led to below-seasonal volume trends in 2015, particularly in industrial end markets.



Source: Institute for Supply Management, AAR, Baird estimates

...And Decelerating Core Pricing Growth.

Weak demand and tough comparisons (after 2014's positive inflection in pricing growth) led to decelerating pricing growth in 2H15.



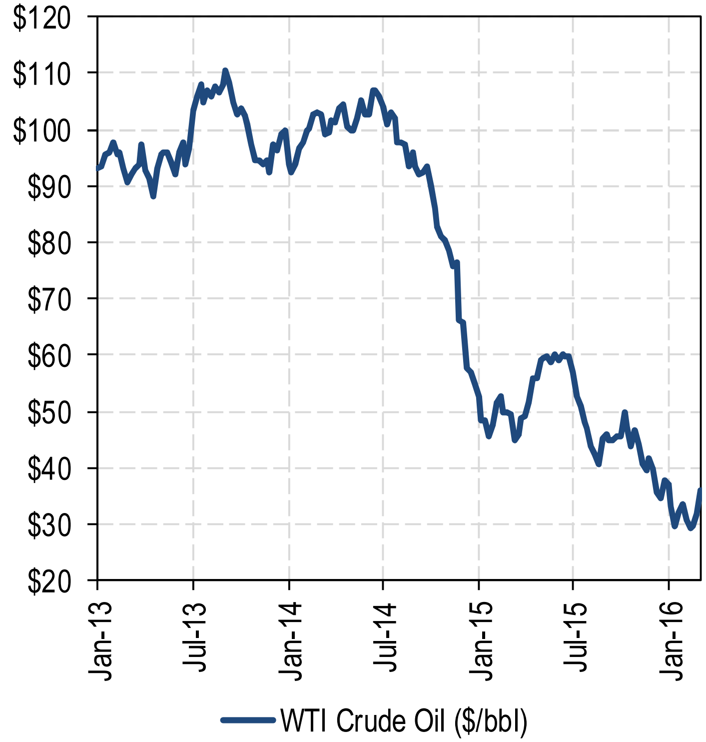
Source: Company data, Baird estimates

A Look Ahead at 2016

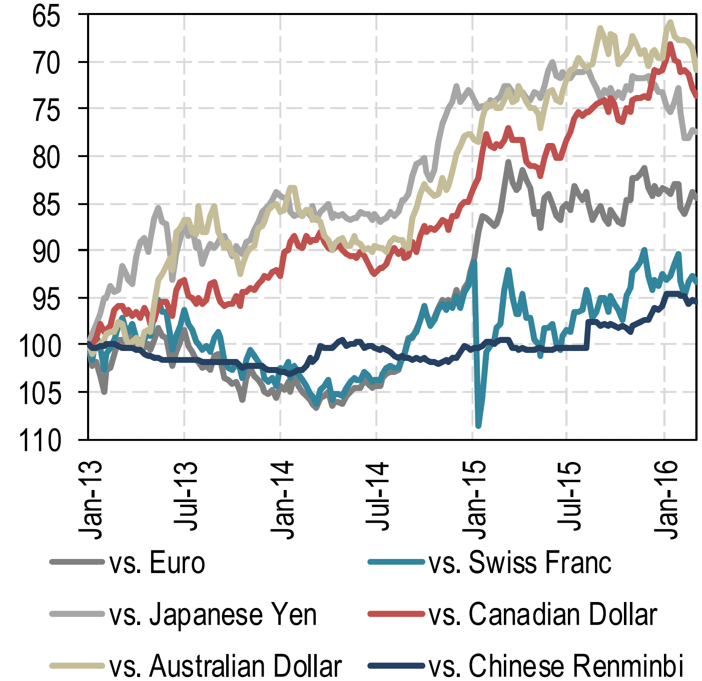
2015's Pressures Remain Risks to Begin 2016

Crude's slide has continued and the USD remains strong – but some important reversals have happened to begin 2016:

Crude's Weakness



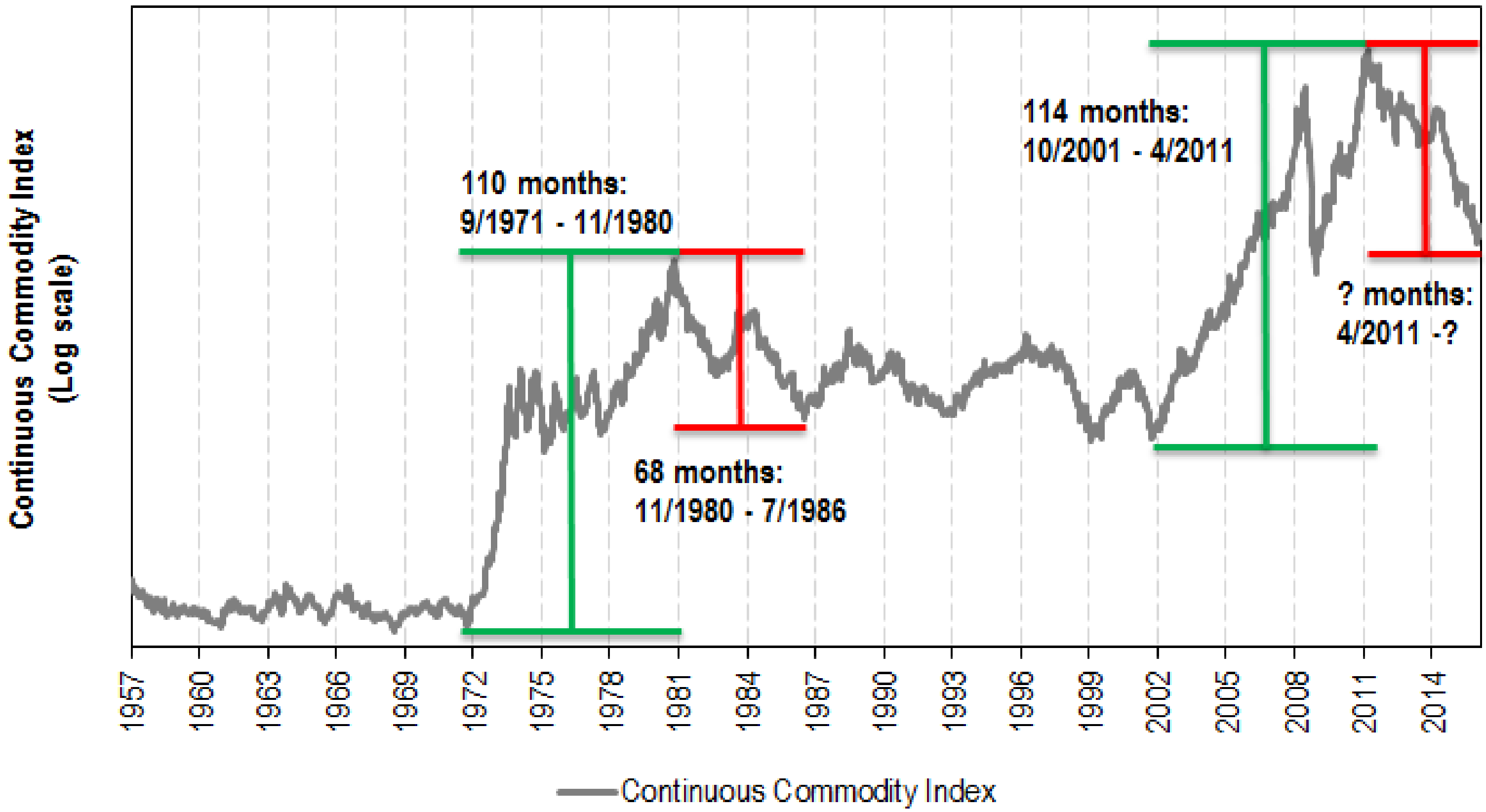
US Dollar's Strength



Source: FactSet

2015's Pressures Remain Risks to Begin 2016

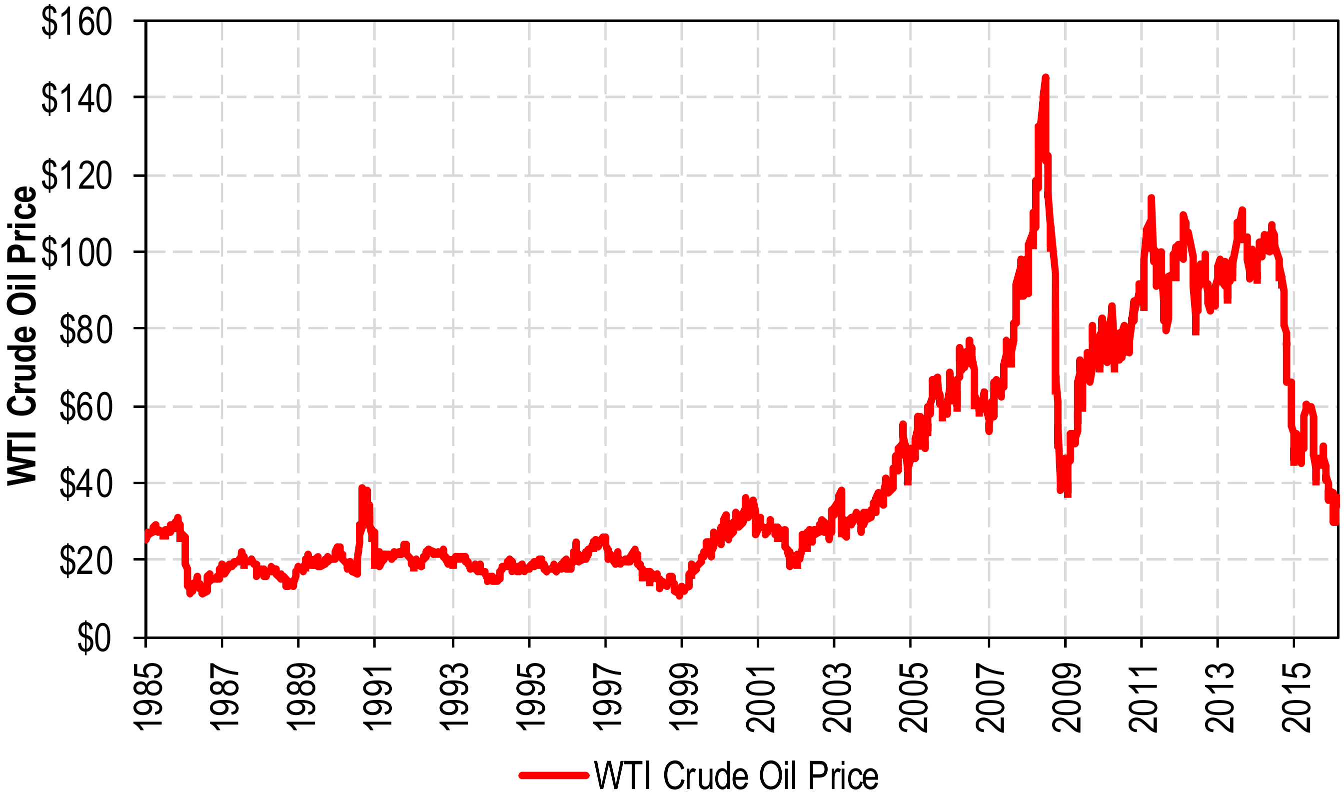
Taking the long view, this new environment could be with us for a while longer.



Source: Thomson Reuters

2015's Pressures Remain Risks to Begin 2016

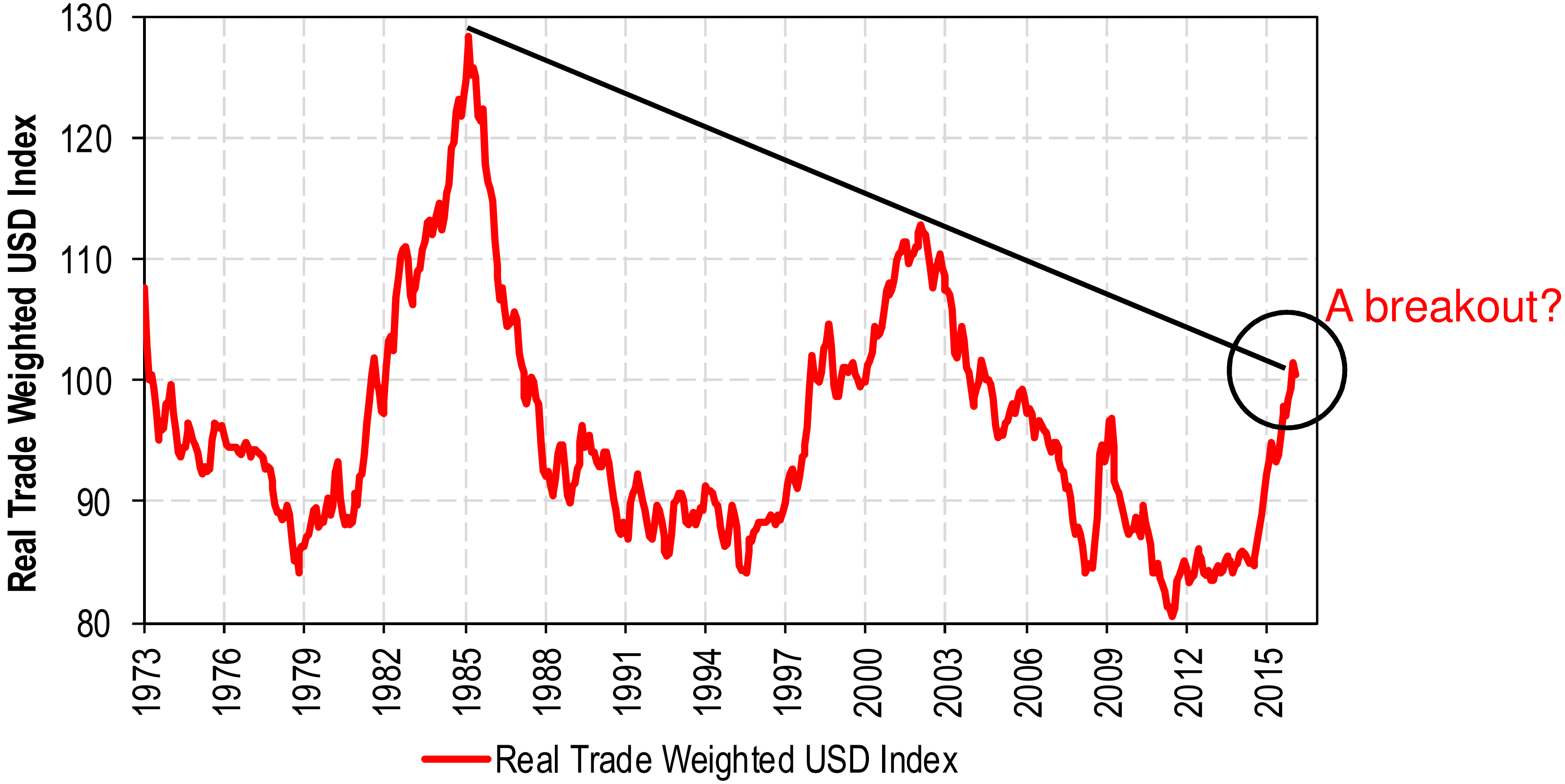
Current crude oil's price is more representative of its long-term average than 2005-2014 levels.



Source: FactSet

2015's Pressures Remain Risks to Begin 2016

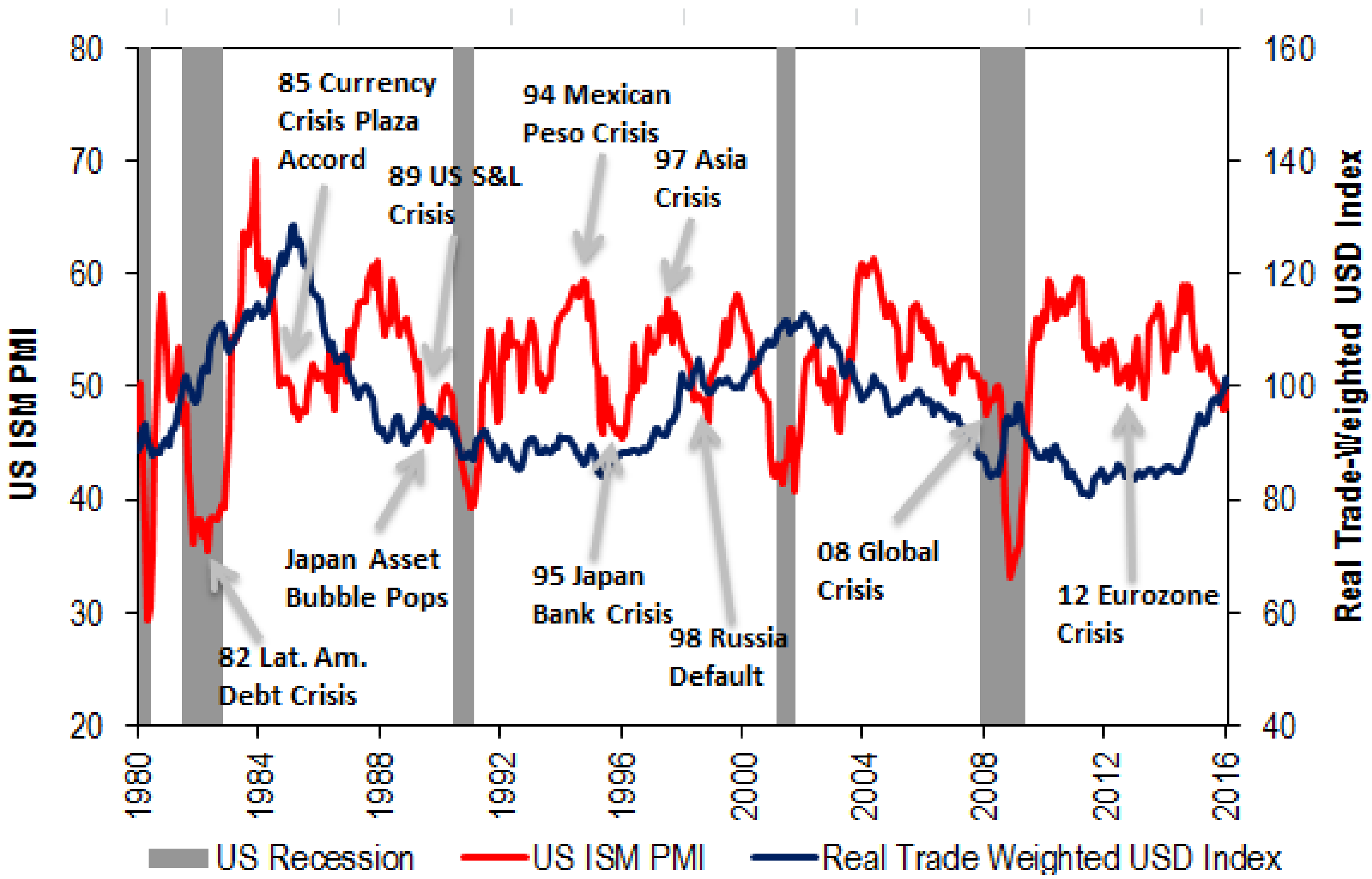
In our view, the USD's direction in upcoming months will go a long way in determining the sources and direction of trade growth rates.



Source: Board of Governors of the Federal Reserve

2015's Pressures Remain Risks to Begin 2016

USD strength tends to bring slowing global growth and global crises.

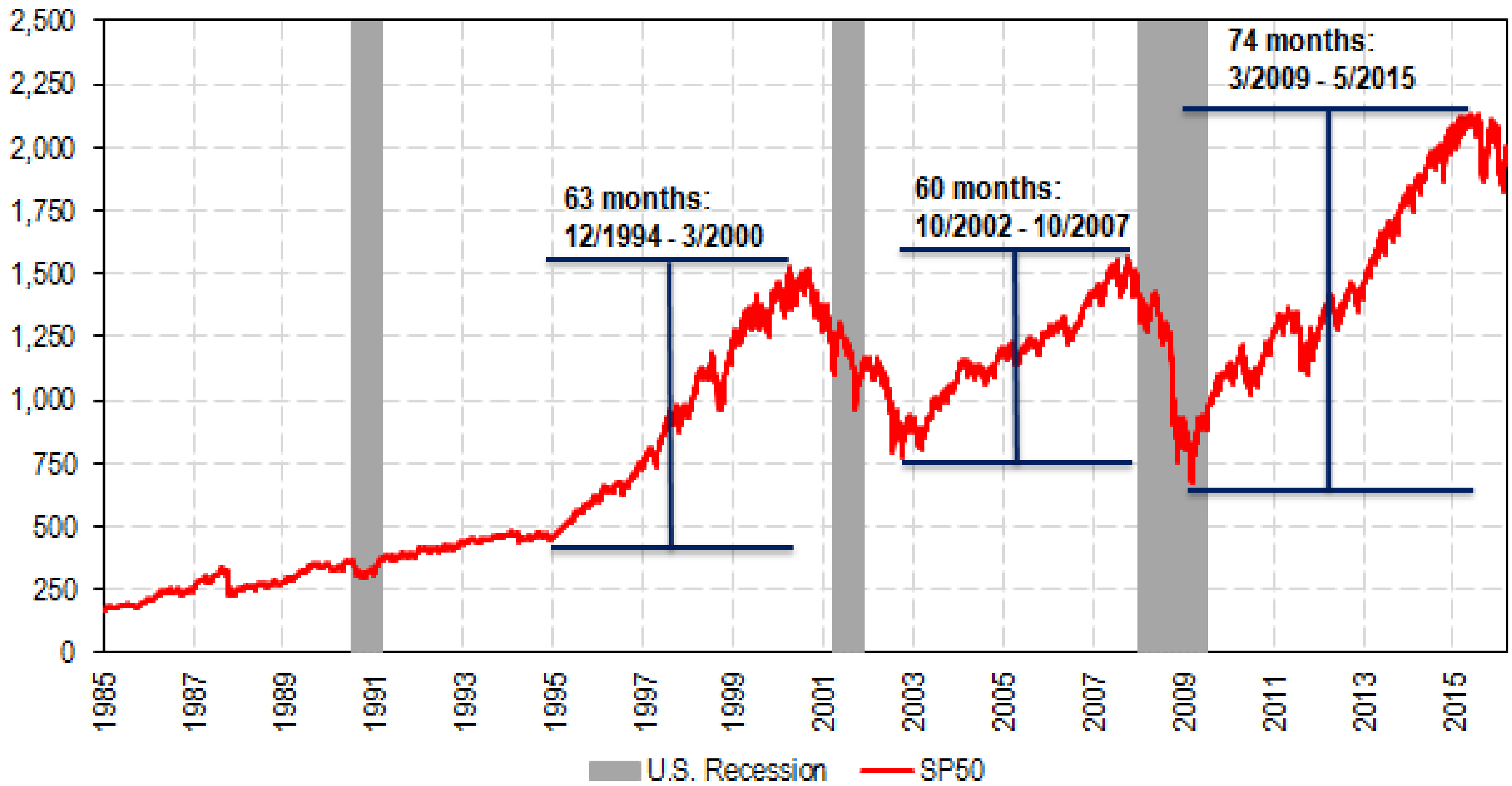


Source: Board of Governors of the Federal Reserve, ISM, NBER

Will 2016 Be a Recession Year? What The Market Is Saying

Will 2016 Be a Recession Year?

