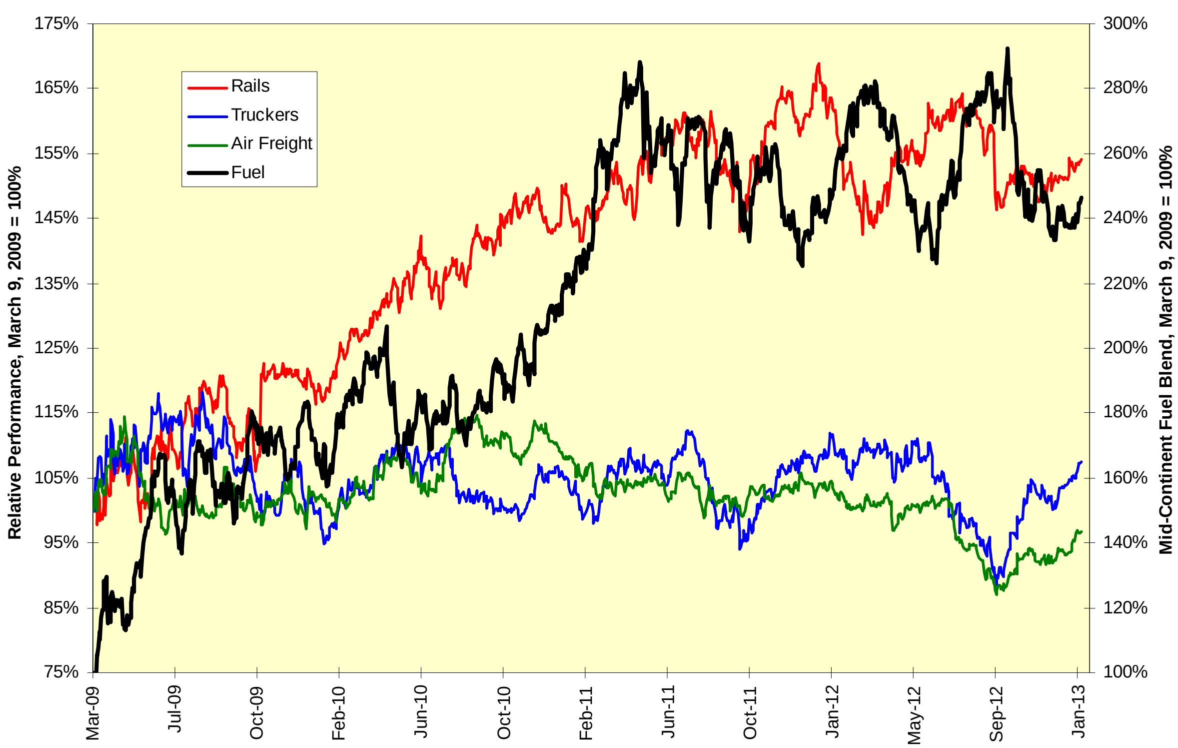
Transportation Stocks' Divergent Responses To Fuel Costs

To paraphrase H.L. Mencken's remark, "For every complex problem, there is a solution that is simple, neat and wrong," for every apparently straightforward market relationship, exceptions abound. I will go so far as to say that in three decades of market analysis, everything interesting to me has involved exceptions to and not confirmations of rules.

Let's take the relationship between transportation stocks and fuel prices. What, really, can be simpler? You take plane, train or truck, put stuff into it, fill the fuel tank and head off to your destination unless, of course, you are Boeing (BA) and have one of those spontaneously combusting lithium ion batteries. The fundamental transportation equation has changed little since the first cave-dwelling ancestor of the UPS (UPS) or FedEx (FDX) delivery man went about his rounds.

