THE DAILY CHECK-IN WITH GOLDMAN SACHS
GUEST: Kevin Martens, Asset Management Division
HOST: Liz Bowyer, Global Head of Content
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Liz Bowyer: Hi Kevin.

Kevin Martens: Hi Liz.

Liz Bowyer: You're a portfolio manager covering the transportation industry for our asset management division. Transportation, obviously, represents a huge part of the economy. And it was deeply impacted by the pandemic. But before we get into that, just describe, generally, what the transportation industry looks like and how it was faring pre pandemic.

Kevin Martens: Yeah, the transportation industry includes lots of different parts. So, there's the air freight market. There are the commercial airlines. There are railroads. There's trucking. There are logistics players who try to piece all of this together. As well as the ocean liners and the shippers who are crossing oceans for us.

And if you think about where we were pre pandemic, port volumes on the west coast were setting multi year lows because we were just coming out of an industrial recession that was brought on by the trade war brought on with China. So, it was, overall, in a relatively weak position.

Industrial activity wasn't great in the US. We were facing a bit of inflation from some of the tariff related noise. So, we entered the recession from a point of, hopefully, stabilizing at a low level. And we were looking forward to the year being a year of recovery for the transportation sector. And then, obviously, the pandemic threw a bit of that into a mess.

Liz Bowyer: So, let's talk about how that's played out starting, maybe, with the airlines.

Kevin Martens: So, the most immediate impact that I think everyone felt was borders were closed. Travel was restricted. So, in terms of commercial airlines, it was very fast and furious. About 60 percent of capacity was cut out of the market. 17,000 commercial airliners were grounded globally. Some airlines even pulled forward the retirement of some older, higher cost airliners. So, as we all get back to traveling, we're probably going to see different aircraft. And that, on the surface, made a lot of sense because we just couldn't travel. We couldn't spread this thing.

Unfortunately, what that also did was the belly capacity in all these commercial airliners is where 50 to 60 percent of the global air freight gets shipped from. And so, all of the sudden as we came out of the initial shock of hitting the pandemic and then consumers immediately started buying again, and then we obviously had a couple rounds of stimulus to put more cash into everyone's pockets to sustain the consumer, we were short on capacity. And so, the air freight market experienced a surge in rates unlike we've ever seen before. Sort of upwards of 100 or 200 percent year over year growth in the cost to ship things via air.

The airlines got very creative. They wound up converting some of the legacy commercial aircraft into freighters. So, you can see pictures online of these really interesting, sort of, commercial airliners with seats everywhere. But instead of people, they're just filled with boxes in all sorts of ways that they could fit them in.

And so, we're in a slightly better position now in that industry as the airlines had excess capacity that they were able to reposition. But it was an initial scramble to figure all of this out.

Liz Bowyer: And how about ocean freight?

Kevin Martens: So, ocean freight initially was significantly impacted due to China having their own manufacturing issues in getting product to port. And then as the pandemic traveled to the US and China got it back together from a manufacturing standpoint, we were experiencing record levels of volume coming to our shores, in particular, on the west coast. And, unfortunately, a lot of our dock workers were sick, and they weren't able to take the product off and effectively move it to the rail or truck.

And so, it was earlier this year it all sort of came to a head where we had a record number of boasts sitting out in the ports on the west coast that we just couldn't process. And it was resulting in backups across supply chains. So, the trucks and the rial who were sitting and waiting for this product couldn't get it out to customers and couldn't get it out to stores.

Liz Bowyer: So, talk more about what happened with the dock workers. That was an example that really highlighted the interconnectedness of our transportation system.

Kevin Martens: Sure, so these are workers, you refer to this as drayage. It's an area of the transport market that most of my career, it's not been something I really focused on. You sort of take it for granted. These are the guys that are bringing goods from the ships to either a truck or to a rail to then move it to its final destination. Or along its way to its final destination.

And unfortunately, due to COVID, as well as the restrictions put in place, this was an industry that was significantly impacted. And was a large cause of why we had the ship build up on the west coast that we did.

So, these workers were sick in high numbers. They were not able to really work at full utilization because of the restrictions put in place. And so, it just had ripple effects across the entire economy where this, I mean, they're literally moving it from the port over to either one of two modes of transport. And it brought most of the transport network in this country to its knees for a little while there.

As you're seeing the infection rates in California improve, we've seen, obviously, the boats clear out of the ports and things are moving a little bit more smoothly now. So, it feels like we've worked through the worst of it.

The next issue that we'll have to deal with within this market is now that truck rates are at an all time high, the drayage workers are looking at those opportunities as any rational person should and saying, it's not a bad time to go drive a truck for maybe a little bit of a longer distance. And so, I can make a little bit more money.