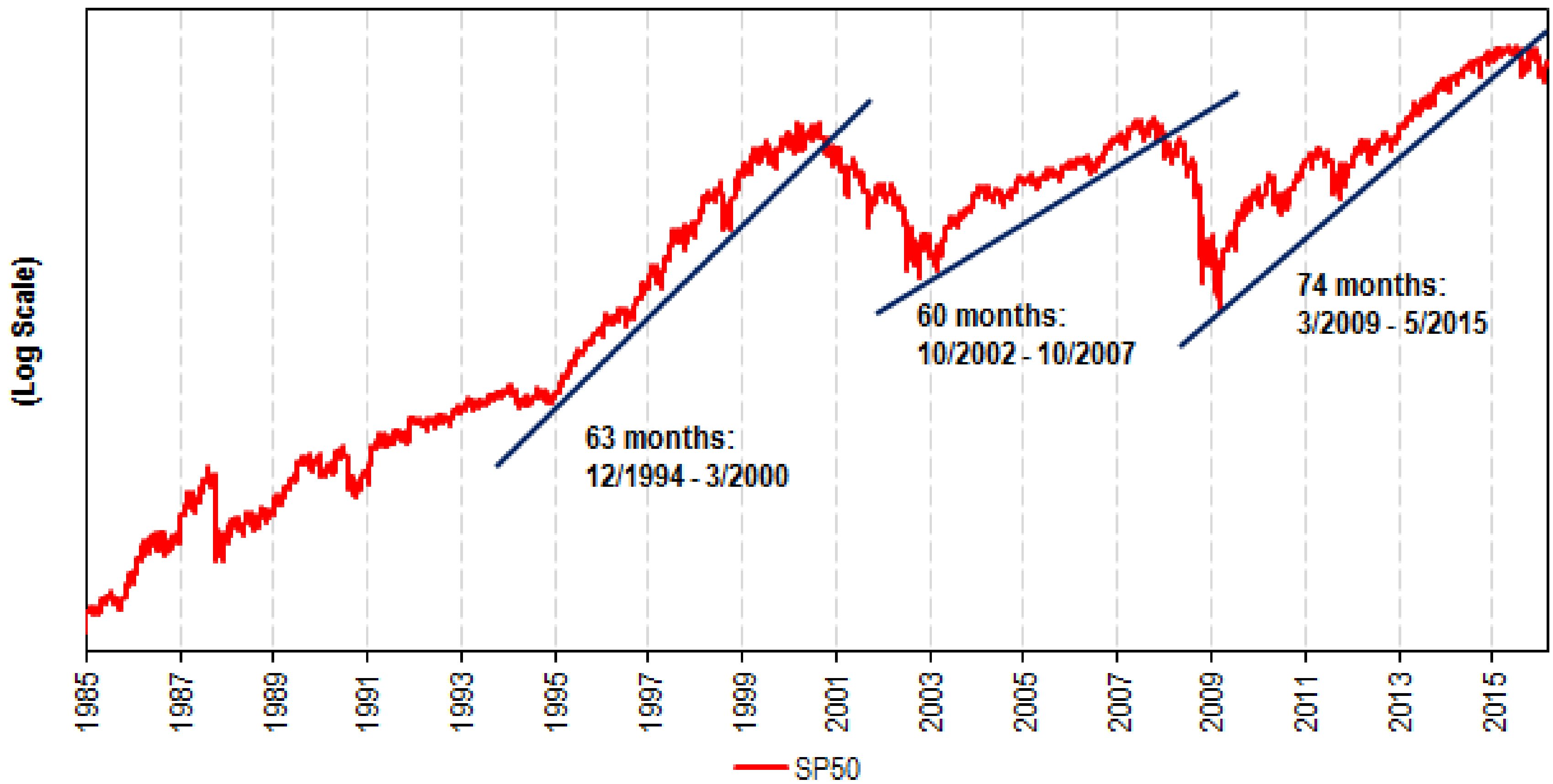
S&P 500 (and broader equity markets) showing signs of topping.



Source: FactSet, NBER

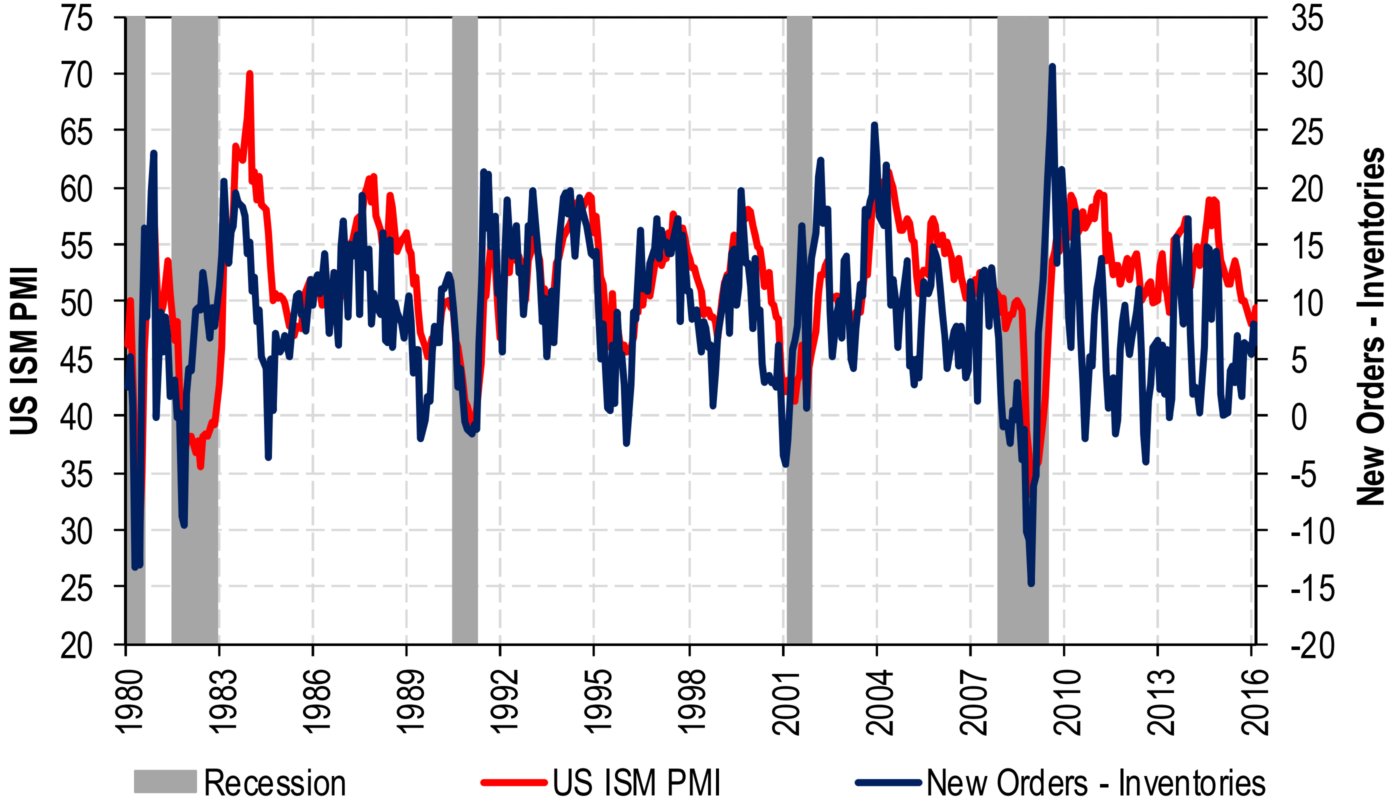
Will 2016 Be a Recession Year?

S&P 500 (and broader equity markets) showing signs of topping.



Will 2016 Be a Recession Year?

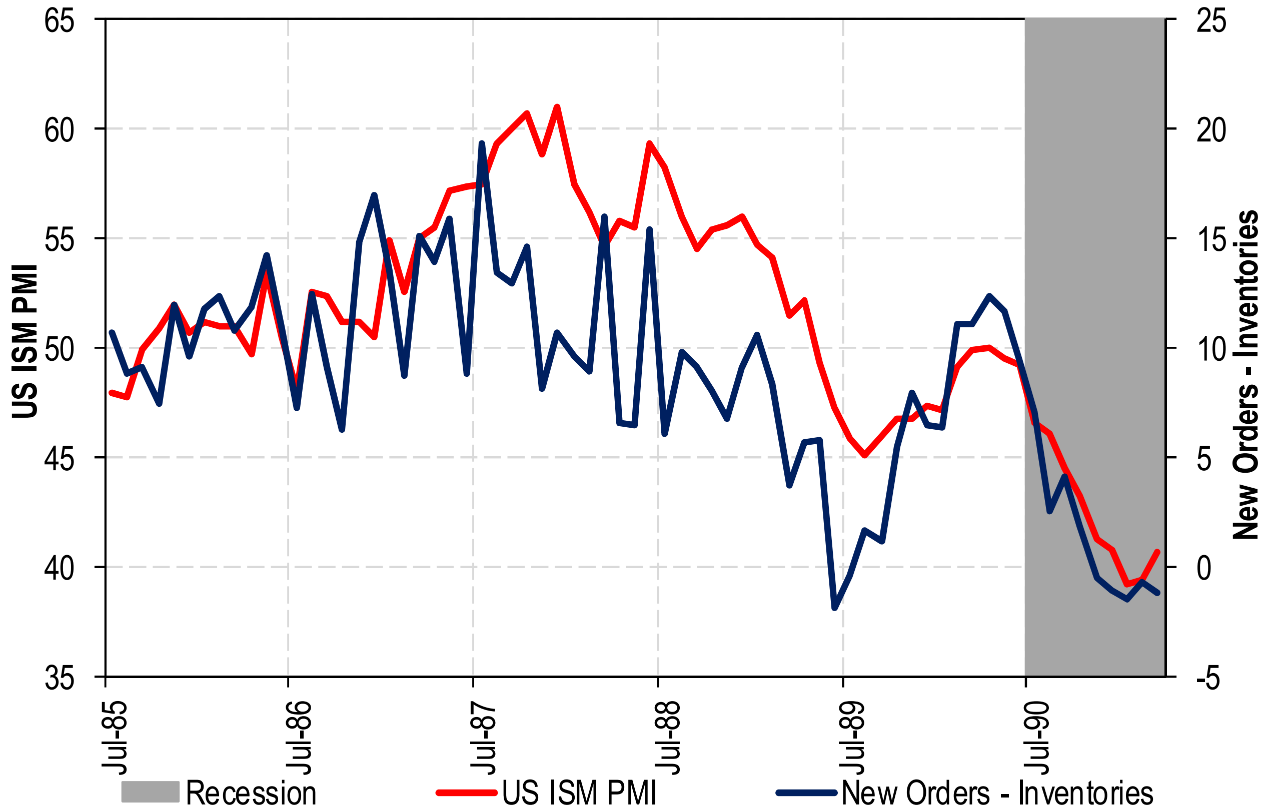
Comparing this cycle to prior cycles, current US ISM PMI conditions do not yet reflect the beginning of a US recession.



Source: Institute of Supply Management, National Bureau of Economic Research

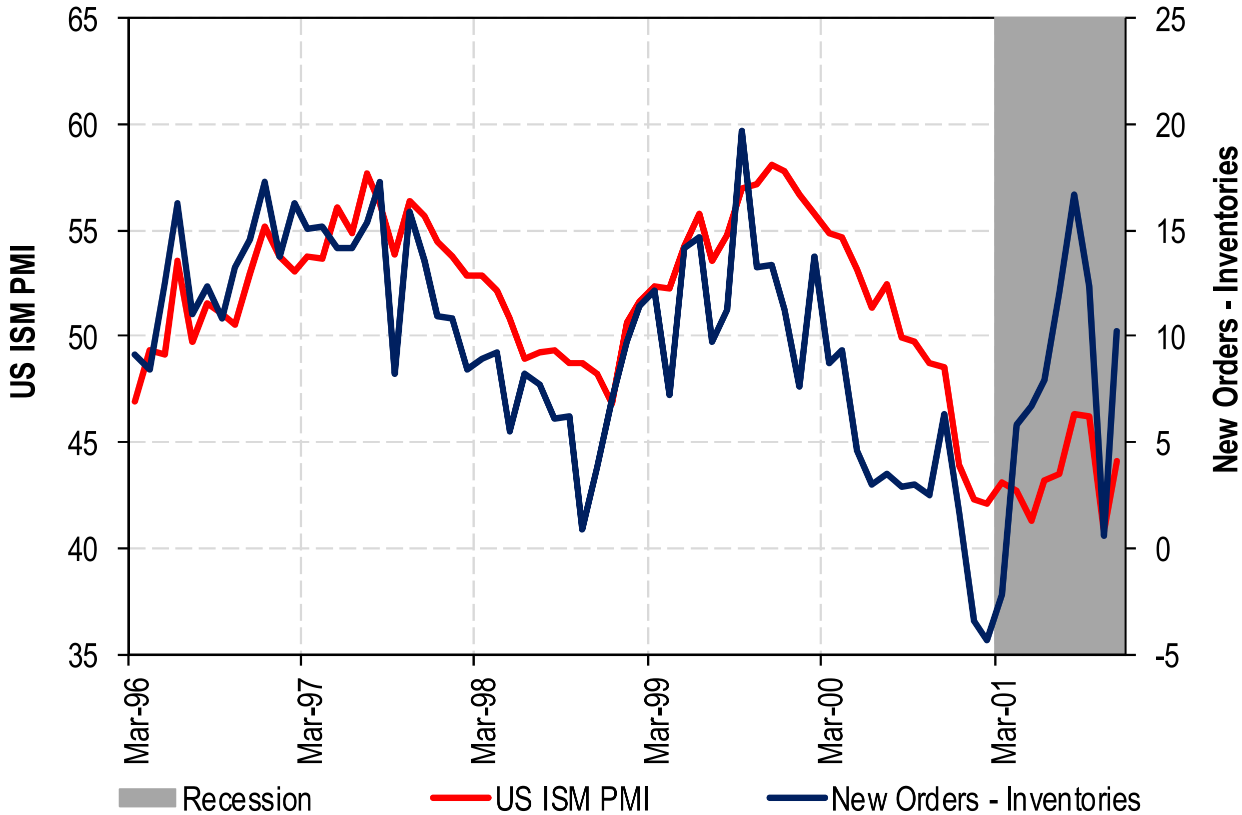
Will 2016 Be a Recession Year?

Mid-1980s into the 1990 recession: New Orders less Inventories deteriorated into the beginning of the recession.



Will 2016 Be a Recession Year?

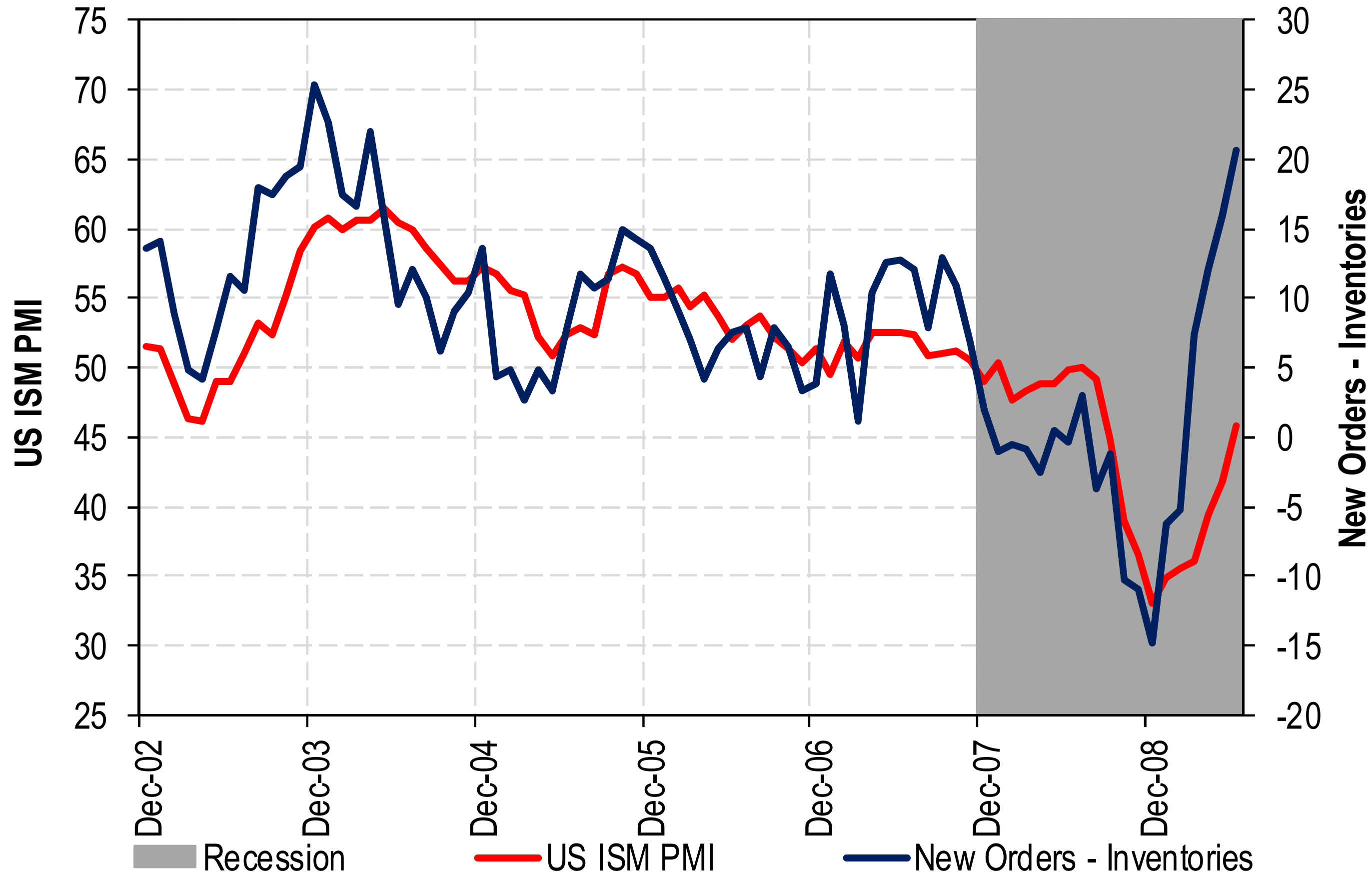
Similar conditions existed entering the 2001 recession...



Source: Institute of Supply Management, National Bureau of Economic Research

Will 2016 Be a Recession Year?

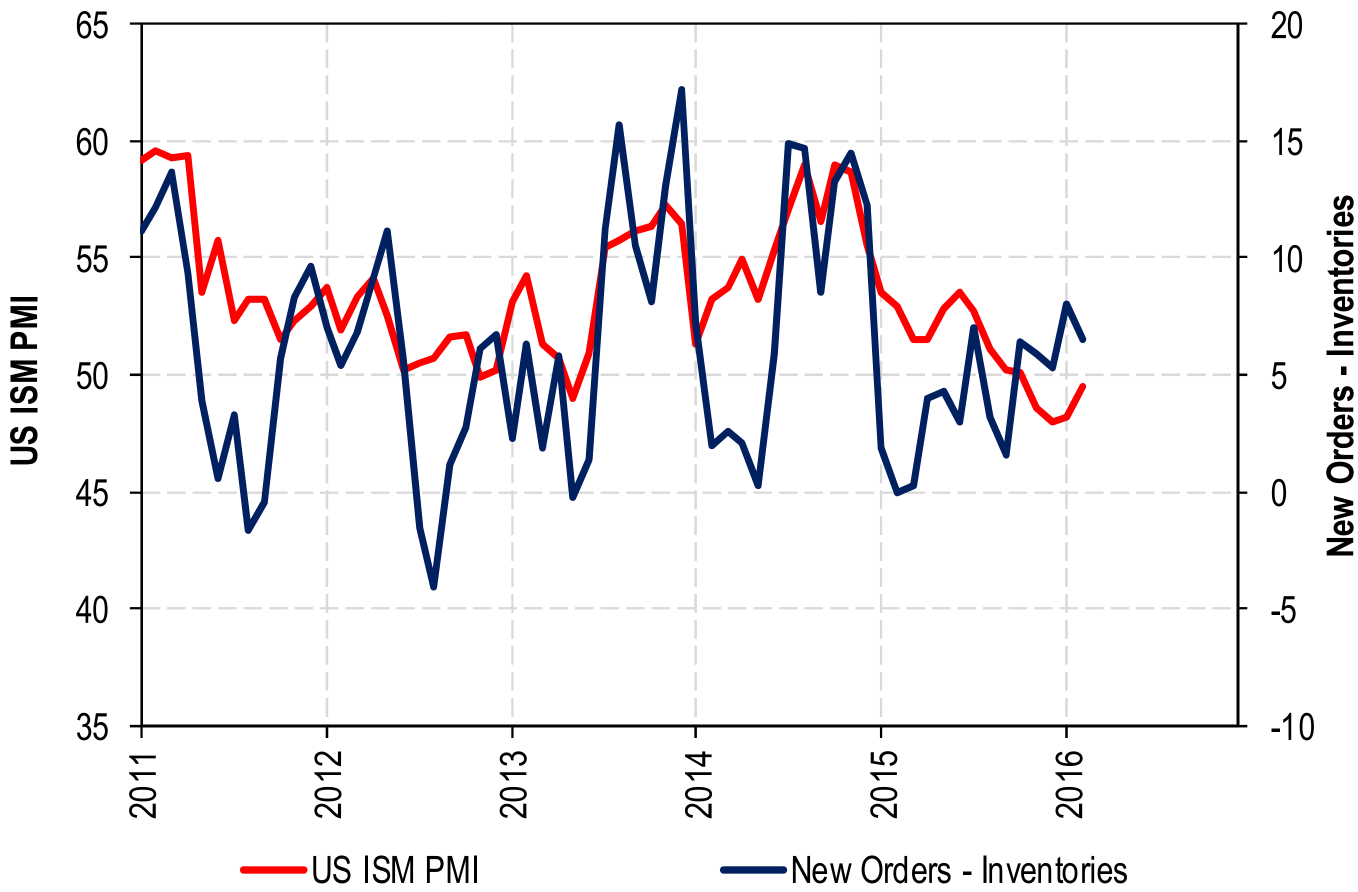
…As well as entering the Dec-2007 start of the last recession.



Source: Institute of Supply Management, National Bureau of Economic Research

Will 2016 Be a Recession Year?

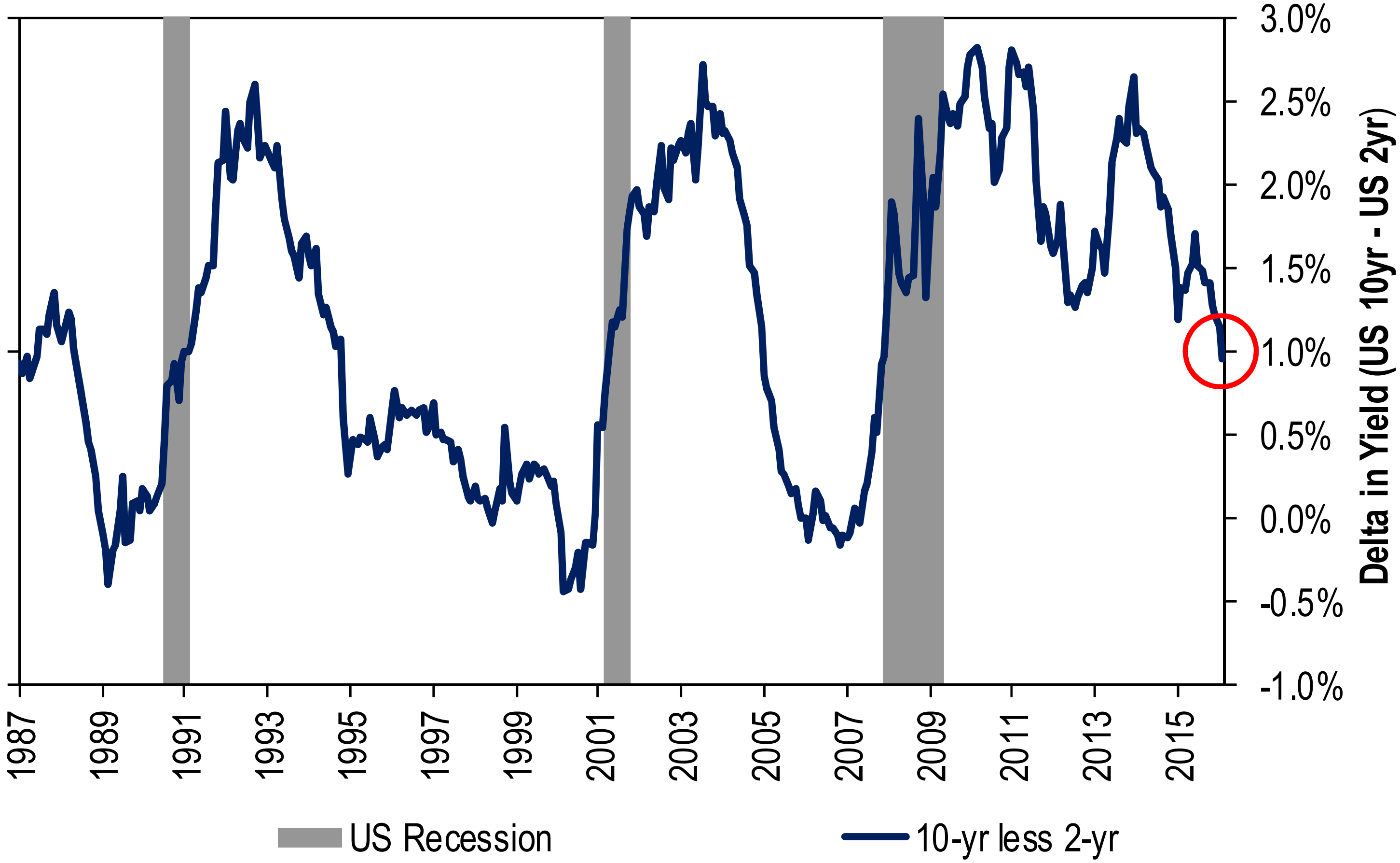
We don't have the same set-up at the moment.