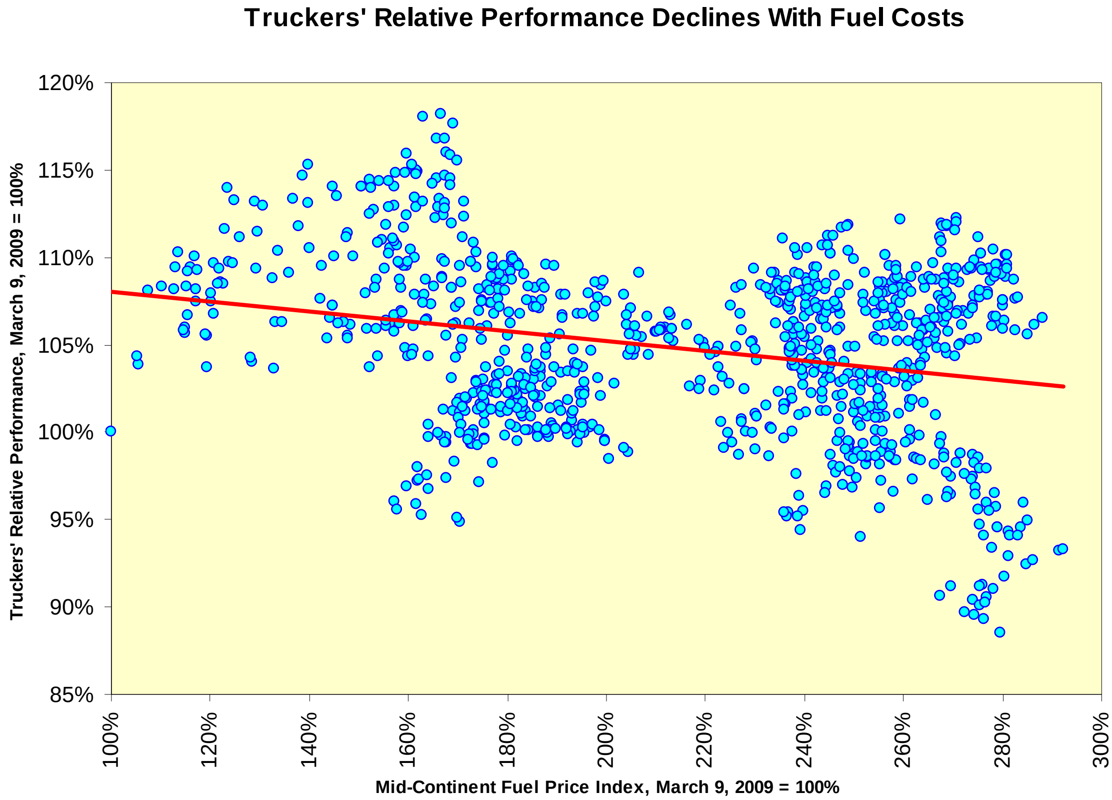
However, if we map the relative performance of various transportation subindices as a function of fuel prices in the mid-continent region since the March 2009 low, we see the relationship is not so simple. The fuel index I am using is a 60/40 blend of low-sulfur diesel fuel and 87-octane gasoline; the performance indices are of the S&P 1500 rail, trucking and air freight indices relative to the S&P 1500 Supercomposite.

Rails' Relative Performance Ignored Rise In Fuel Prices



The rail index, which includes firms such as CSX (CSX), Norfolk Sothern (NSC) and Union Pacific (UNP) has been able to outperform the broad market in the face of rising fuel prices. The trucking index, which includes firms such as Con-way (CNW) and JB Hunt (JBHT) and the air freight index, which includes the aforementioned FedEx and UPS, have outperformed the broad market slightly over the past four years, but neither index has been able to build on its gains.

If we isolate the trucking index and map it as a function of fuel prices, we see a negative trend relationship, albeit a statistically insignificant one.



Why have the rails been able to absorb higher fuel costs? The answer lies both in the types of cargo transported, the distances involved and the high barriers to competition. Let's say you are shipping grain from the Midwest to New Orleans after the harvest season or coal to Norfolk for export; you cannot practically use another mode of transportation for the sheer quantities involved. The same applies for containerized cargo landing at Los Angeles/Long Beach, Oakland or another West Coast port for transshipment eastward. Yes, you could hitch the container to a truck and drive it 2,000 miles, but that would be a money-losing venture.

The barrier to competition for railroads is, perversely, one of its drawbacks: Railroads, like pipelines, are point-to-point operations. Anyone trying to compete with a railroad or a pipeline over the long haul on a fixed route is in trouble. However, once the goods are delivered to a distribution node, final delivery becomes competitive.

As various transportation indices such as the Dow Jones Transports hit nominal record highs, keep your eye on fuel prices. Higher fuel prices impinge, as we should expect, on trucking and air shipment firms. Railroads? Why, they just keep on trucking.