And so, the labor market is going to be the next issue to deal with within the supply chain for the US, where workers are going to look around for where they have better opportunities given all the broad inflation that we've seen. And we're seeing just efforts across the board from transport companies to start bringing people back and hire aggressively.

Liz Bowyer: So, you mentioned that truck rates are at an all time high. Describe what we've seen generally with trucking since the pandemic.

Kevin Martens: Sure. So, the trucking market, initially, was impacted by COVID like everything else. So, we had about a 10 percentage point drop in capacity utilization. As stimulus dollars came through, people got more comfortable with working and living at home and all of the lockdown measures, you saw consumer spending resume. And I think we finished last year, according to the census, up about 3 percent on consumer spending.

Within that number though, e-commerce had a surge of activity, which makes sense given the world that we were living in. So, e-commerce went from roughly 11 percent retail sales to 14. And according to some of the players in there, what they saw was, in particular, the baby boomers really came of age in adopting e-commerce. And they had sort of been the missing piece in all of this for quite a few years now.

And so, not only did we have volume come back as consumers were feeling better, and now capacity utilization in the trucking market is at 99 percent. So, we've come full circle here. But in addition to that, where the trucks have to go and how these supply chains move has changed dramatically as e-commerce requires different points of distribution than traditional retail. And so, there's been a lot of adjustments under the hood, which has resulted in record levels of rates right now for truck load.

Liz Bowyer: So, Kevin, given these shifts that we're seeing play out, how does that shape your view of the transportation industry as an investor.

Kevin Martens: Interesting. We've had, effectively, what would normally be one or two longer cycles compressed into about a year and a half here. So, it's been very busy.

I think, initially, as you could tell from my earlier comments, in the best performers coming out of this were the air freight companies. They were just a very large, disproportionate winner given the dynamics that were happening.

I think looking forward from here, you would expect it to shift a little bit more towards the industrial lever plays. So, you would think railroads and then a little subsector of trucking that's called less than truckload where they have a mix of industrial and consumer exposure. And these are players where they're not making just point to point, it's multiple stops with less than a full truckload of freight. And so, they're really critical to e-commerce next day delivery, as well as having exposure to the industrial recovery.

And the real question mark that's out there that we're debating right now and just trying to figure out is, is this 14 percent penetration from e-commerce, is this the new baseline that we should assume? Is there going to be a little bit of a give back? Or do we grow from here and resume the historical sort of high single digit growth in e-commerce? And that really affects the US parcel market in particular. And so, I think that's the area of most interesting debate right now. And we're living through it. And we're going to see how this goes as the US opens up and how the consumer behaves and how much they want to go back to the store versus continuing to order at a level that they were last year from online retailers.

Liz Bowyer: Well, and to that end, stocks of transportation companies have really continued to rally. Any concerns about valuations?

Kevin Martens: At some point, I think, we're definitely going to start being concerned about it. The first place where we saw it was in the airlines. Where the airlines, from the trough of the pandemic, the airlines were the best performing group from that point, basically until we hit earnings this season. And I think what you found is investors are now focused, now that the recovery's underway, investors have to return to focusing on, okay, I could dream the dream that everything within travel is going to recover. But at some point, the airlines do have to hire a significant number of pilots back. They have to hire back a significant number of crews. We have to reopen the airports. They have to sort of work the kinks out of bringing 17,000 commercial aircraft out of storage. And it's probably not going to be cheap. And it's probably not going to be easy.

So, you saw the airlines go from the top performing to lagging the broader group, year to day basis, post the first quarter of earnings. What you're seeing now is some of the industrial levered players with pricing power emerging because there is broad inflation in the economy. And you want to be in areas that have pricing power. And so, you're seeing the rails pick up a little bit here. The less than truckload players as well where, you know, there's pricing power. There are great operating levers. They're critical to us maintaining e-commerce and growing e-commerce from current levels. And so, you're starting to see those start to outperform. And they don't really look expensive relative to history, yet, assuming a full recovery.

And then if you think of the other early beneficiary, the truckload market saw a spike in rates initially. But what you can see there is the supply response is well underway. And so, again, Q4 was a record level of new trucks being ordered in this country. First quarter was second only to 2018, which was driven by some changes in regulation where we had significant orders of trucks. So, we know that the supply of trucks is coming. They're going to have to hire truck drivers back and at higher rates than they would like to. So, there's probably going to be some margin compression experienced in that as you bring back supply, you bring back drivers at higher costs. And ultimately, they are commodity markets. And so, you would expect rate to react to that appropriately.

Liz Bowyer: Thanks, Kevin.

Kevin Martens: Thanks, Liz.