Source: Institute of Supply Management, National Bureau of Economic Research

Will 2016 Be a Recession Year?

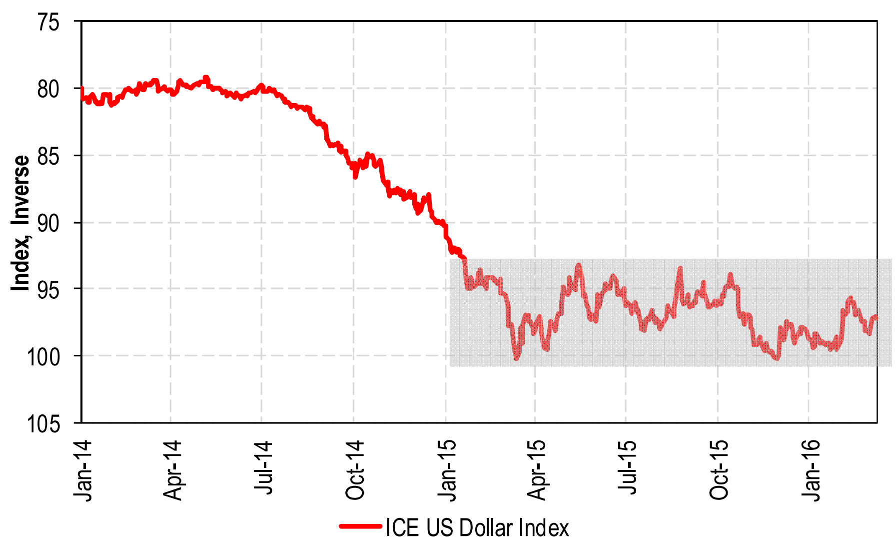
The US Treasury yield curve is flattening but hasn't inverted.

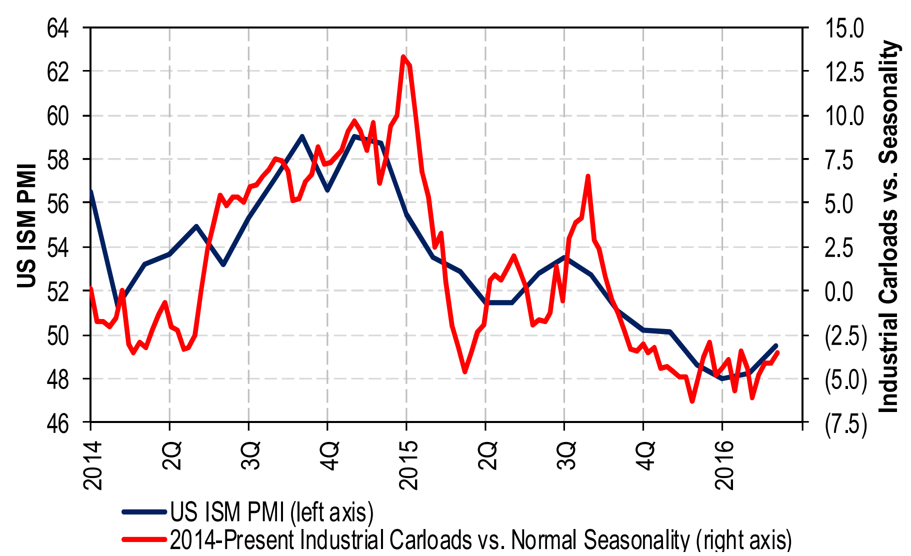


Source: National Bureau of Economic Research (NBER), FactSet

Will 2016 Be a Recession Year?

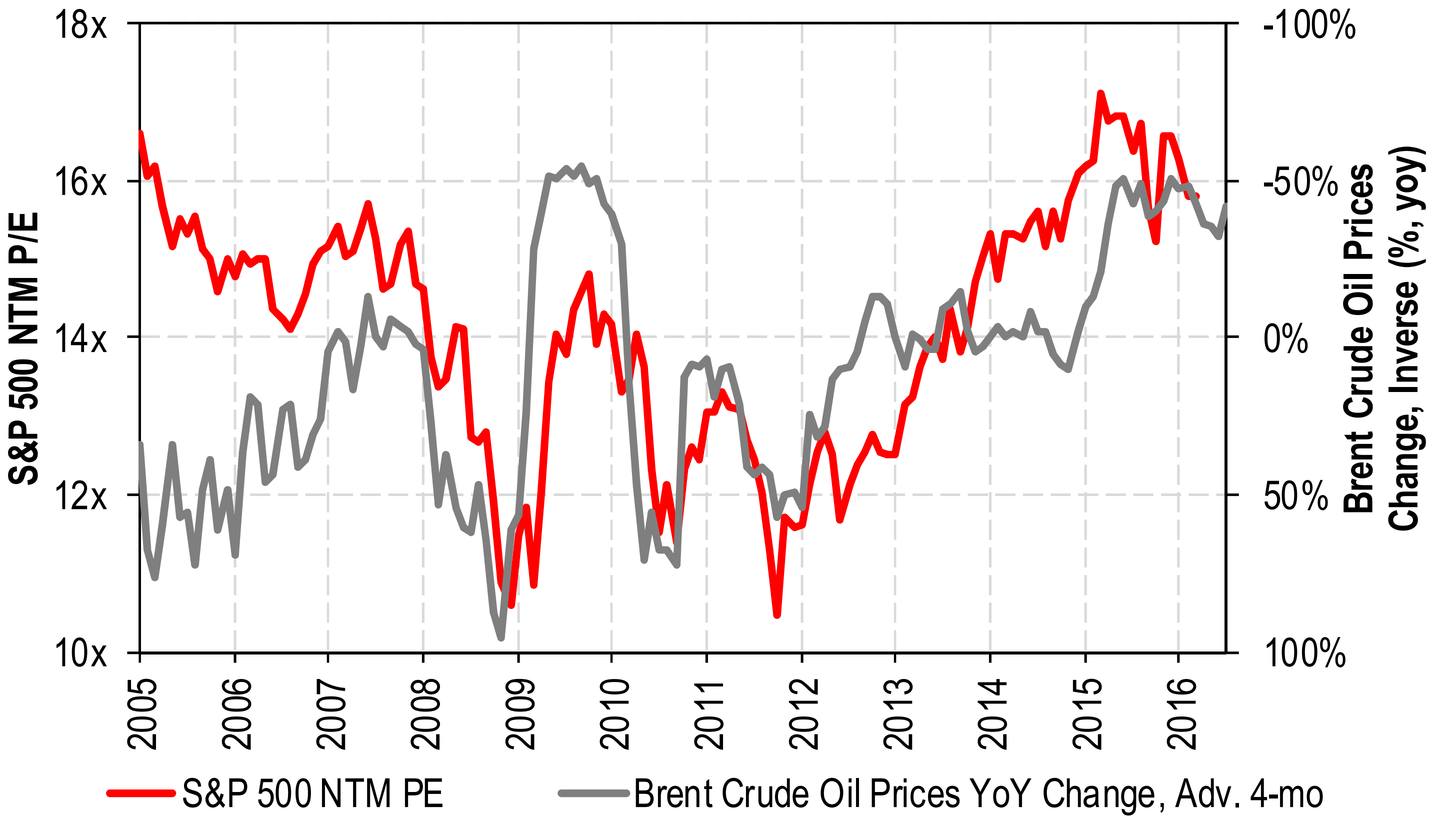
The USD has weakened recently and has not made fresh highs since mid-March 2015, setting up for potential improvement in seasonally adjusted industrial-related volumes in the coming months (relative to well-below seasonal trends during 4Q15).





Will 2016 Be a Recession Year?

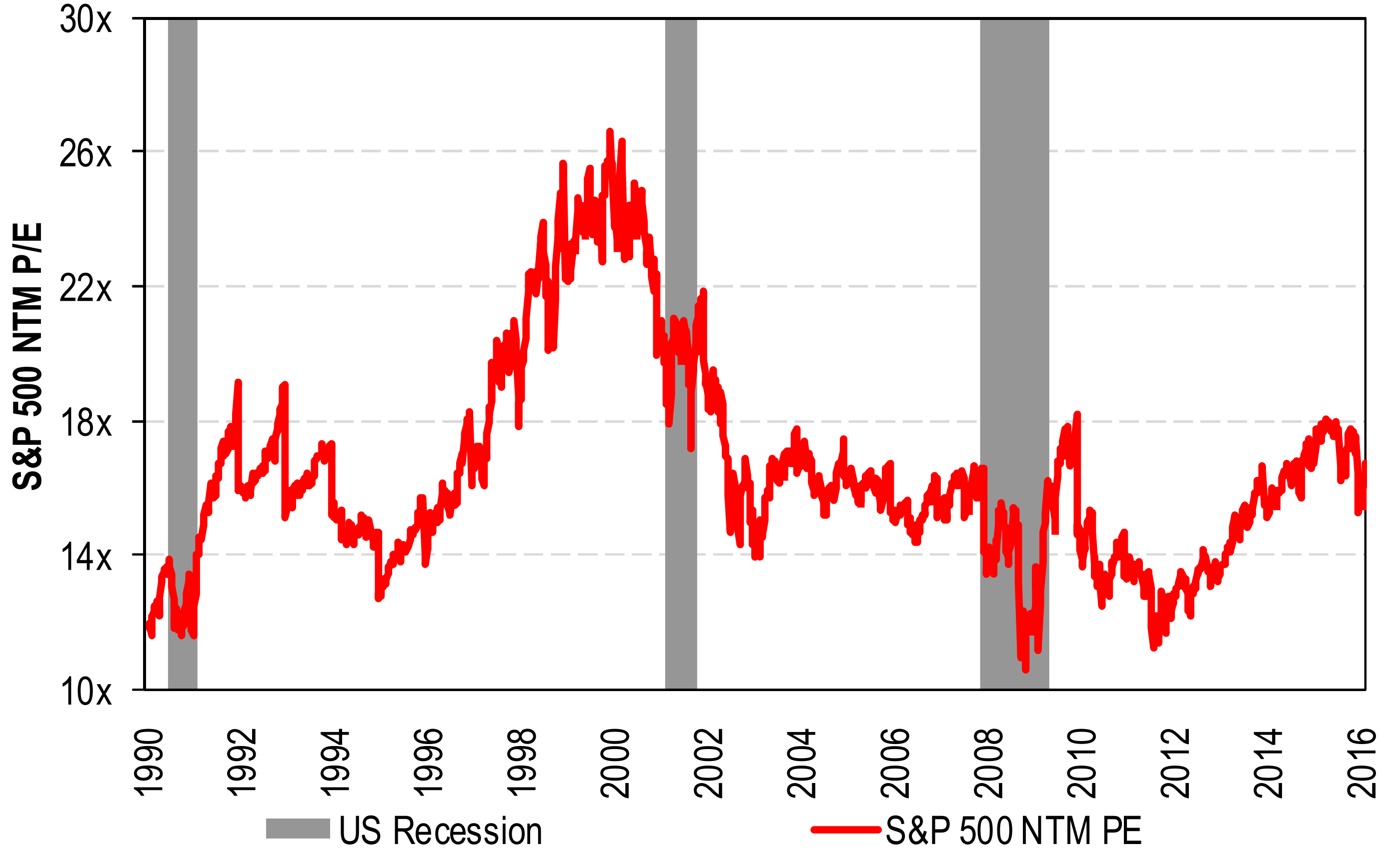
Falling crude oil prices also historically inflate equity valuations...



Source: FactSet

Will 2016 Be a Recession Year?

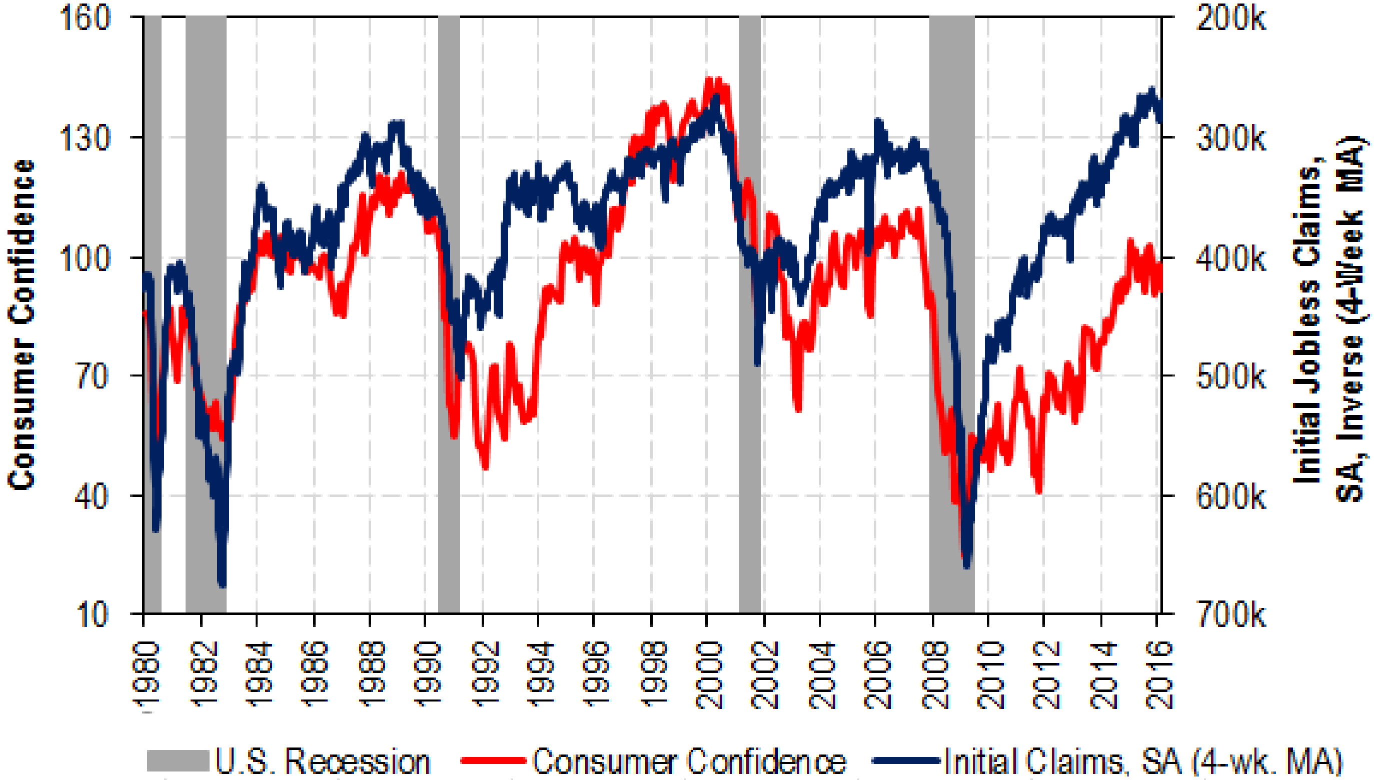
…And current valuations aren't unreasonable in the context of the last 25 years (or against recent 1.75% US 10-year Treasury yields).



Source: Bloomberg, NBER

Will 2016 Be a Recession Year?

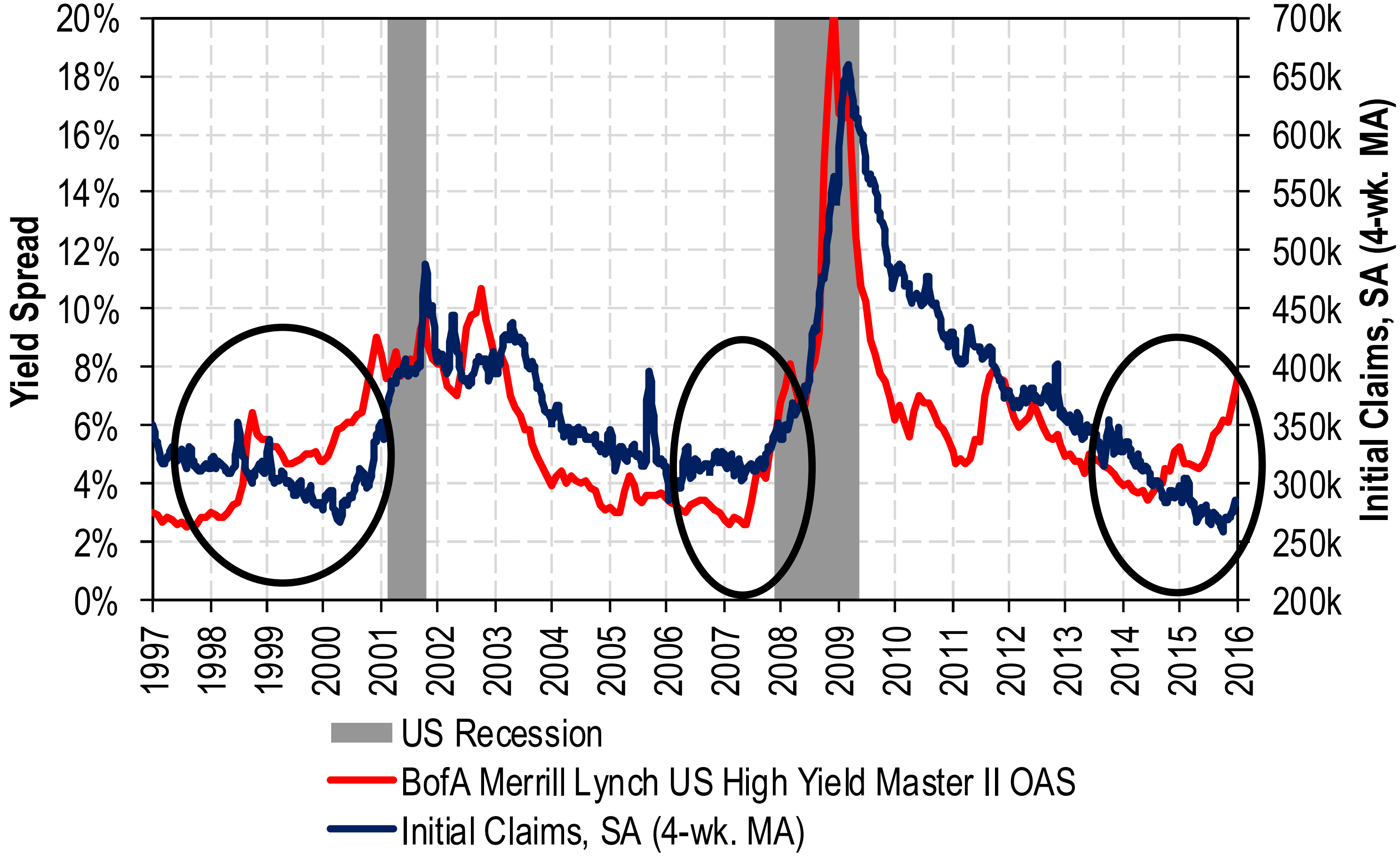
Consumer confidence and initial jobless claims are near cycle peaks (but jobless claims in particular are a lagging indicator, and recent readings have weakened).



Source: Conference Board, NBER, U.S. Employment and Training Association

2016's Economic Landscape Reflects A Late-Cycle US Recovery

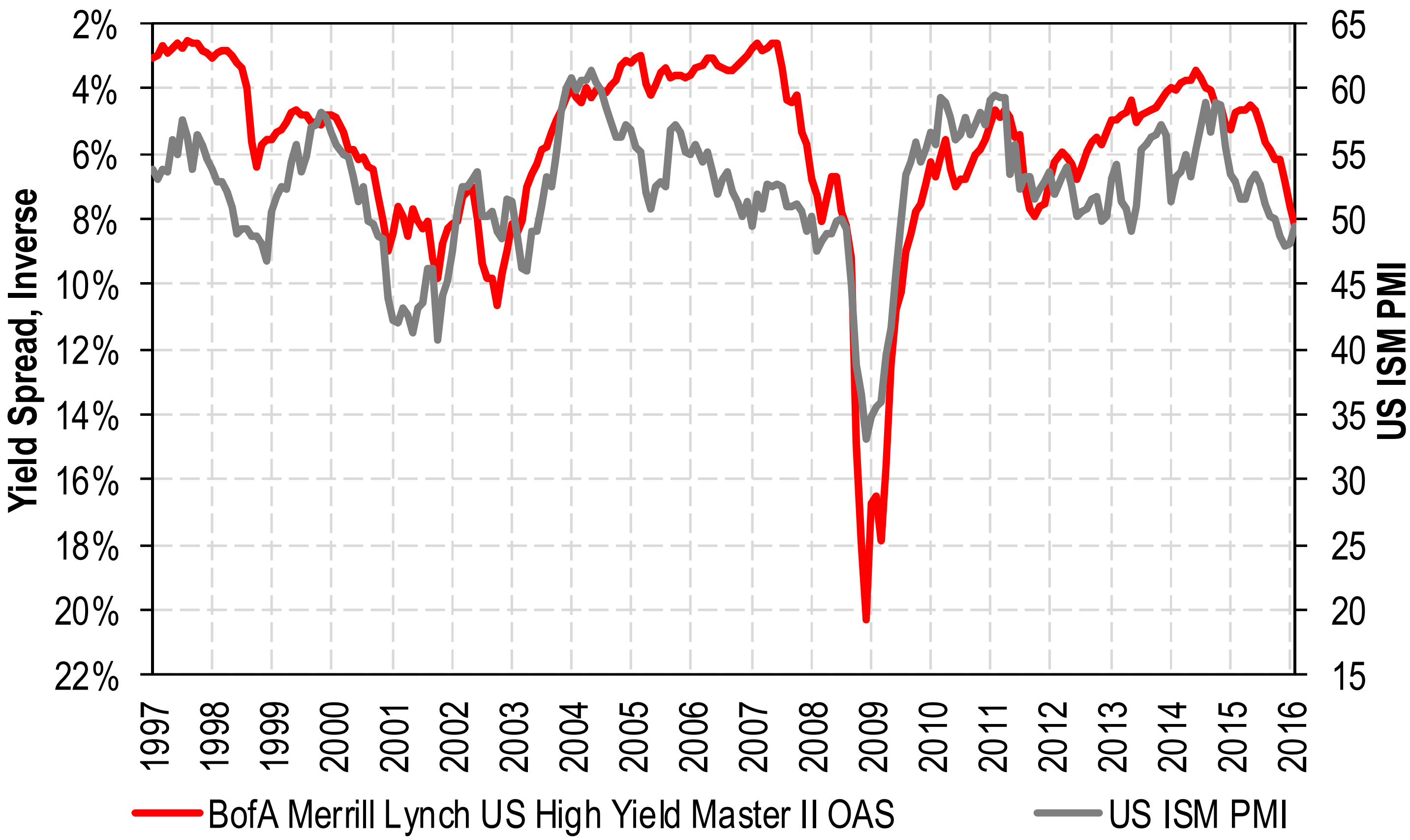
Widening yield spreads are reflective of a later-cycle US recovery.



Source: Bank of America Merrill Lynch, FactSet,
FRED, National Bureau of Economic Research (NBER)

2016's Economic Landscape Reflects A Late-Cycle US Recovery

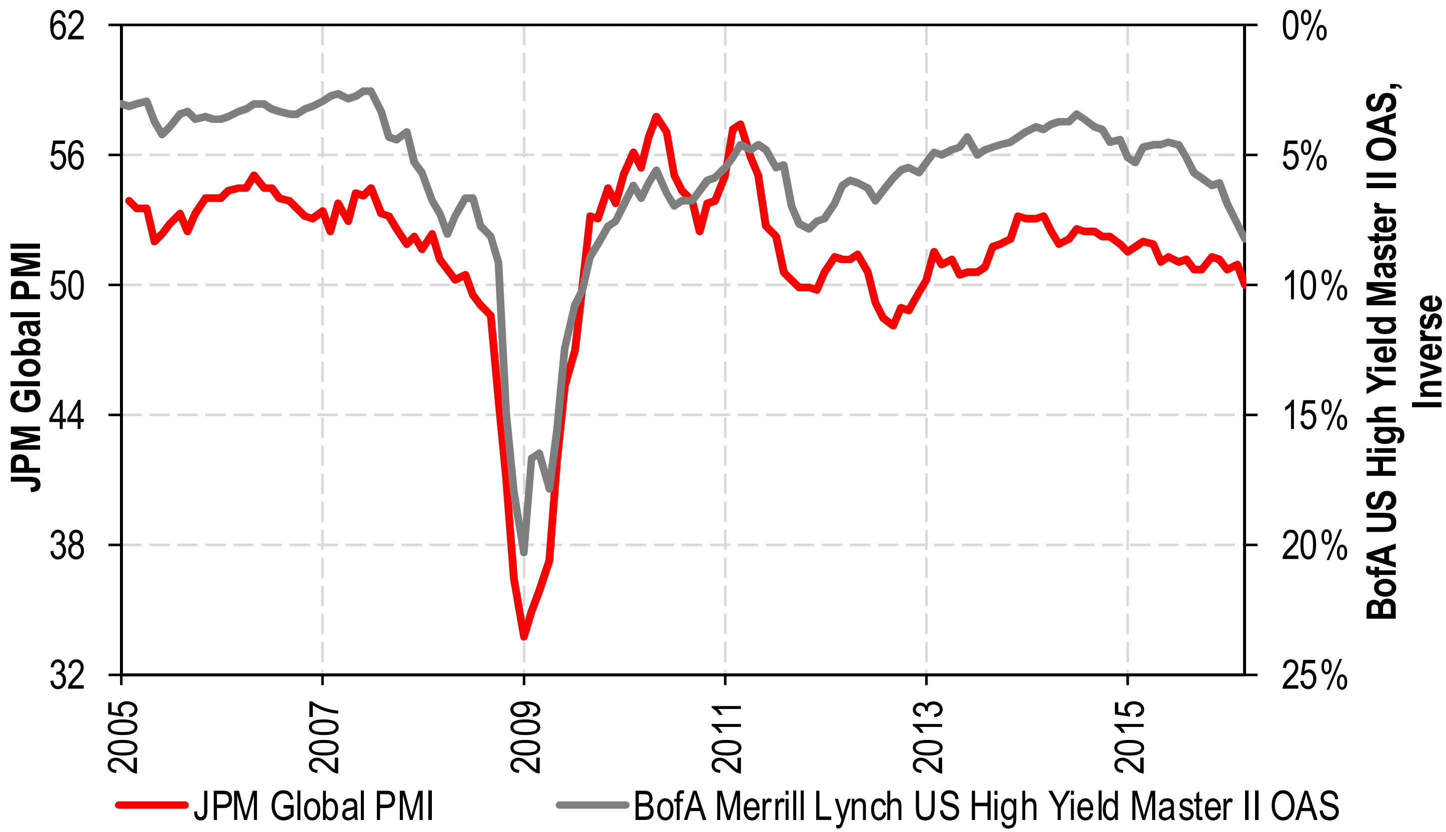
Widening yield spreads also tend to coincide with a weakening US ISM PMI.



Source: BAML, ISM

Implications for 2016 Freight Demand

Weakening international PMI also coincides with widening yield spreads...

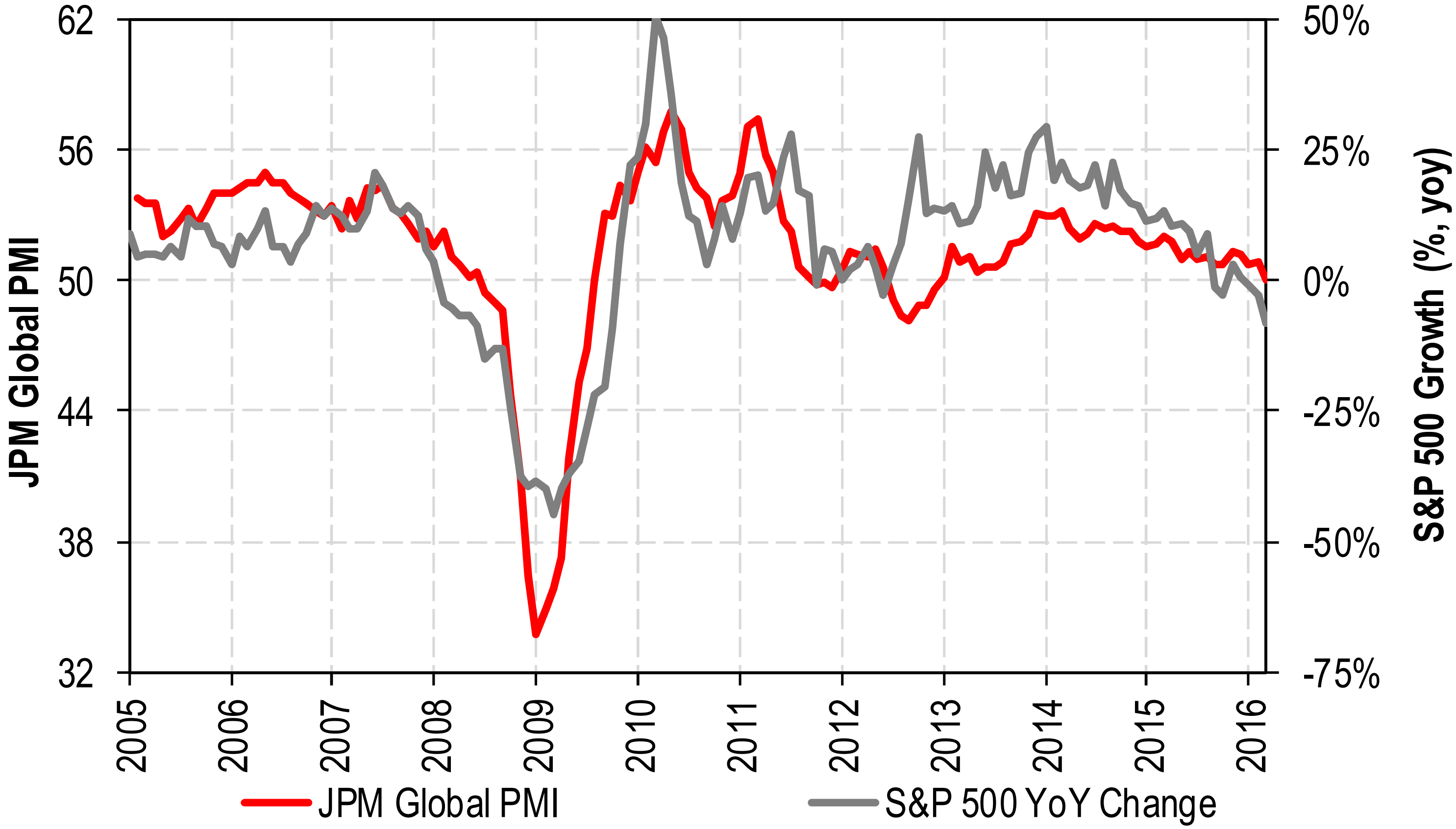


Source: BAML, JP Morgan

Implications for 2016 Freight Demand

BAIRD

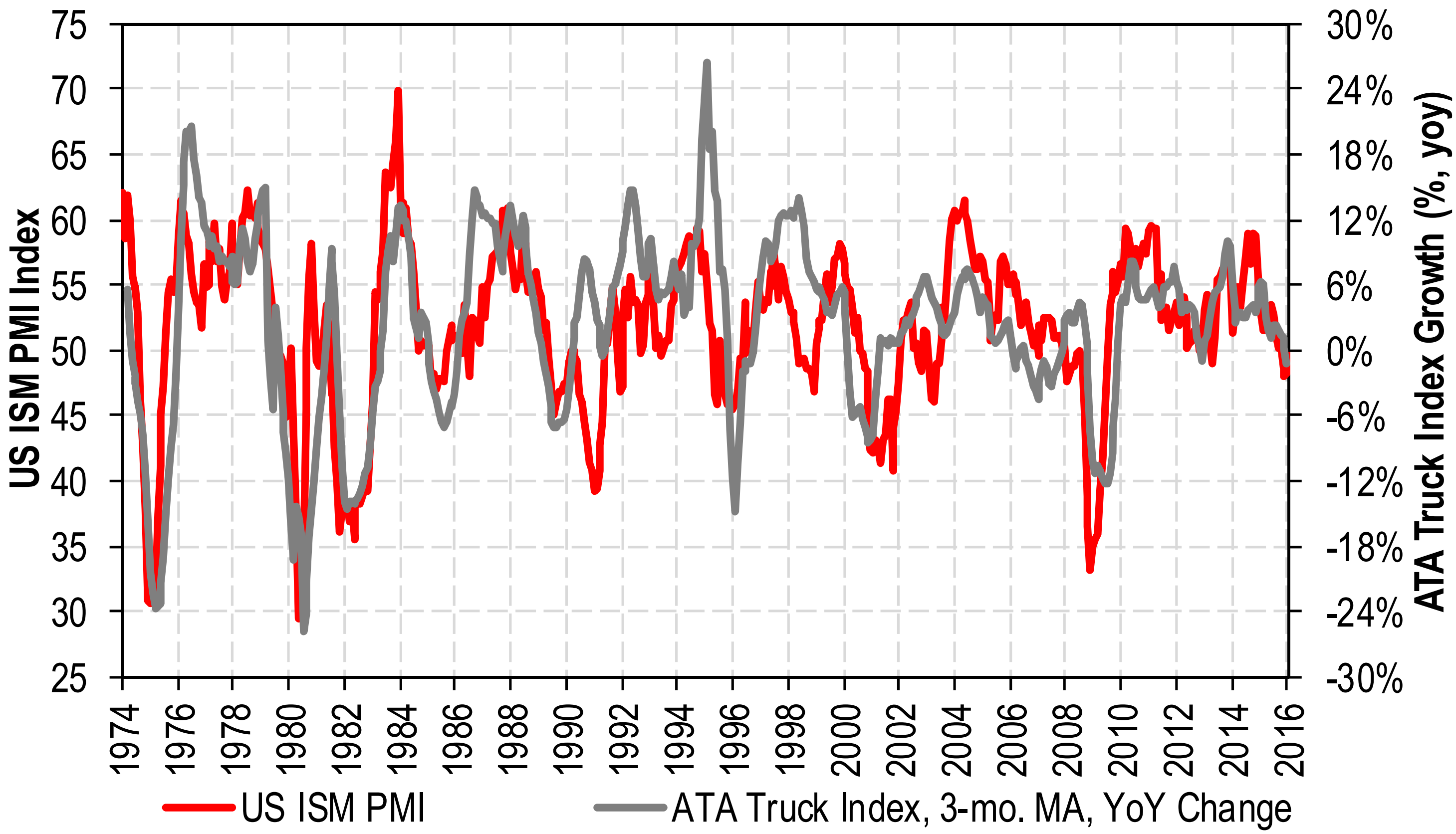
...And a softening US stock market.



Source: FactSet, JP Morgan

Implications for 2016 Freight Demand

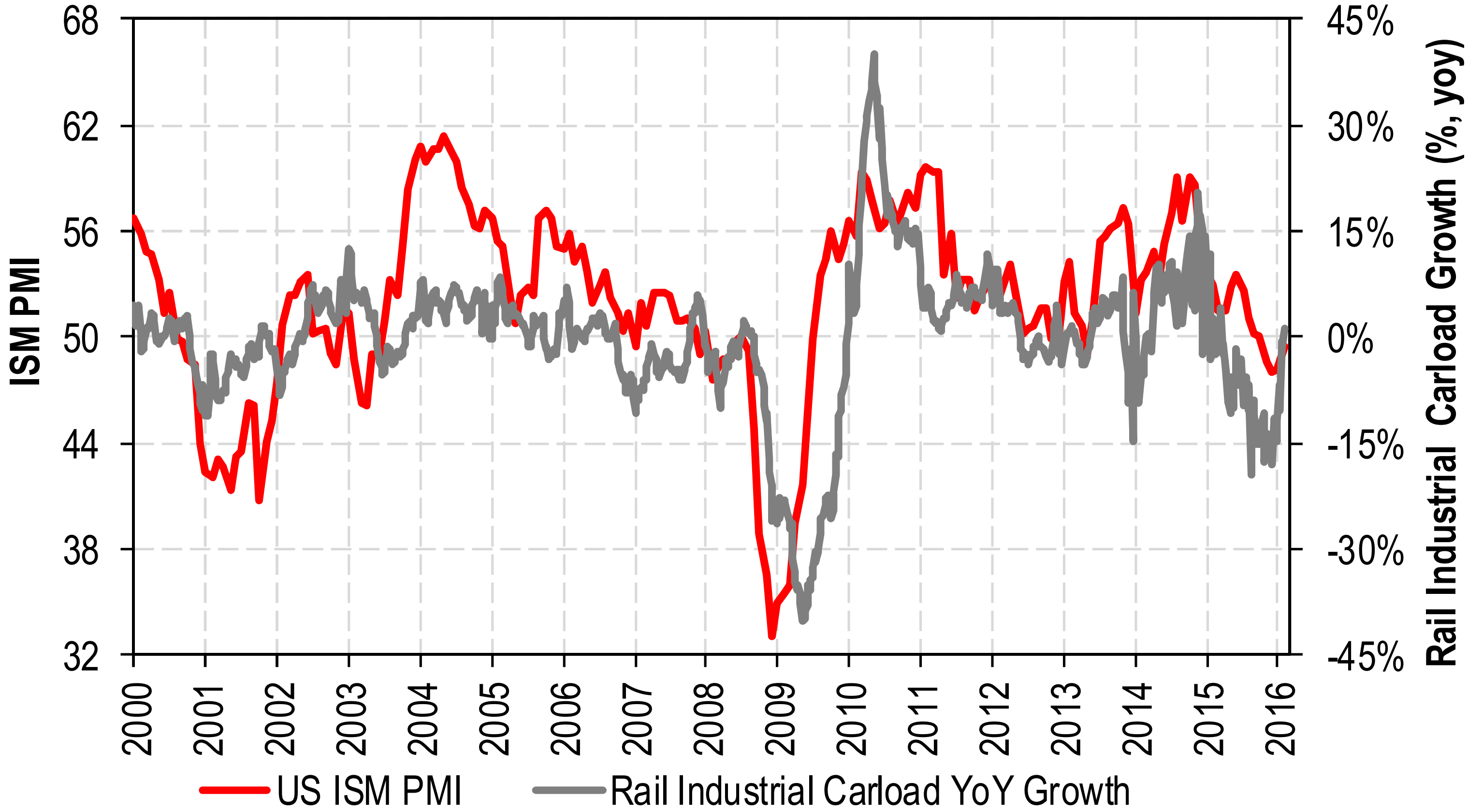
PMI weakness is correlated with declines in ATA trucking index growth...



Source: ATA, ISM

Implications for 2016 Freight Demand

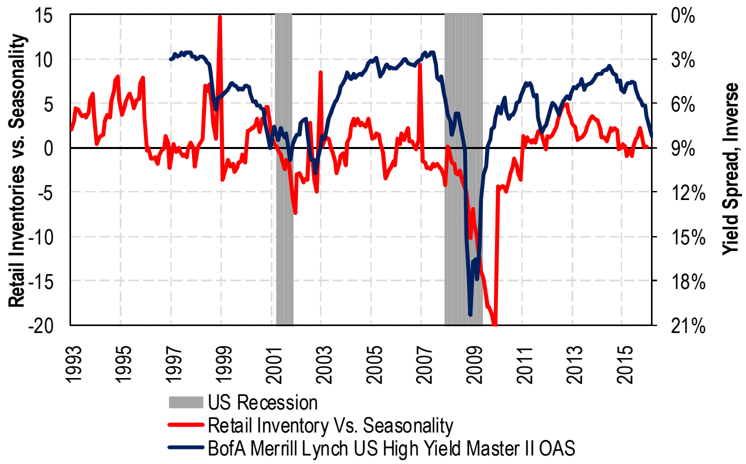
...And declines in industrial carload growth.

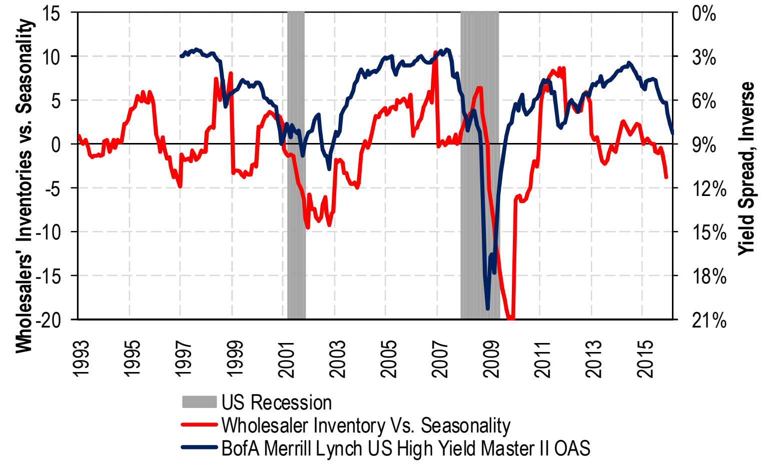


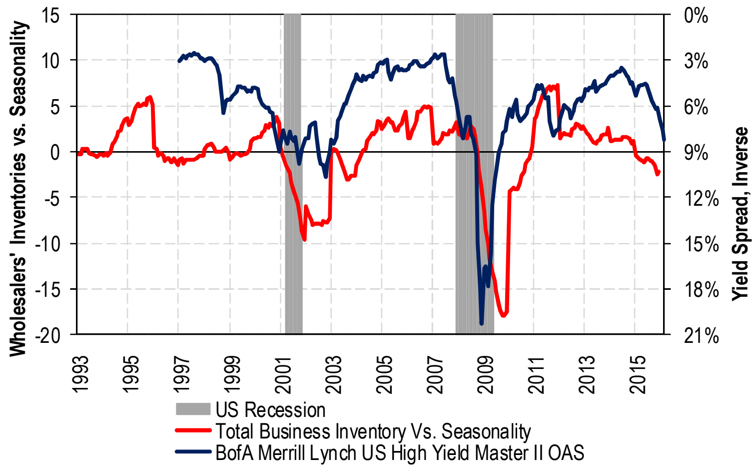
Source: AAR, ISM

Implications for 2016 Freight Demand

Widening spreads and US recessions can also trigger inventory destocking, another risk to freight volumes.



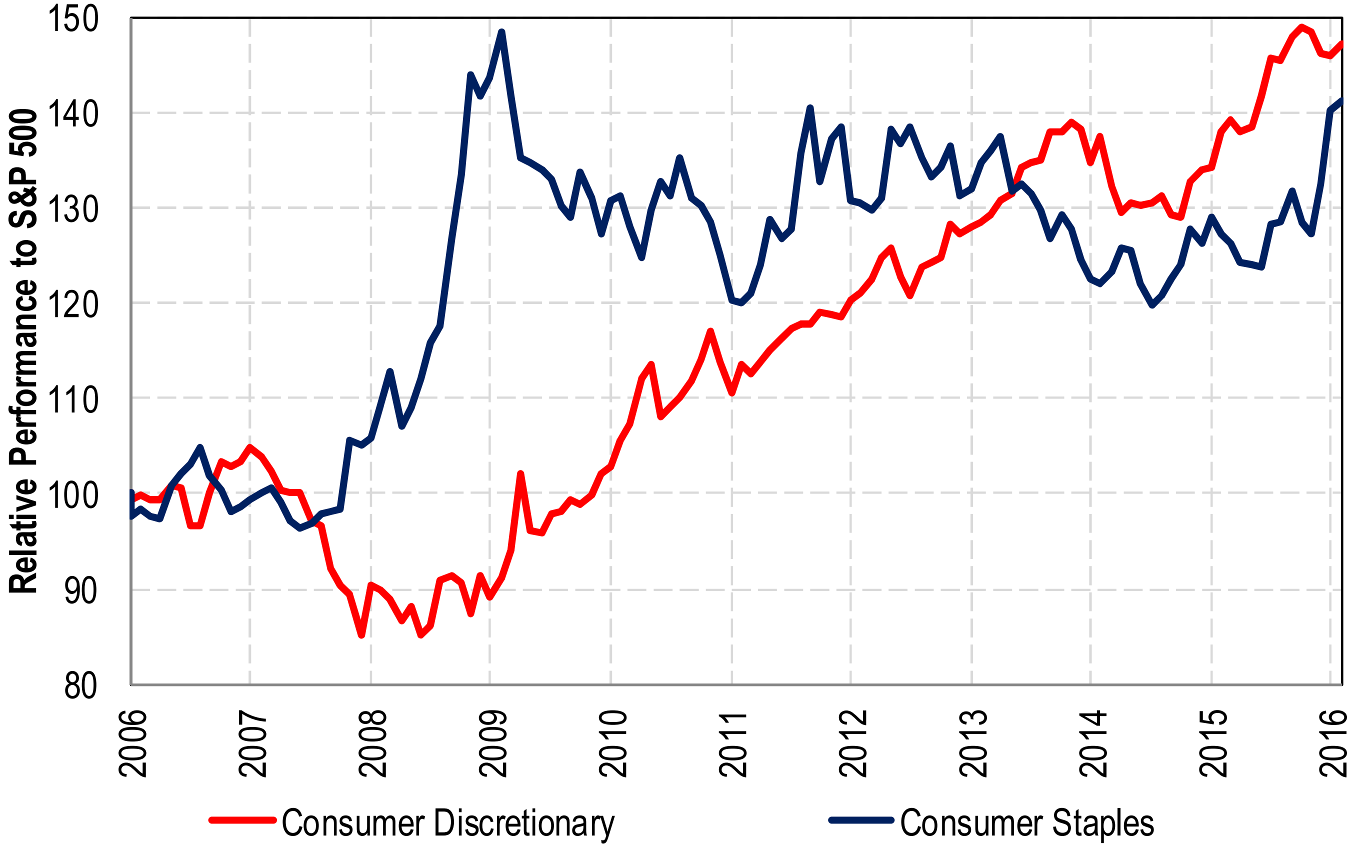




Source: BAML, NBER, US Census Bureau

Implications for 2016 Freight Demand

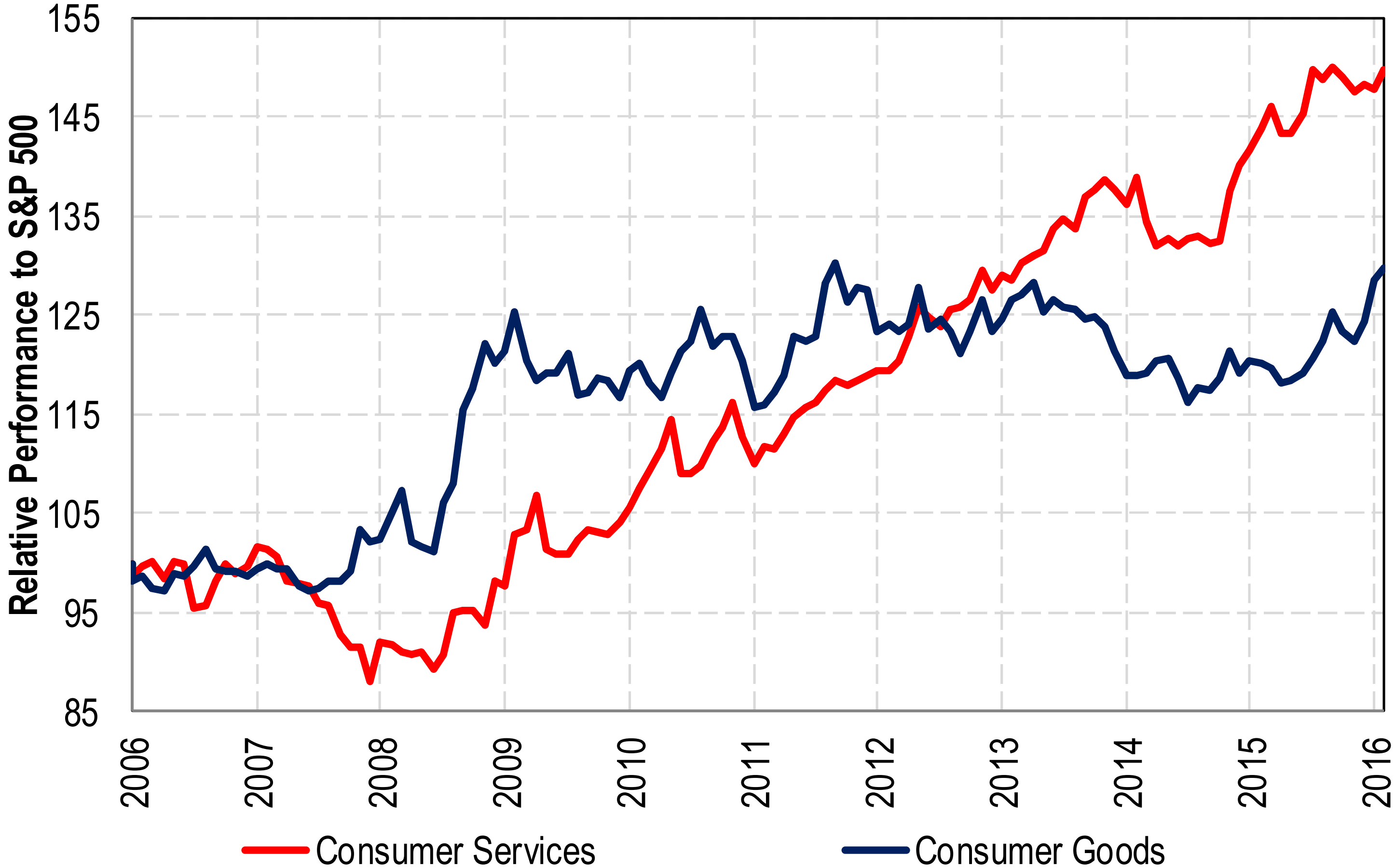
Consumer discretionary stocks outperformed staples during 2015, but the gap has narrowed to begin 2016.



Source: FactSet

Implications for 2016 Freight Demand

The outperformance of consumer services vs. goods has continued into 2016.

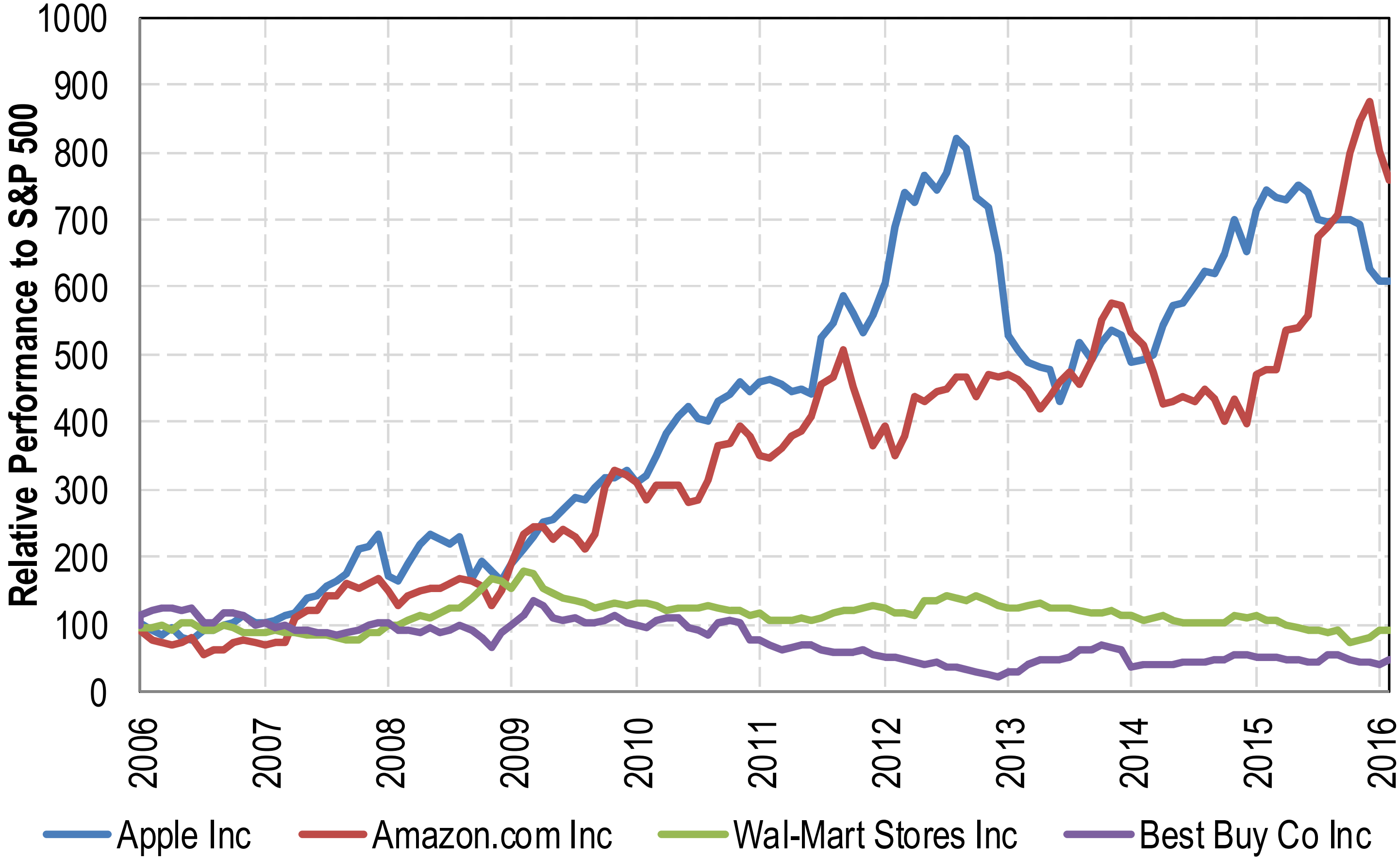


Source: FactSet

Implications for 2016 Freight Demand

BAIRD

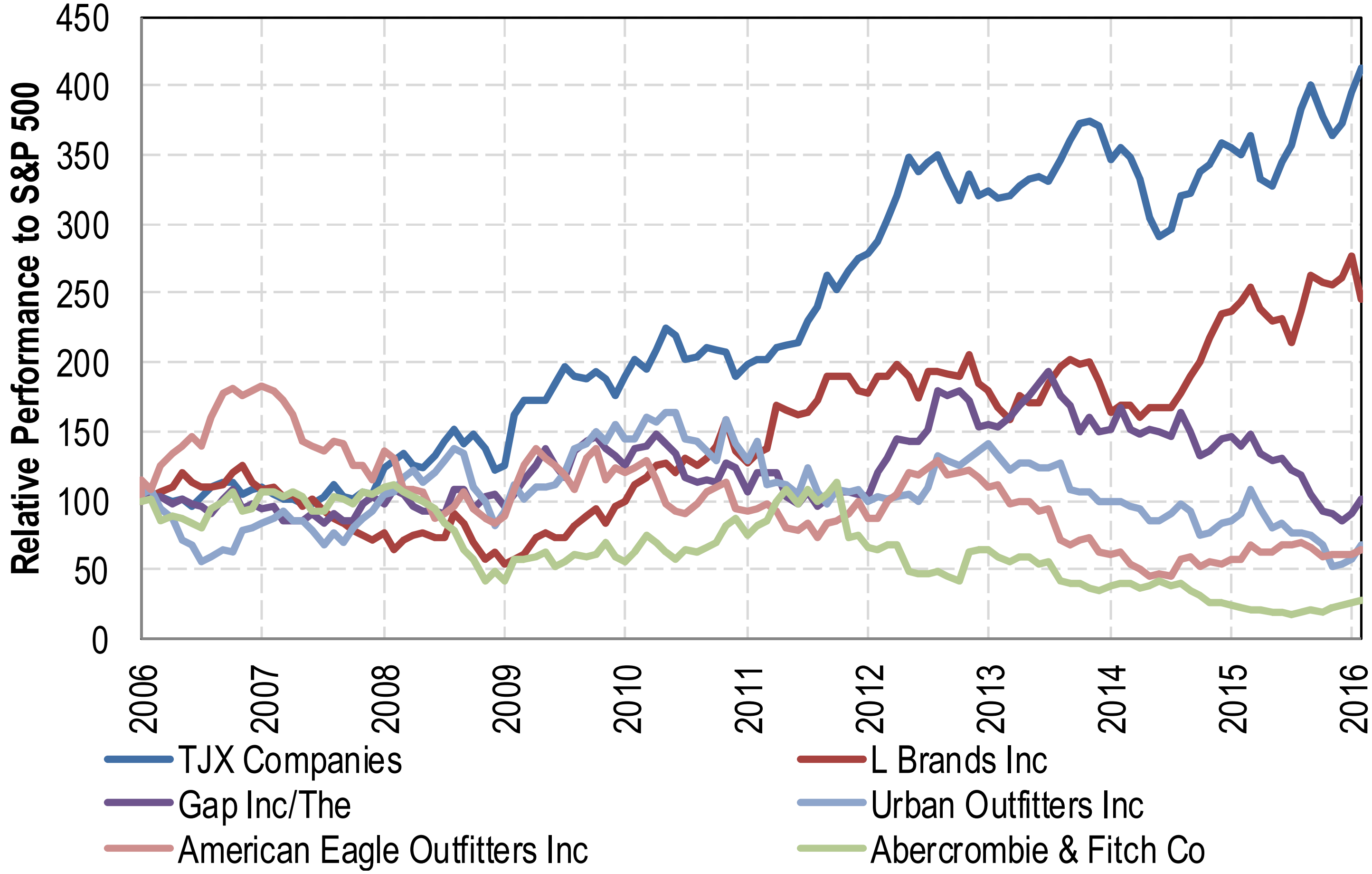
Retail stock performance masks clear winners and losers.



Source: FactSet

Implications for 2016 Freight Demand

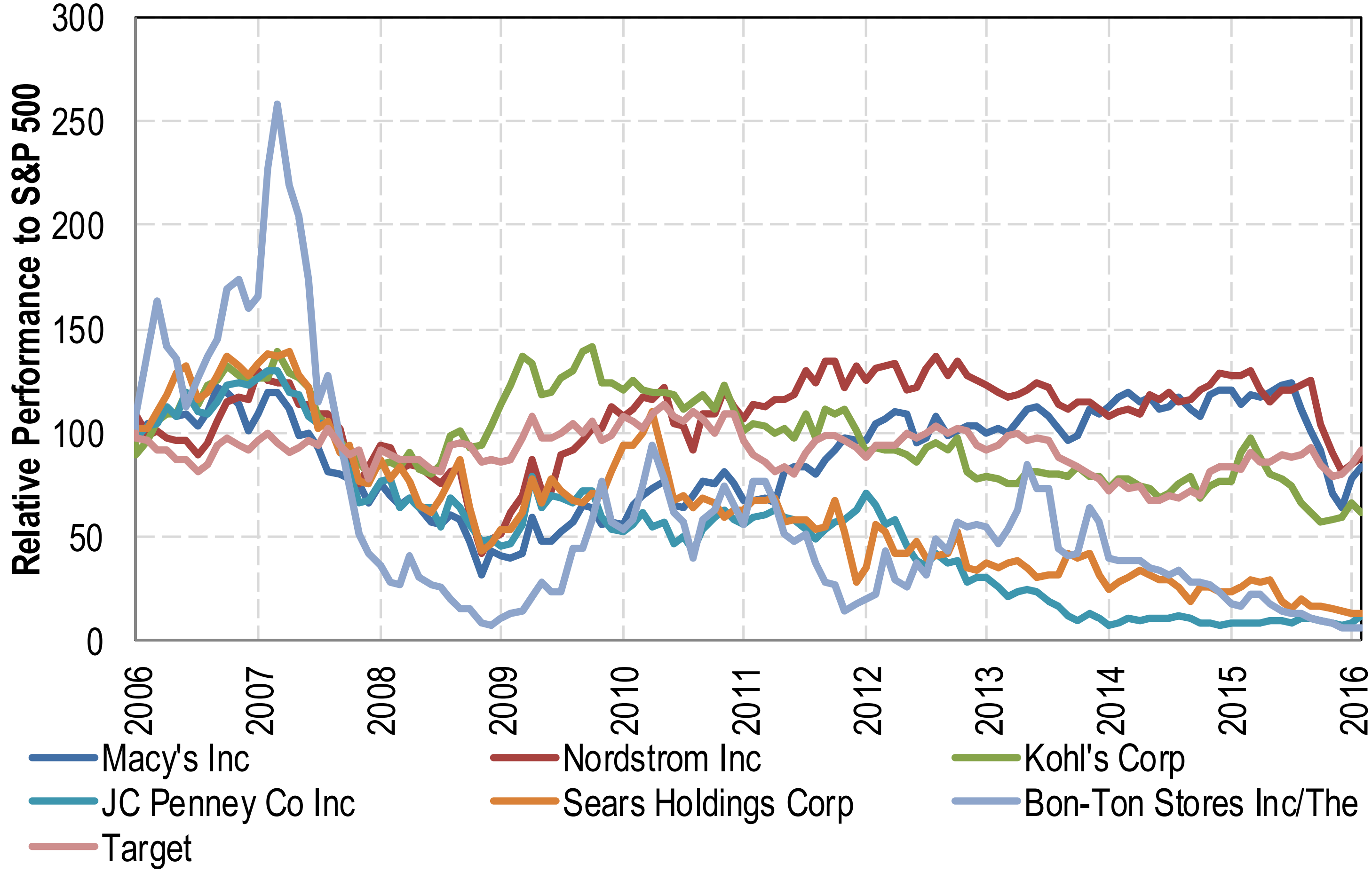
Retail stock performance masks clear winners and losers.



Source: FactSet

Implications for 2016 Freight Demand

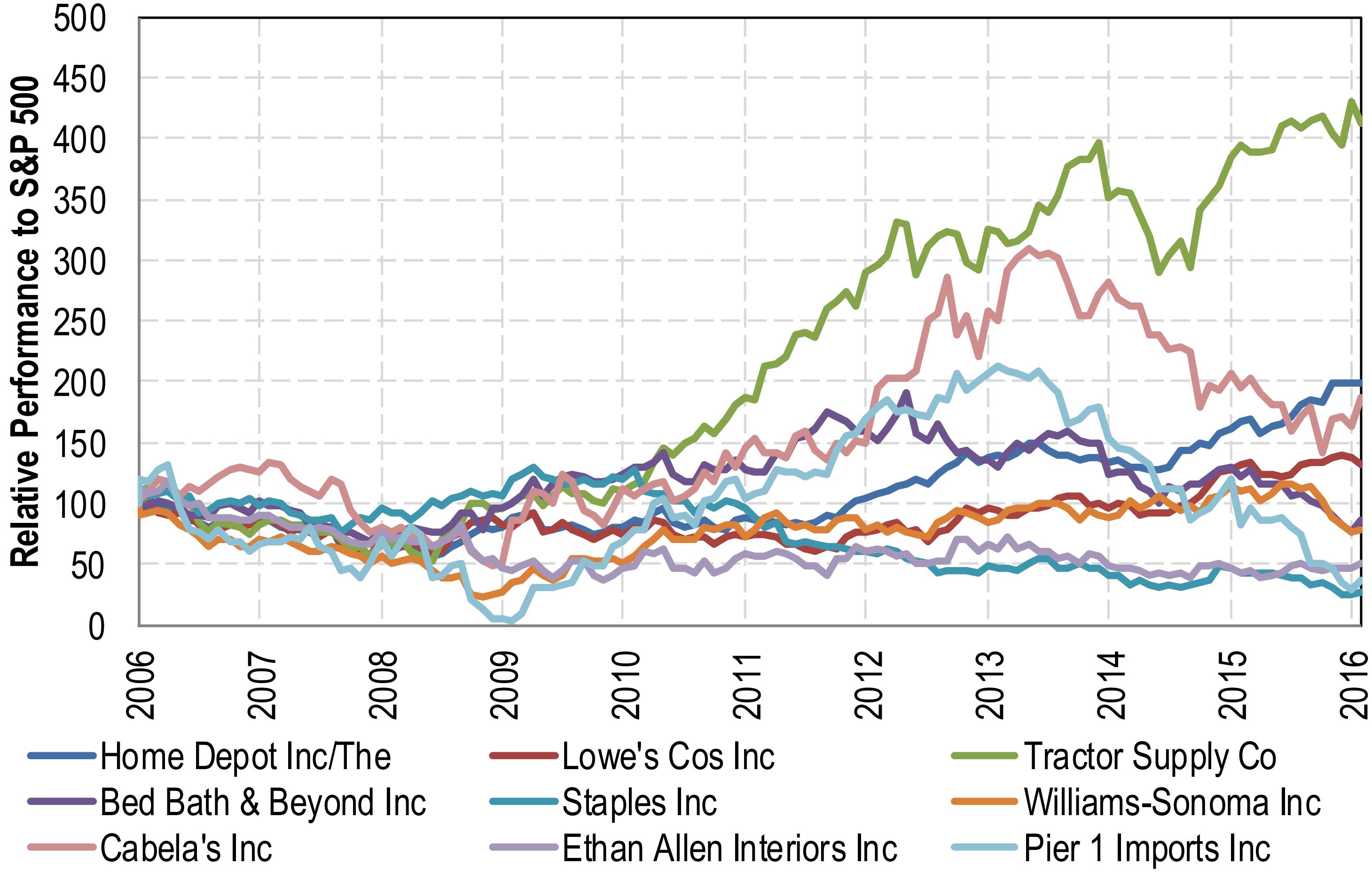
Retail stock performance masks clear winners and losers.



Source: FactSet

Implications for 2016 Freight Demand

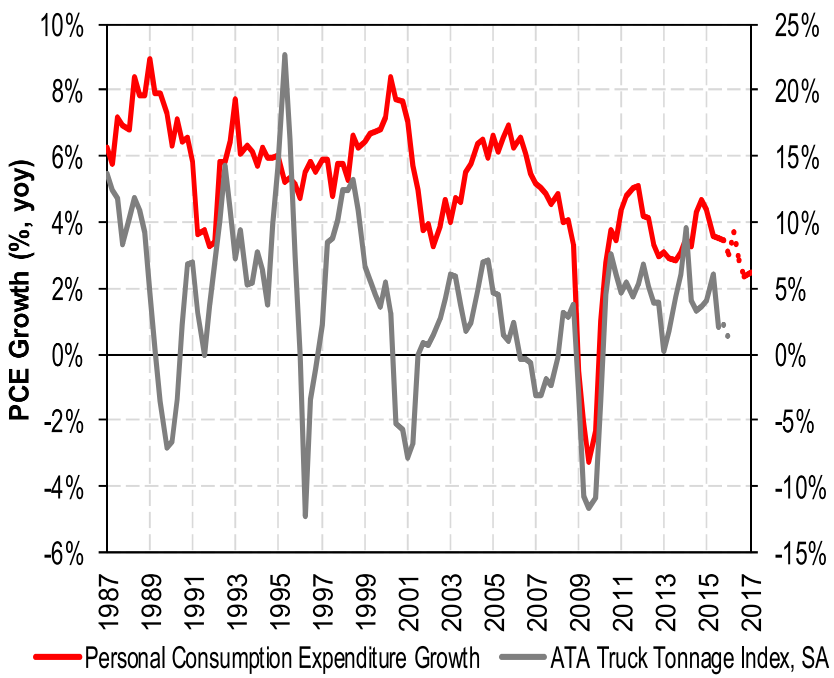
Retail stock performance masks clear winners and losers.

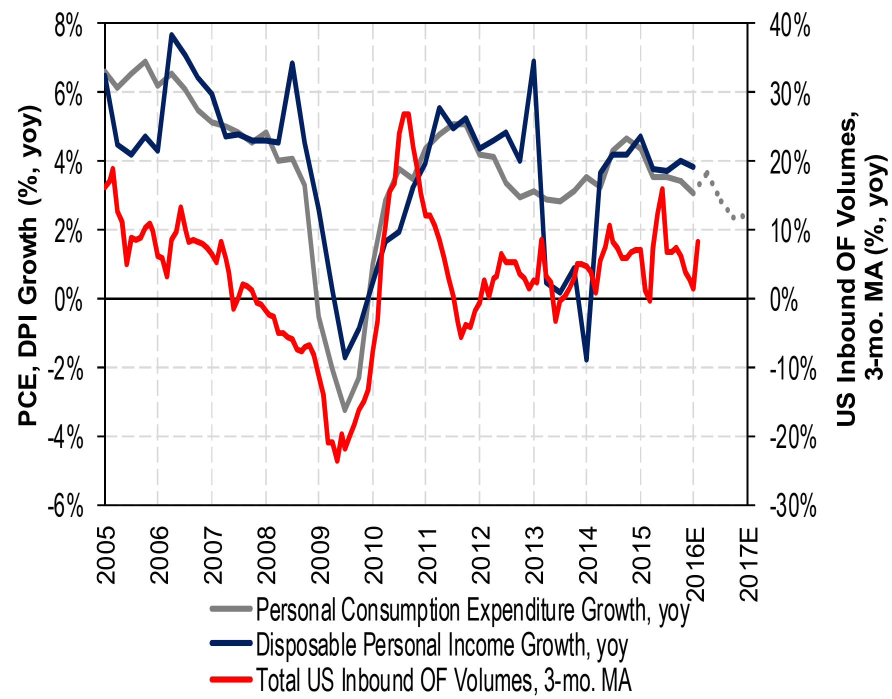


Source: FactSet

Implications for 2016 Freight Demand

Preliminary 2016 consumer spending forecasts do not reflect a strengthening consumer demand outlook, either.

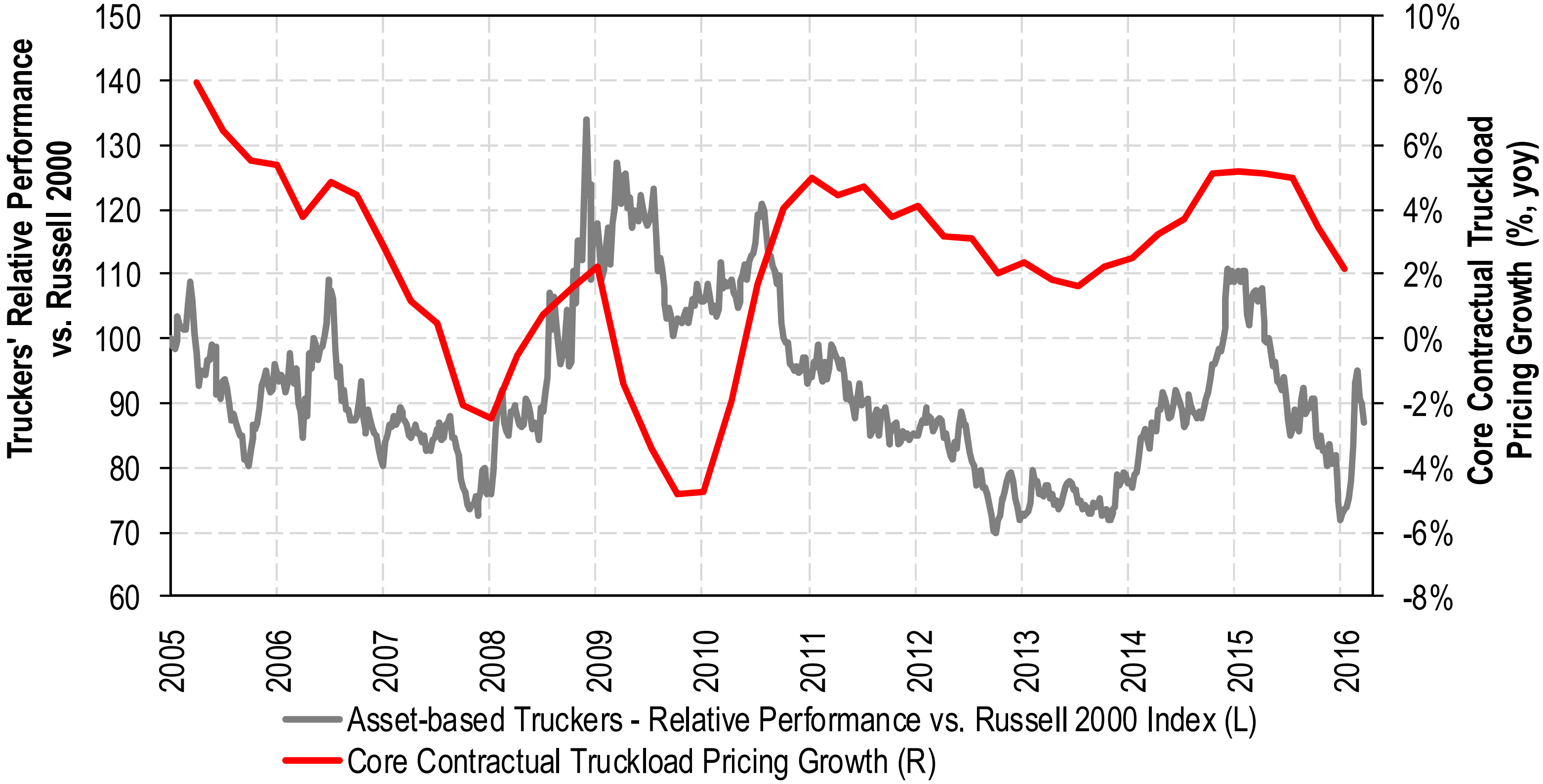




Source: ATA, Blue Chip Economic Indicators, Federal Reserve, Port data, US Dept. of Commerce, Baird estimates

Implications for 2016 Freight Demand

Risks to industrial and consumer demand set transports up for a continuation of the deceleration in core pricing growth, and we expect a very active 2016 bid season, which should produce core 2016 TL pricing growth of +1-2% yoy.

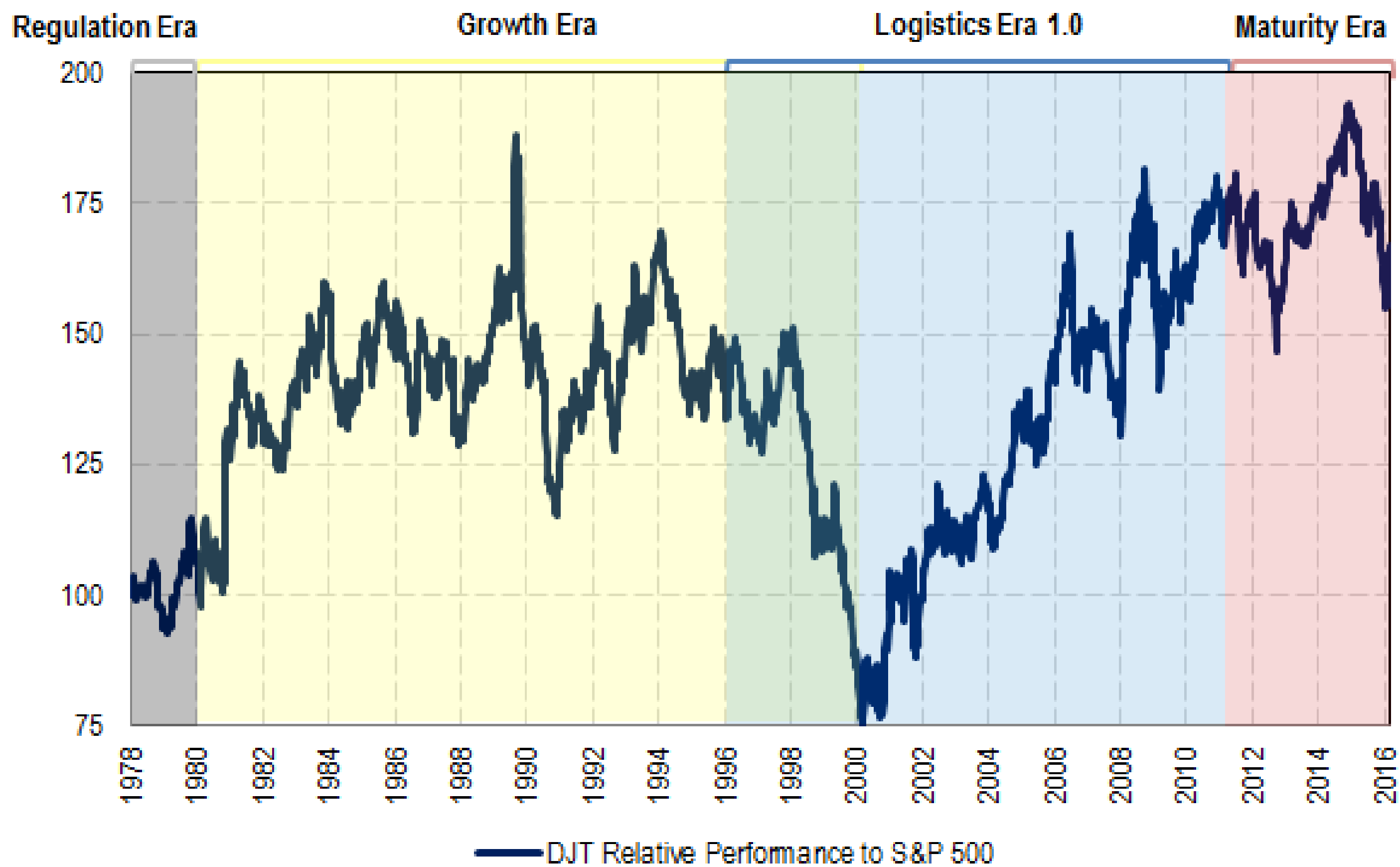


Source: FactSet, Baird estimates

A Look at Transports Since Deregulation

Perspective on Transports Since Deregulation

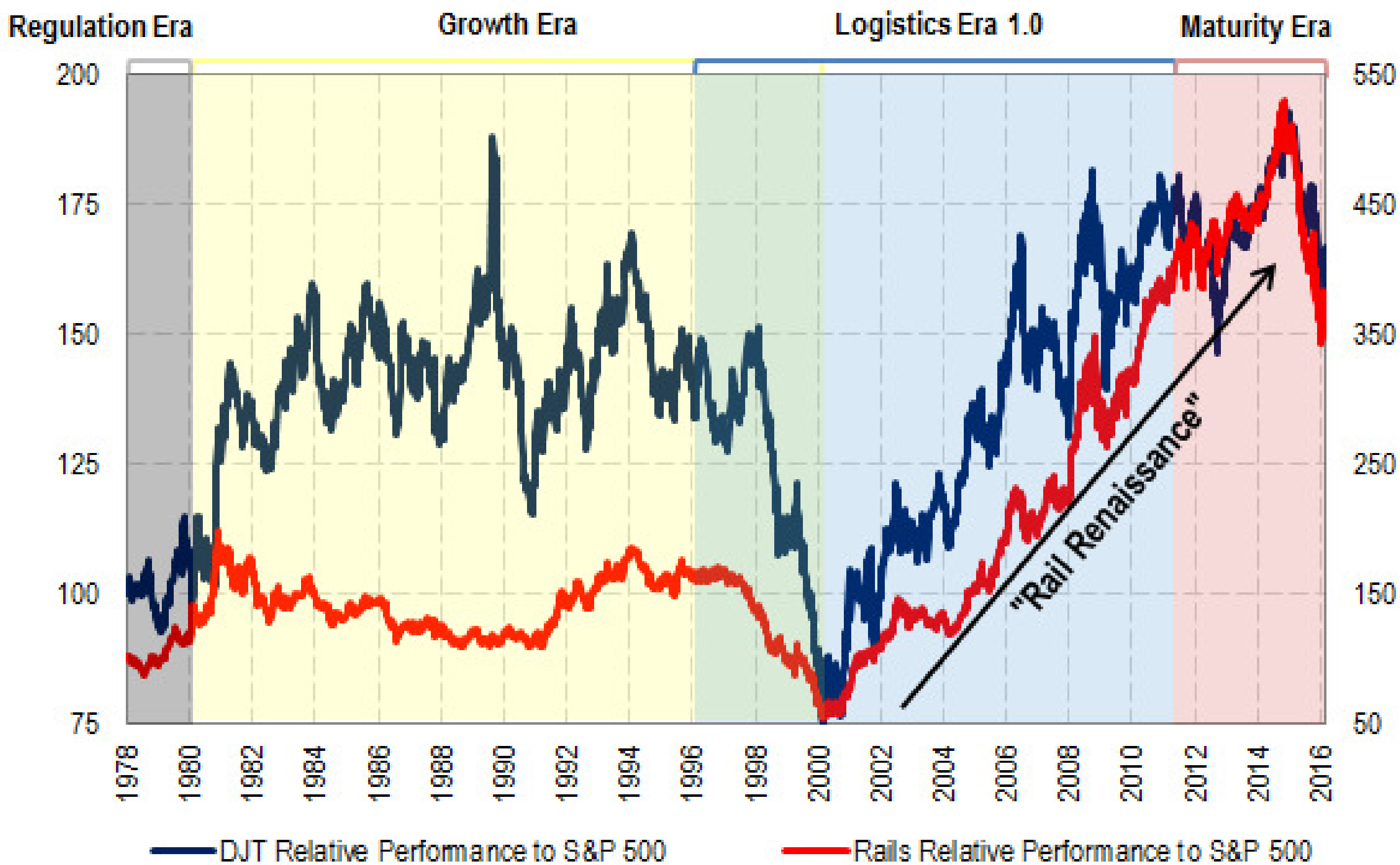
The modern transportation industry is defined by four key Eras: 1) Regulation, 2) Growth, 3) Logistics Era 1.0, and 4) Maturity.



Source: FactSet

Rails Across Eras

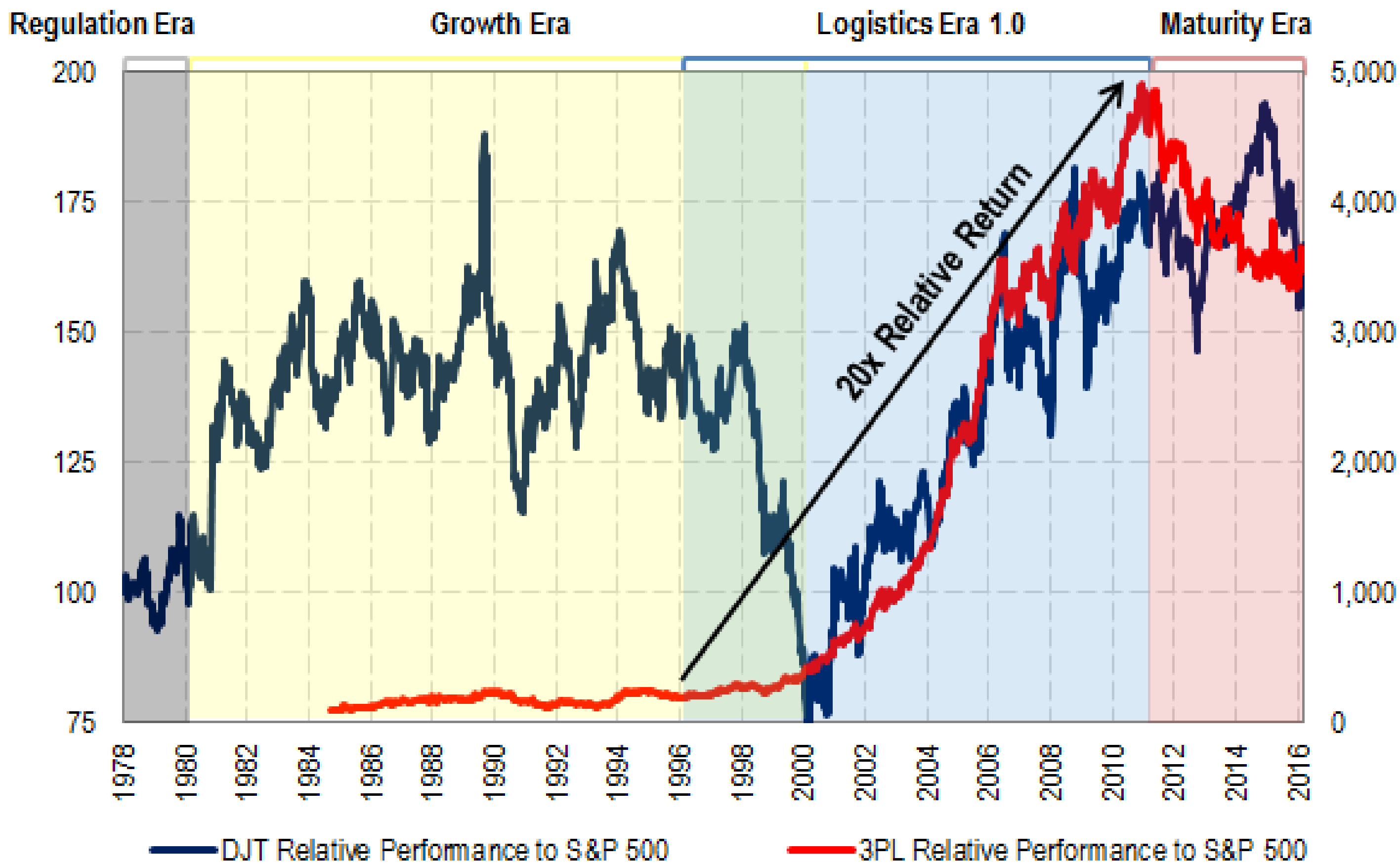
Industry deregulation in the ’80s and consolidation in the ’90s allowed for the pricing renaissance and outperformance of the 2000s.



Source: FactSet

3PLs Across Eras

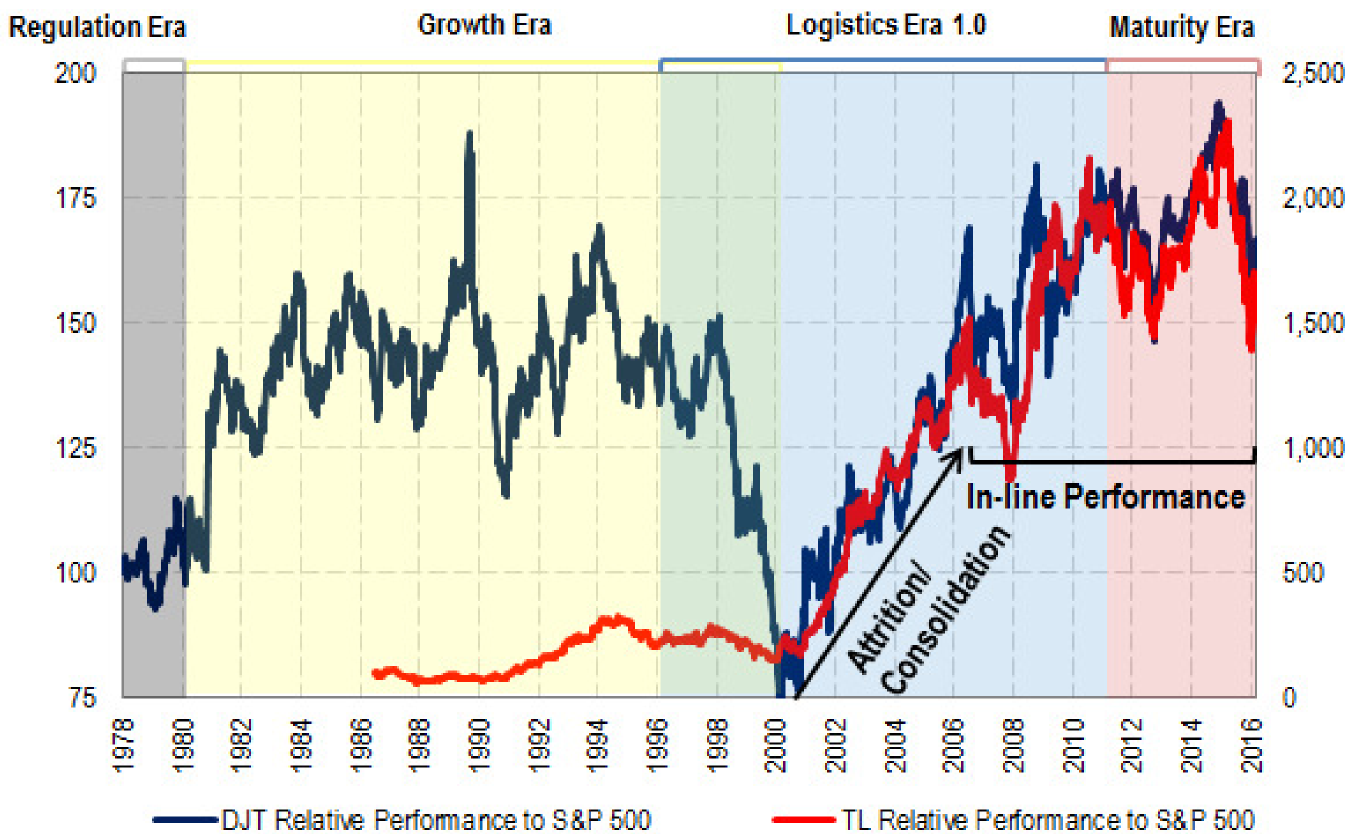
The commercialization of IT in the mid-’90s set the stage for the next 15 years of massive growth for 3PLs.



Source: FactSet

TLs Across Eras

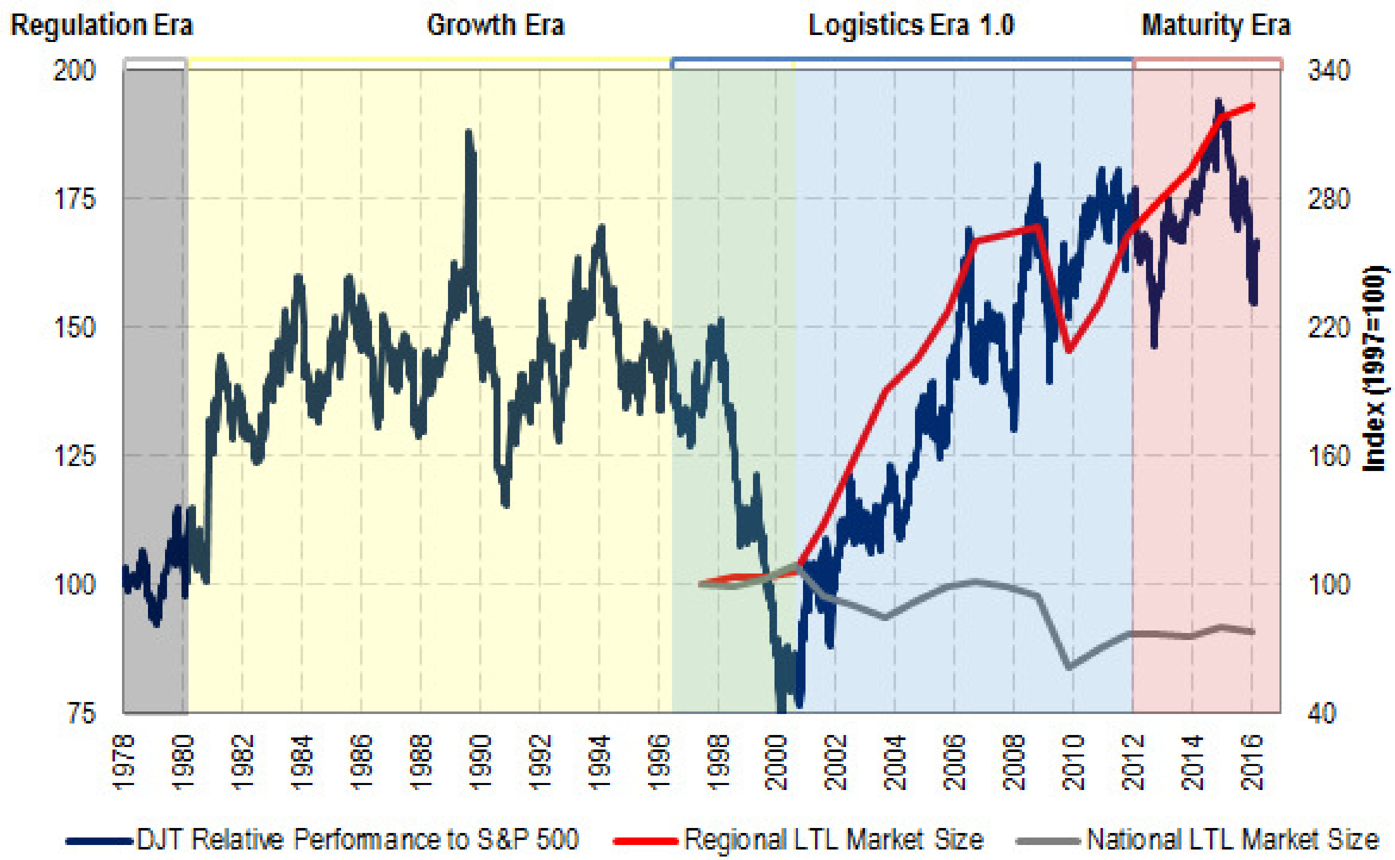
Excess capacity in the mid-to-late '90s led to industry attrition, consolidation, and outperformance in the early-to-mid 2000s.



Source: FactSet

LTLs Across Eras

Distribution trending towards shorter lead time and quicker delivery requires DCs to be closer to destination points, driving regional carrier share growth.



Source: FactSet

What Defines the Maturity Era?

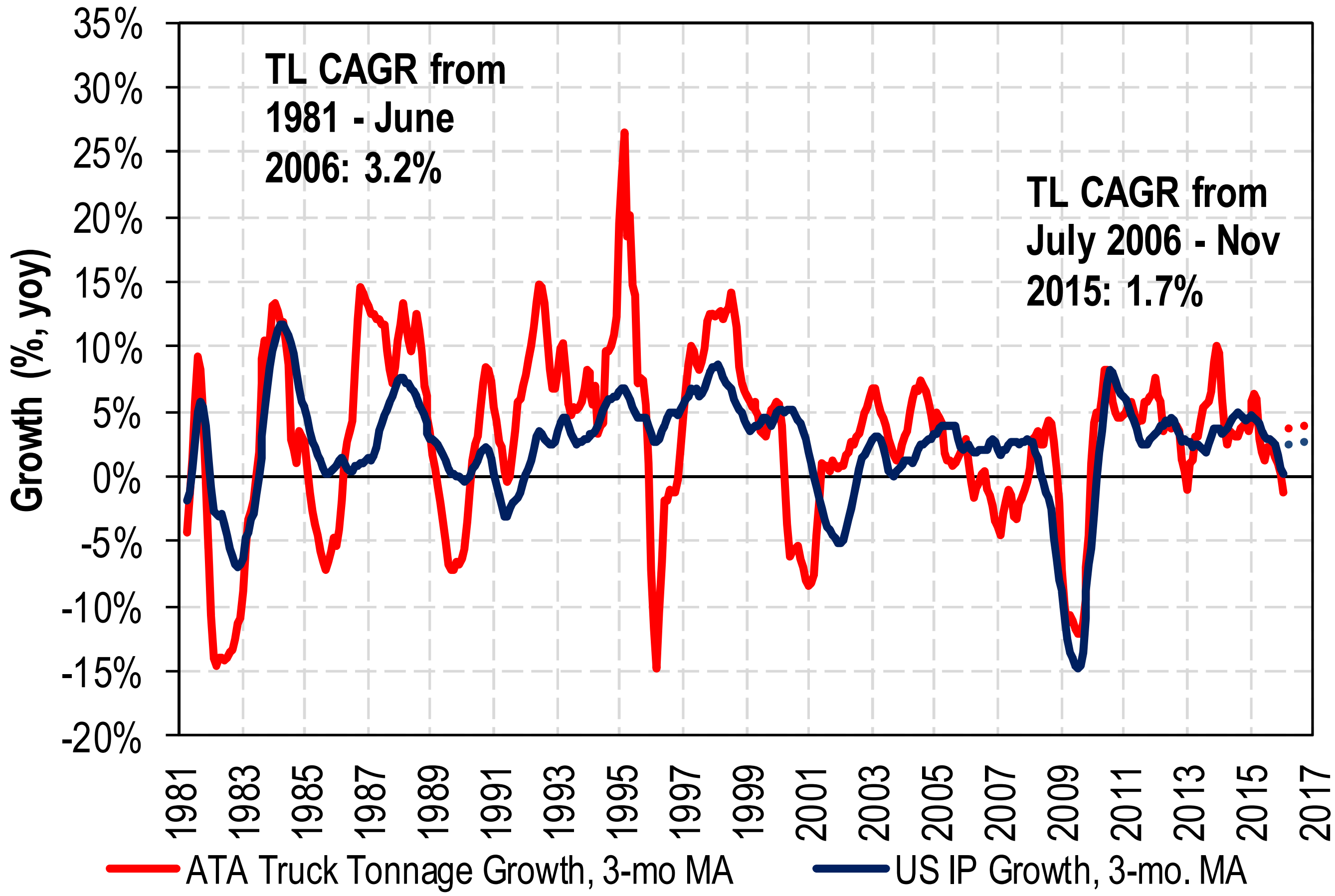
The trade maturity era is characterized by:

1. Structurally slower end-market demand
2. Productivity headwinds
3. Demographic changes
4. Increasing regulation

TL Tonnage Growth Has Slowed…

BAIRD

Truckload volume has experienced structurally slower growth...

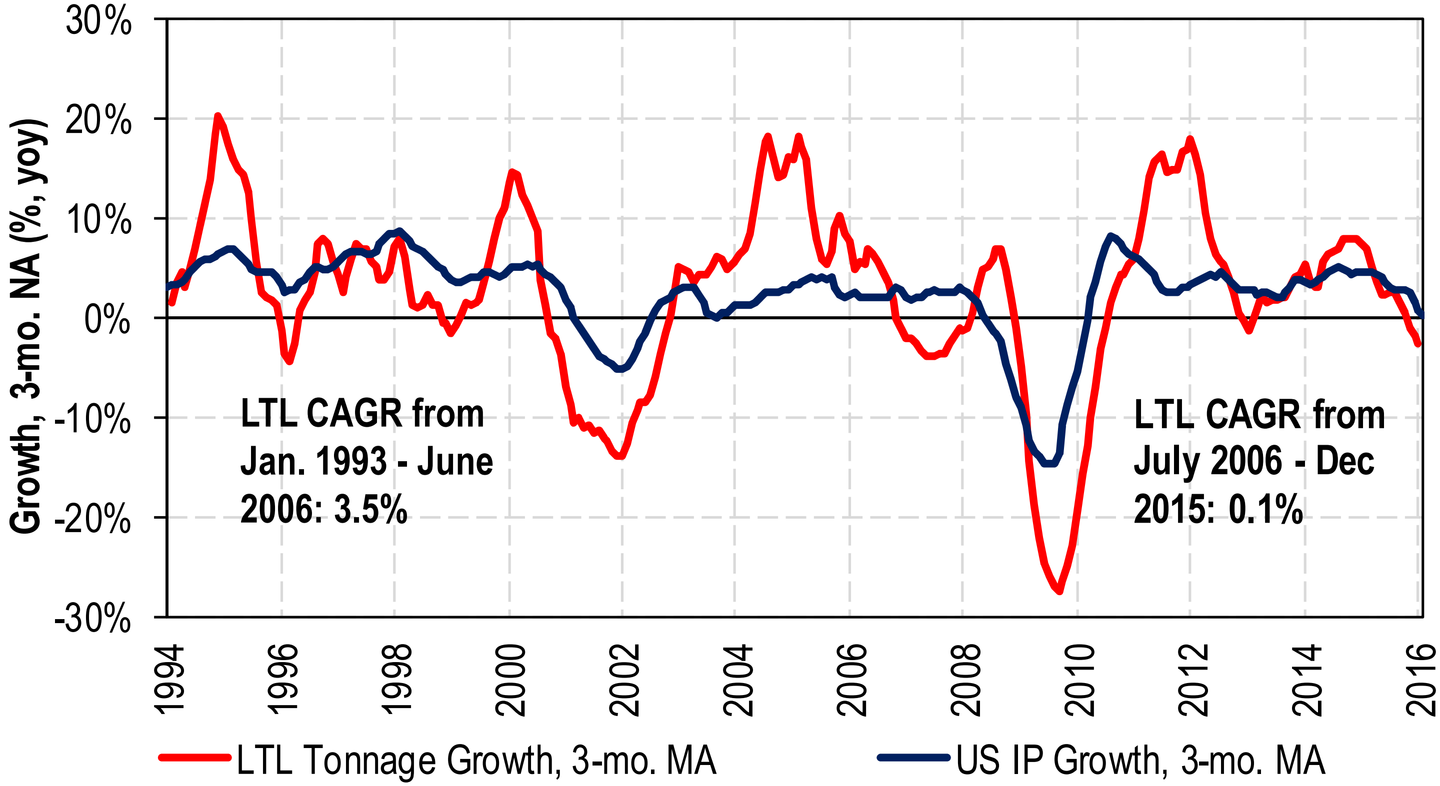


Source: ATA, Blue Chip Economic Indicators, Federal Reserve, Baird estimates

…As Has LTL Tonnage Growth…

BAIRD

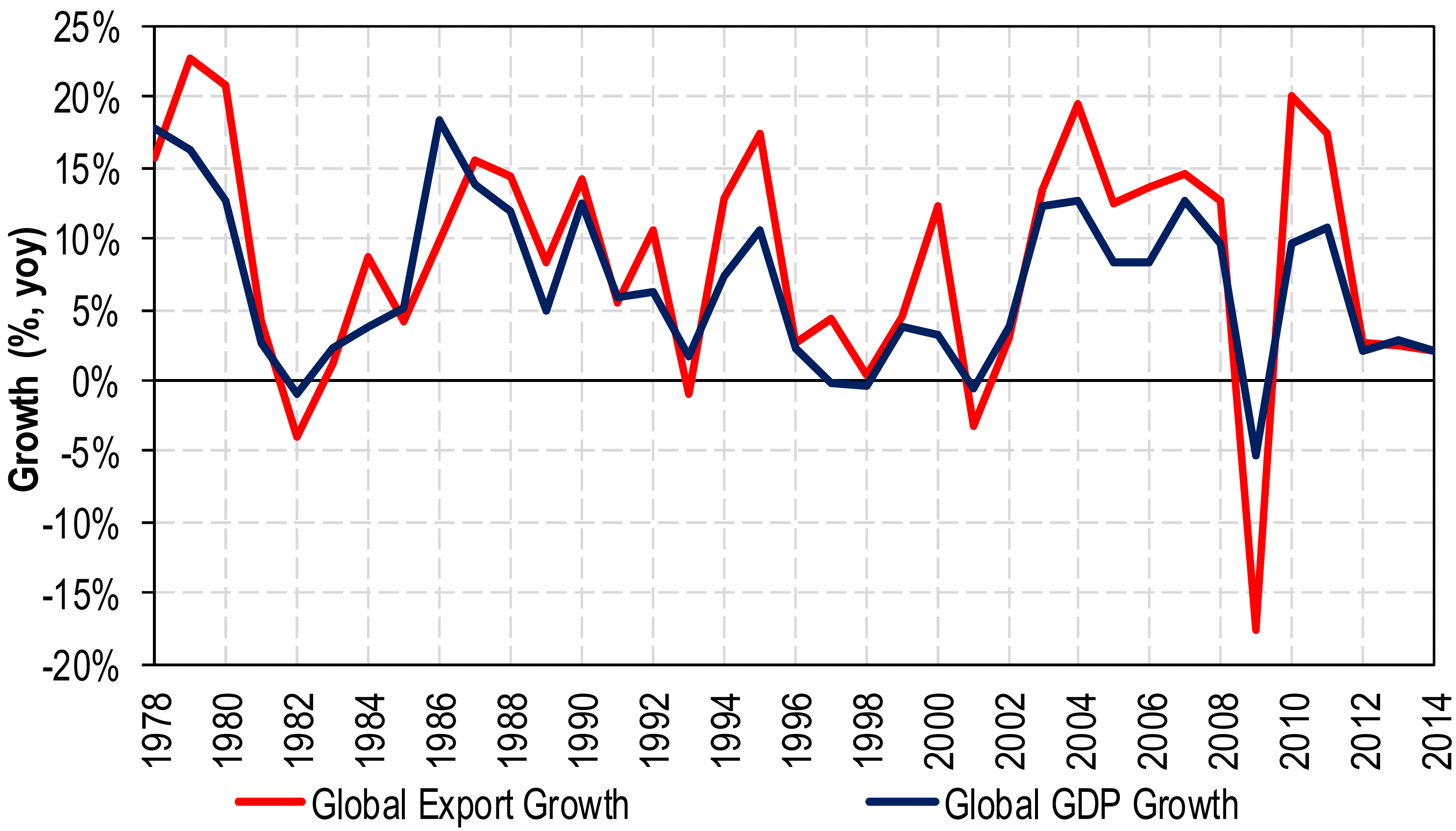
...As has LTL volume growth, which has shown a volume CAGR of just 0.1% post-2006 freight recession.



Source: ATA, Federal Reserve

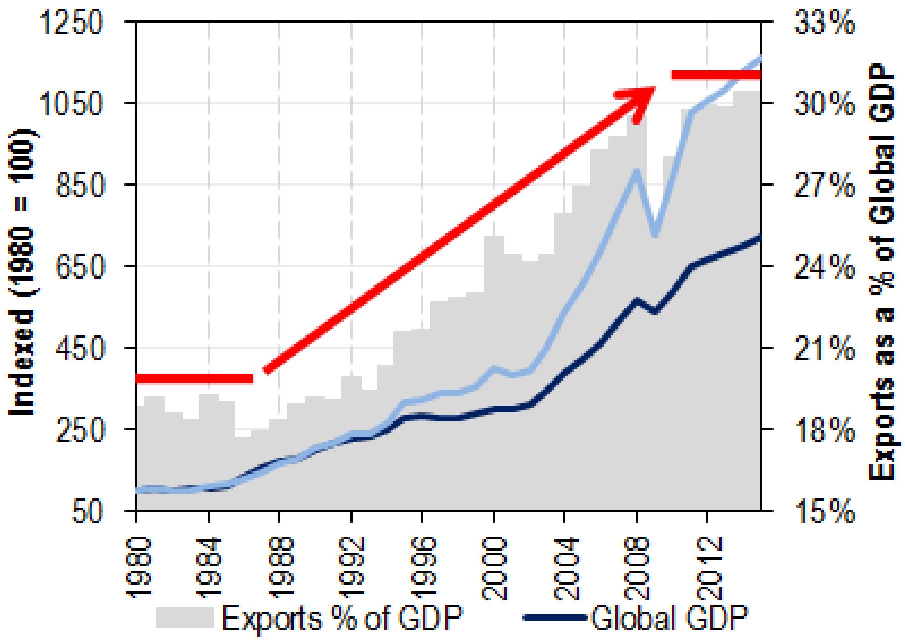
...And International Trade Growth

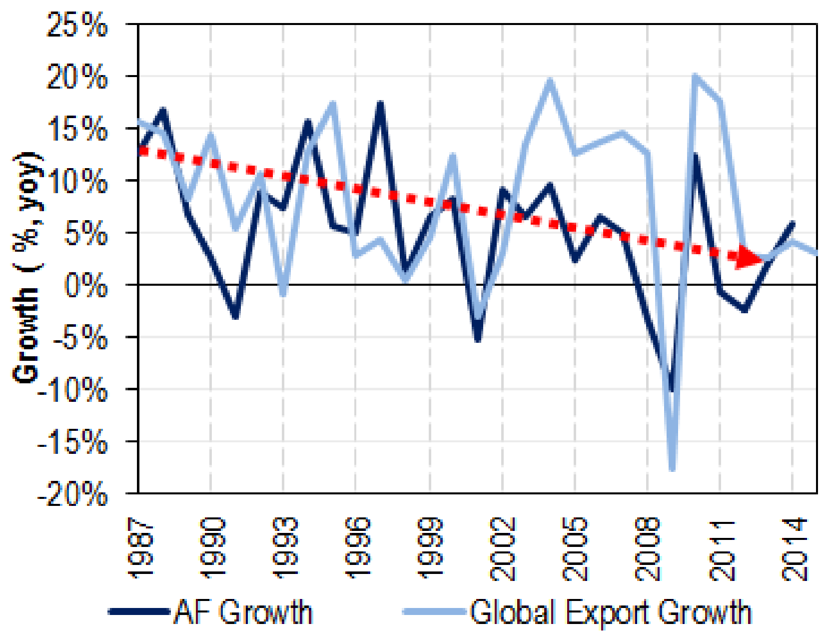
Annualized growth post-2006 has been 5.0% versus the 8.5% 1978-2006 CAGR.



Source: World Bank

Global Trade's Penetration a Driver of Recent Slowdown in Growth





Source: IATA, World Bank, Baird estimates

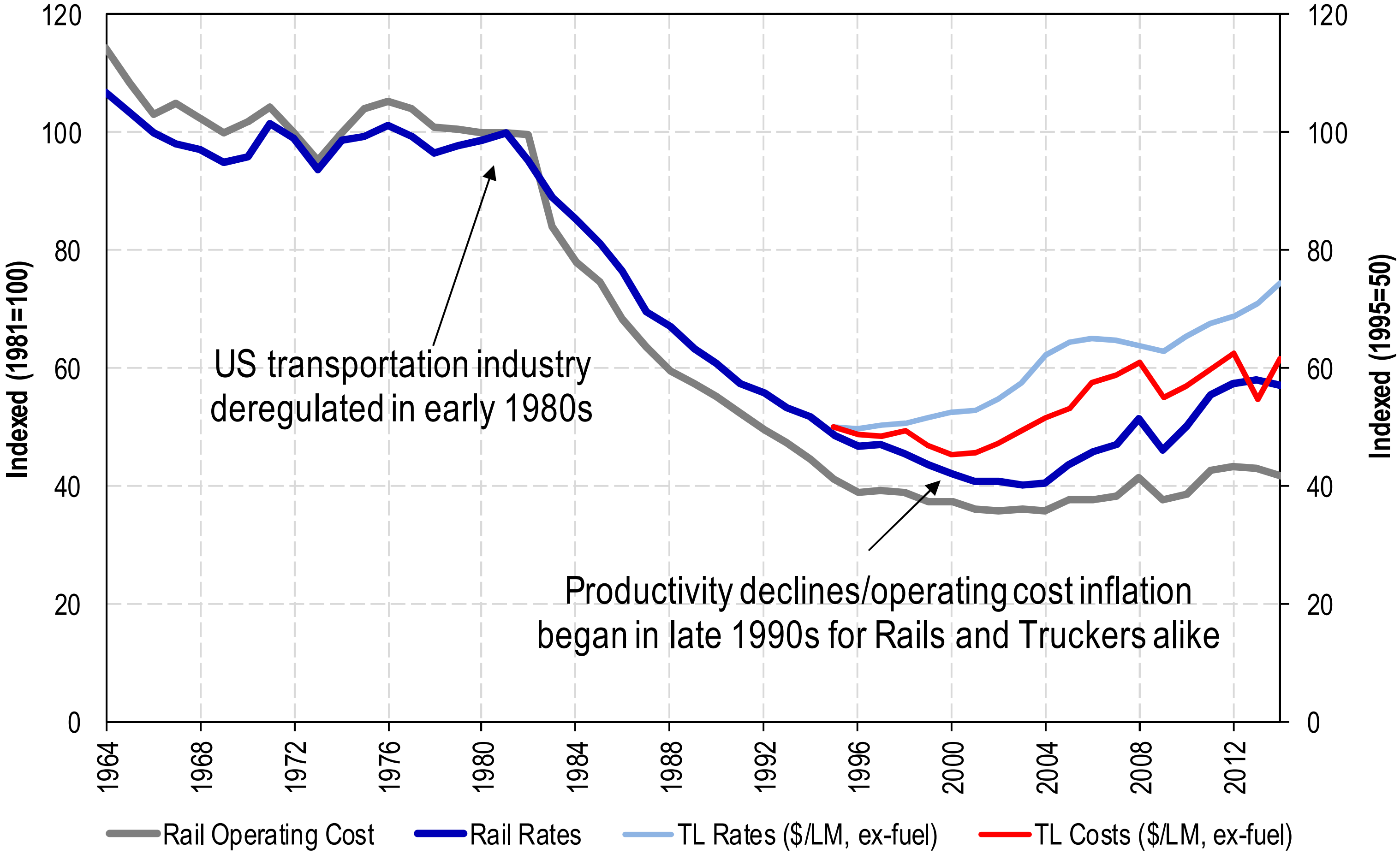
Maturity Era

The trade maturity era is characterized by:

1. Structurally slower end-market demand
2. Productivity headwinds
3. Demographic changes
4. Increasing regulation

Long-Term Productivity Headwinds Are Real

Trucking has followed a similar trend line since the mid-1990s.

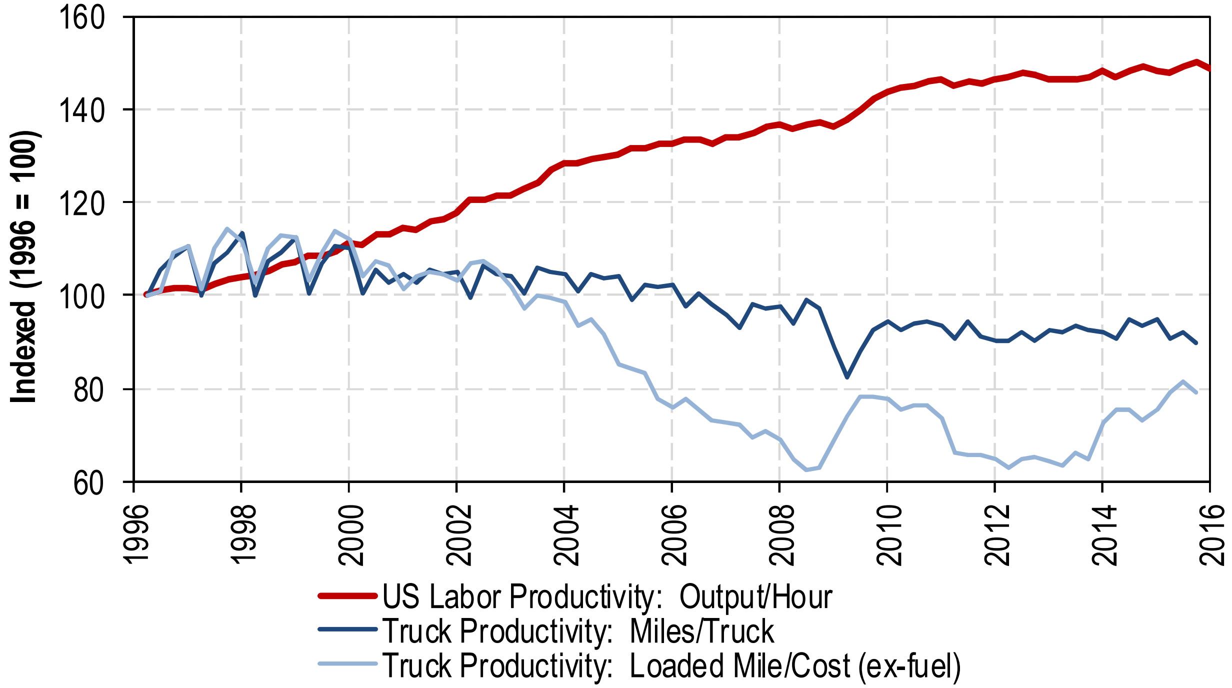


Source: AAR, Company data, Baird estimates

Long-Term Productivity Headwinds Are Real

Since 2003, large public truckload carriers' fleet productivity has <u>fallen</u> ~5% due to the cumulative effect of various drivers' hours-of-service regulations.

Over the same period, US labor productivity has <u>risen</u> ~27%.



Source: ACT Research, BLS, Baird estimates

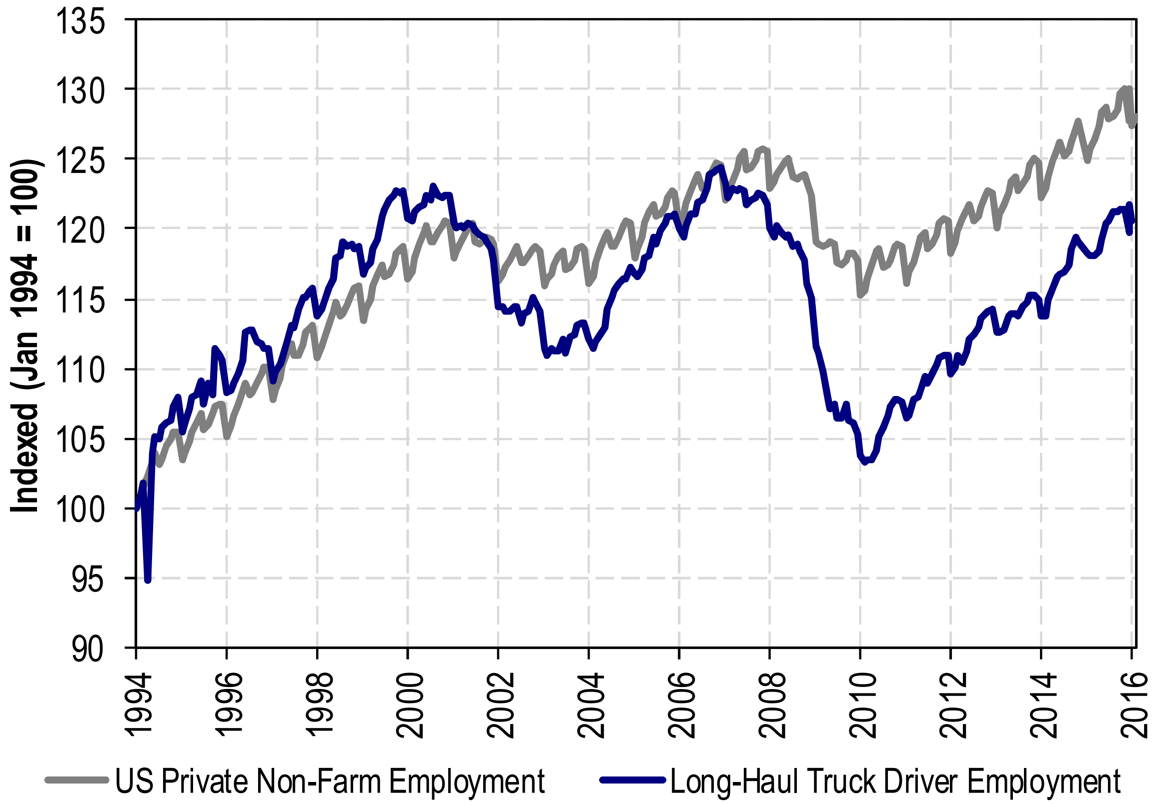
Maturity Era

The trade maturity era is characterized by:

1. Structurally slower end-market demand
2. Productivity headwinds
3. Demographic changes
4. Increasing regulation

Rates Need to Rise in Order to Address The Demographic Issue

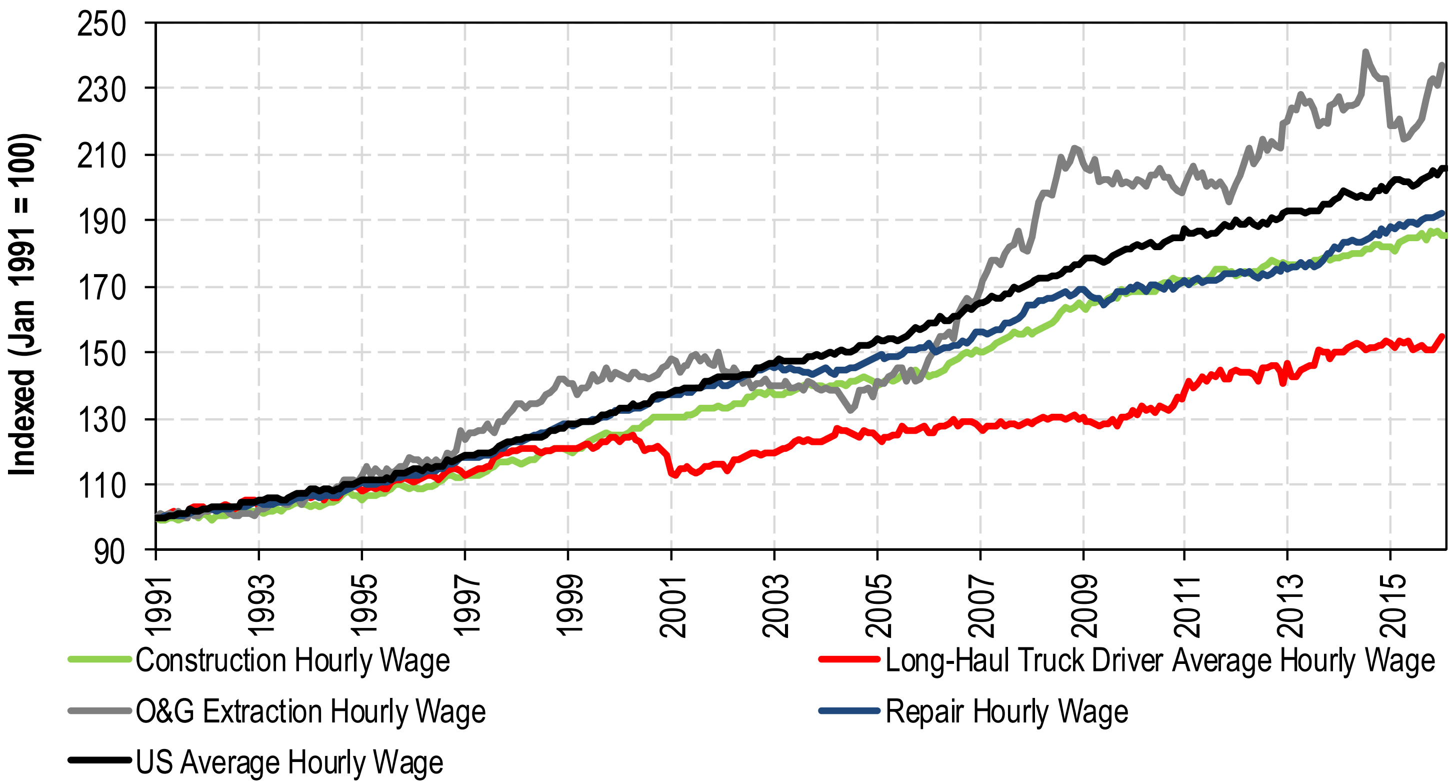
Since 2000, long-haul truck driver employment has risen ~1%, while US private non-farm employment has risen ~12%.



Source: BLS, Baird estimates

Rates Need to Rise in Order to Address The Demographic Issue

Truck driving wage growth has lagged competing jobs and broader US labor wage growth over the past 25 years.



Hourly wage (CAGRs) since 1990:

Construction: 2.5%

Oil & Gas: 3.4%

Repair: 2.6%

US Average: 2.9%

Truck Driver: **1.8%**

Source: BLS

Maturity Era

The trade maturity era is characterized by:

1. Structurally slower end-market demand
2. Productivity headwinds
3. Demographic changes
4. Increasing regulation

Rates Need to Rise in Order to Address The Regulation Issue

Despite the short-term tailwind from the July 2013 HOS modifications being suspended (~2-4% tailwind to productivity among compliant carriers), long-term productivity headwinds are real.

The long-awaited Electronic Logging Device (ELD) mandate was approved on December 10, and is a potential 4-8% headwind to productivity over the next several years.

Source: senate.gov, Company data, Baird estimates

Rates Need to Rise in Order to Address The Regulation Issue

And the ELD mandate is just one of a long list of pending/potential regulations that could limit productivity:

- Electronic Stability Controls
- Speed Limiters
- Minimum Training Requirements
- OSHA Worker Protection
- Increase in Minimum Insurance
- Safe Harbor
- Drug & Alcohol Database
- Prohibition of Coercion
- Pattern of Violation
- Employee Free Choice
- Safe Food Transportation
- Health Regulations and Treatments
- Immigration Effects
- Regional Equipment
- Etc.

Source: senate.gov, Company data, Baird estimates

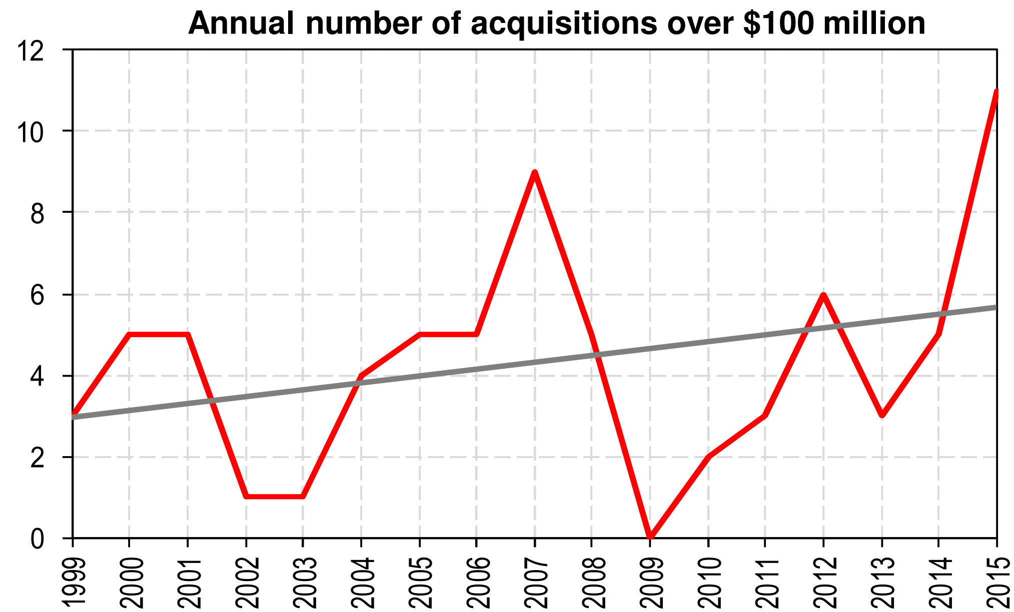
The Next Era?

Consolidation

Logistics 2.0

Industry Consolidation

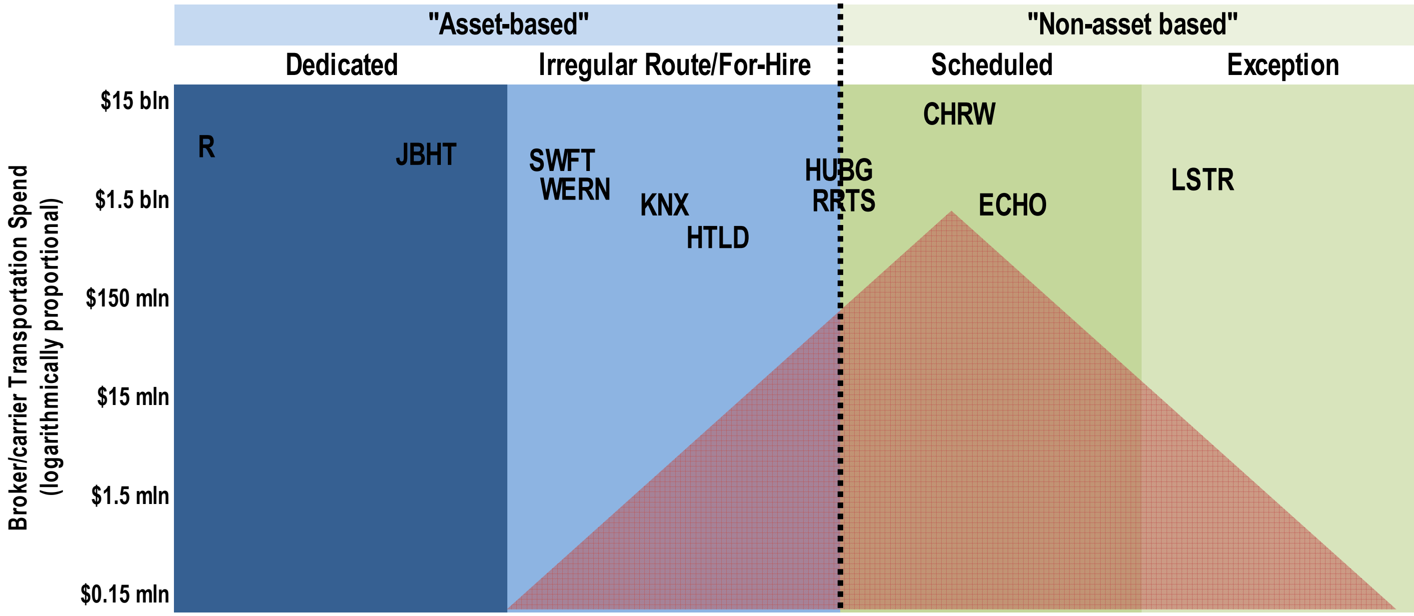
- 2015 was a year of large deals.
- 11 deals were larger than $100 million during 2015.
- Deals were across subsectors.



Sector	Date	Acquirer	Target	EV ($mln)	EV to EBITDA
LTL	Sep-15	XPO Logistics	Con-Way Inc.	$ 3,000	5.9x
Freight Forwarding	Oct-15	DSV A/S	UTI Worldwide	$ 1,350	8.4x
Domestic Brokerage	Jul-15	UPS	Coyote Logistics	$ 1,800	18.0x
Parcel	Apr-15	FedEx	TNT Express	$ 4,800	10.3x
Rail	Offer only	Canadian Pacific	Norfolk Southern	$ 29,000	7.0x

Source: Armstrong & Associates, Company data, Moody's, Baird estimates

In Our View, Carriers and Brokers With Scale

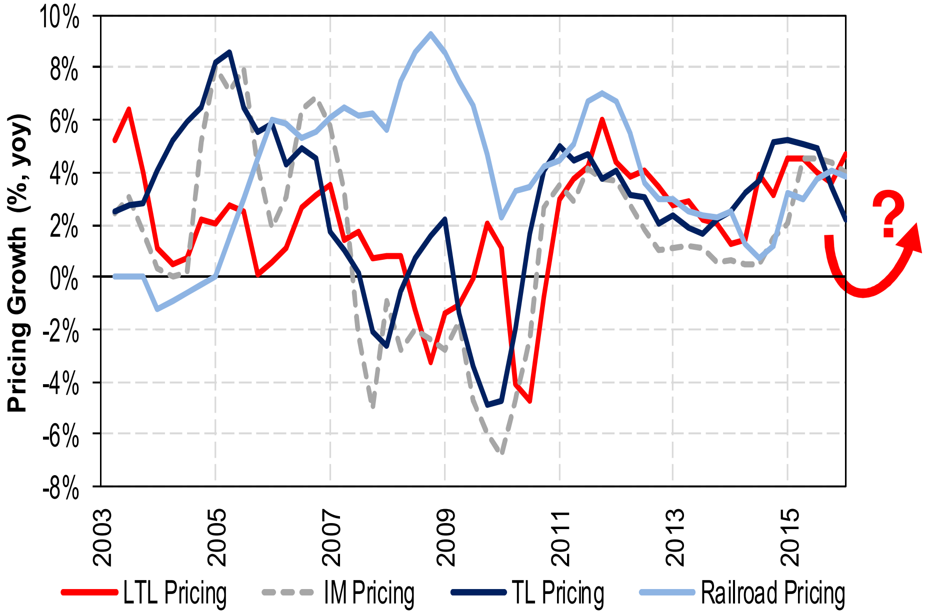


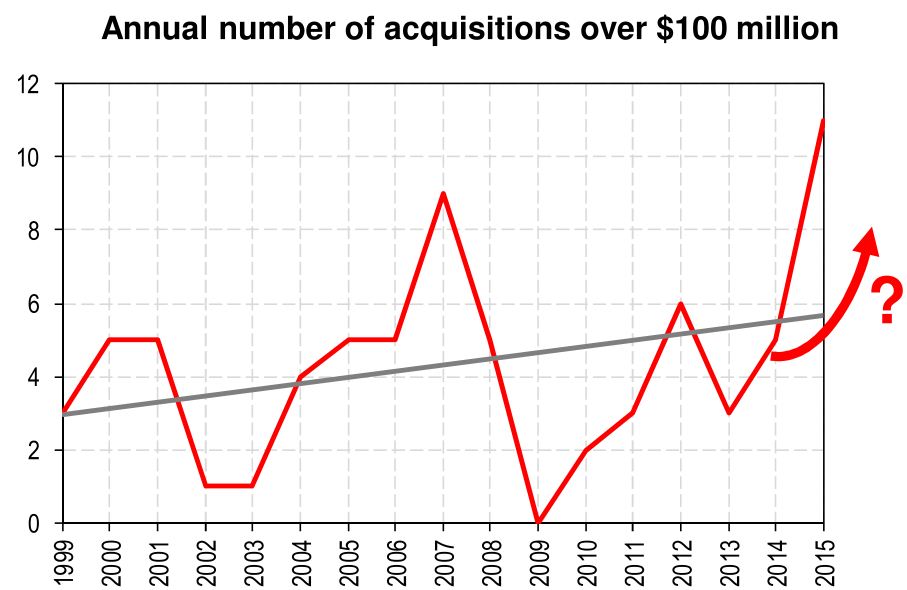
Dynamics this cycle	Dedicated	Irregular Route/For-Hire	Scheduled	Exception
	*Pressures to shippers operating private fleets (rising equipment costs, capital scarcity, driver regulations) leading to elevated inquiries about outsourcing management to dedicated fleet operators	*Core carrier concept among shippers highlights credible concerns about access to reliable capacity *Carriers with scale strategically positioned to protect margins and expand service offering *Small carriers/individual owner-operators facing numerous headwinds, limiting capacity adds	*Pressures to small carriers/owner-operators (~80% of TL market) limit available capacity base *Coupled with slower end-market growth and increasing competition, expect gross margin pressure for brokers lacking scale	*Constraints to capacity base similarly pressures gross margins *But, brokers filling need (exception/emergency freight) or niche (specialized equipment) in position to deliver value, particularly among small/medium-sized shippers

Source: Company data, Baird estimates

The "Dawn": Healthy Pricing, Industry Consolidation

Reduced productivity and increased attrition from demographics and regulation should drive healthier long-term pricing fundamentals and further industry consolidation.





Source: Armstrong & Associates, Company data, Baird estimates

Three Key Focal Points

1. 2015: The year of decelerating growth and transport stock underperformance.

2. 2016: “It’s always darkest before the dawn.”

3. A new era of transportation is upon us; successful models will deal with the challenges facing the industry, including:
   - Regulations
   - Demographics
   - Technology

Appendix – Important Disclosures and Analyst Certification

Robert W. Baird & Co. Incorporated and/or its affiliates expect to receive or intend to seek investment banking related compensation from the company or companies mentioned in this report within the next three months.
Robert W. Baird & Co. Incorporated may not be licensed to execute transactions in all foreign listed securities directly. Transactions in foreign listed securities may be prohibited for residents of the United States. Please contact a Baird representative for more information.

Investment Ratings: Outperform (O) - Expected to outperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months. **Neutral (N)** - Expected to perform in line with the broader U.S. equity market over the next 12 months. **Underperform (U)** - Expected to underperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months.

Risk Ratings: L - Lower Risk - Higher-quality companies for investors seeking capital appreciation or income with an emphasis on safety. Company characteristics may include: stable earnings, conservative balance sheets, and an established history of revenue and earnings. A - **Average Risk** - Growth situations for investors seeking capital appreciation with an emphasis on safety. Company characteristics may include: moderate volatility, modest balance-sheet leverage, and stable patterns of revenue and earnings. **H - Higher Risk** - Higher-growth situations appropriate for investors seeking capital appreciation with the acceptance of risk. Company characteristics may include: higher balance-sheet leverage, dynamic business environments, and higher levels of earnings and price volatility. **S - Speculative Risk** - High-growth situations appropriate only for investors willing to accept a high degree of volatility and risk. Company characteristics may include: unpredictable earnings, small capitalization, aggressive growth strategies, rapidly changing market dynamics, high leverage, extreme price volatility and unknown competitive challenges.

Valuation, Ratings and Risks. The recommendation and price target contained within this report are based on a time horizon of 12 months but there is no guarantee the objective will be achieved within the specified time horizon. Price targets are determined by a subjective review of fundamental and/or quantitative factors of the issuer, its industry, and the security type. A variety of methods may be used to determine the value of a security including, but not limited to, discounted cash flow, earnings multiples, peer group comparisons, and sum of the parts. Overall market risk, interest rate risk, and general economic risks impact all securities. Specific information regarding the price target and recommendation is provided in the text of our most recent research report.

Distribution of Investment Ratings. As of February 29, 2016, Baird U.S. Equity Research covered 711 companies, with 51% rated Outperform/Buy, 48% rated Neutral/Hold and 1% rated Underperform/Sell. Within these rating categories, 15% of Outperform/Buy-rated and 5% of Neutral/Hold-rated companies have compensated Baird for investment banking services in the past 12 months and/or Baird managed or co-managed a public offering of securities for these companies in the past 12 months.

Analyst Compensation. Analyst compensation is based on: 1) the correlation between the analyst's recommendations and stock price performance; 2) ratings and direct feedback from our investing clients, our institutional and retail sales force (as applicable) and from independent rating services; 3) the analyst's productivity, including the quality of the analyst's research and the analyst's contribution to the growth and development of our overall research effort and 4) compliance with all of Robert W. Baird's internal policies and procedures. This compensation criteria and actual compensation is reviewed and approved on an annual basis by Baird's Research Oversight Committee.

Analyst compensation is derived from all revenue sources of the firm, including revenues from investment banking. Baird does not compensate research analysts based on specific investment banking transactions.

A complete listing of all companies covered by Baird U.S. Equity Research and applicable research disclosures can be accessed at http://www.rwbaird.com/research-insights/research/coverage/research-disclosure.aspx.
You can also call 1-800-792-2473 or write: Robert W. Baird & Co., Equity Research, 777 E. Wisconsin Avenue, Milwaukee, WI 53202.

Analyst Certification. The senior research analyst(s) certifies that the views expressed in this research report and/or financial model accurately reflect such senior analyst's personal views about the subject securities or issuers and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

Disclaimers

Baird prohibits analysts from owning stock in companies they cover.
This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

ADDITIONAL INFORMATION ON COMPANIES MENTIONED HEREIN IS AVAILABLE UPON REQUEST The Dow Jones Industrial Average, S&P 500, S&P 400 and Russell 2000 are unmanaged common stock indices used to measure and report performance of various sectors of the stock market; direct investment in indices is not available.

Baird is exempt from the requirement to hold an Australian financial services license. Baird is regulated by the United States Securities and Exchange Commission, FINRA, and various other self-regulatory organizations and those laws and regulations may differ from Australian laws. This report has been prepared in accordance with the laws and regulations governing United States broker-dealers and not Australian laws.

Other Disclosures

The information and rating included in this report represent the Analyst's long-term (12 month) view as described above. The research analyst(s) named in this report may at times, discuss, at the request of our clients, including Robert W. Baird & Co. salespersons and traders, or may have discussed in this report, certain trading strategies based on catalysts or events that may have a near-term impact on the market price of the equity securities discussed in this report. These trading strategies may differ from the analysts' published price target or rating for such securities. Any such trading strategies are distinct from and do not affect the analysts' fundamental long-term (12 month) rating for such securities, as described above. In addition, Robert W. Baird & Co. Incorporated and/or its affiliates (Baird) may provide to certain clients additional or research supplemental products or services, such as outlooks, commentaries and other detailed analyses, which focus on covered stocks, companies, industries or sectors. Not all clients who receive our standard company-specific research reports are eligible to receive these additional or supplemental products or services. Baird determines in its sole discretion the clients who will receive additional or supplemental products or services, in light of various factors including the size and scope of the client relationships. These additional or supplemental products or services may feature different analytical or research techniques and information than are contained in Baird's standard research reports. Any ratings and recommendations contained in such additional or research supplemental products are consistent with the Analyst's long-term ratings and recommendations contained in more broadly disseminated standard research reports.

United Kingdom ("UK") disclosure requirements for the purpose of distributing this research into the UK and other countries for which Robert W. Baird Limited ("RWBL") holds a MiFID passport.

This material is distributed in the UK and the European Economic Area ("EEA") by RWBL, which has an office at Finsbury Circus House, 15 Finsbury Circus, London EC2M 7EB and is authorized and regulated by the Financial Conduct Authority ("FCA").

For the purposes of the FCA requirements, this investment research report is classified as investment research and is objective.

This material is only directed at and is only made available to persons in the EEA who would satisfy the criteria of being "Professional" investors under MiFID and to persons in the UK falling within articles 19, 38, 47, and 49 of the Financial Services and Markets Act of 2000 (Financial Promotion) Order 2005 (all such persons being referred to as "relevant persons"). Accordingly, this document is intended only for persons regarded as investment professionals (or equivalent) and is not to be distributed to or passed onto any other person (such as persons who would be classified as Retail clients under MiFID).

Robert W. Baird & Co. Incorporated and RWBL have in place organizational and administrative arrangements for the disclosure and avoidance of conflicts of interest with respect to research recommendations.

This material is not intended for persons in jurisdictions where the distribution or publication of this research report is not permitted under the applicable laws or regulations of such jurisdiction.

Investment involves risk. The price of securities may fluctuate and past performance is not indicative of future results. Any recommendation contained in the research report does not have regard to the specific investment objectives, financial situation and the particular needs of any individuals. You are advised to exercise caution in relation to the research report. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

RWBL is exempt from the requirement to hold an Australian financial services license. RWBL is regulated by the FCA under UK laws, which may differ from Australian laws. This document has been prepared in accordance with FCA requirements and not Australian laws.

Dividend Yield. As used in this report, the term "dividend yield" refers, on a percentage basis, to the historical distributions made by the issuer relative to its current market price. Such distributions are not guaranteed, may be modified at the issuer's discretion, may exceed operating cash flow, subsidized by borrowed funds or include a return of investment principal.