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Are transportation stocks the market's canary in a coal mine?

Stephen Culp October 5, 2018

NEW YORK (Reuters) - The U.S. transportation sector, which many see as a proxy indicator of the economy’s health, has retreated 2.3 percent from its Sept. 14 record, hinting to some analysts that the longest bull market on record has entered its late stages.

Railways, freight carriers and package deliverers get less attention than heavy-hitting momentum stocks like Apple Inc (AAPL.O) and Amazon.com (AMZN.O), but the sector could be showing cracks in what analysts and the U.S. Federal Reserve characterize as a robust economy.

Several constituents of the Dow Jones Transportation Average (DJT) have provided disappointing guidance in recent months. As the third-quarter reporting season approaches, investors will watch to gauge whether trade, fuel and dollar risks are affecting the sector’s bottom line.

The 20-company DJT .DJT has recently diverged from the broader market after a strong run since late June, suggesting these headwinds could be taking a toll.

As the DJT has retreated, the broader Dow Jones Industrial Average .DJI has moved in the opposite direction. The Dow reached its most recent all-time high on Tuesday, 13 trading days after the DJT's Sept. 14 record. Diverging highs between the two indexes can signal growing market instability. Similar divergences occurred leading into the recessions of 2001 and 2008-2009, and most recently heading into the market correction that began in late January.

"The transports have been going sideways and haven't confirmed the new highs in the industrials," said Michael O'Rourke, chief market strategist at JonesTrading in Greenwich, Connecticut. "If the transports were to break down further from these levels, if you saw them declining another 2 or 3 percent in the near future, you would call that a bearish non-confirmation."

On Thursday, both indexes closed lower, with the DJT slipping 0.4 percent and the Dow Jones Industrial Average dropping 0.75 percent.

Delta Air Lines Inc (DAL.N) is due to report on Oct. 9, a week after a lackluster forecasts from the company and its peer United Continental (UAL.O) pulled U.S. airline stocks lower. The bulk of the companies in the DJT are expected to post results in the latter half of October.

FedEx Corp (FDX.N), the first in the group to post quarterly earnings on Sept. 17, missed Wall Street estimates as costs weighed on margins. The global package delivery company has been challenged this year by the ongoing trade disputes between the United States and its major bilateral trading partners, notably China and Europe.
Although a preliminary deal to replace the North American Free Trade Agreement (NAFTA) has boosted railway stocks, looming tariffs threaten to increase the cost of transporting goods and services, further testing other DJT constituents.

"There may well be blood in the water before we actually get some kind of agreement on trade between the US and China," said **Bernard Baumohl, managing director and chief global economist at the Economic Outlook Group** in Princeton, New Jersey. "It could do some serious damage in the long run as China seeks to establish new supply chain routes from other countries and rely less on the United States."

Analysts see costs of transportation fuels, which include gasoline, diesel and jet fuel, continuing to climb due to tightening supply and increasing demand.

Rising fuel costs are "depressing stocks that make up the transportation index," **Baumohl** added.

Brent Crude prices LCOc1 have risen nearly 27 percent since the beginning up the year and energy analysts see the trend continuing well into 2019.

“In the near-term we’ve seen prices increase as a result of Iranian sanctions reducing the supply of crude oil to the market,” said Andrew Lipow, consultant at Lipow Oil Associates in Houston. “I expect that over the next year, the price in transportation fuel is going to be increasing.”

The climbing dollar could also pressure transportation companies as American goods grow less affordable to foreign consumers, which might result in fewer shipments abroad.

The dollar index .DXY, which measures the dollar against a basket of major world currencies, has risen almost 4 percent so far this year.

“The net effect is that (the strong dollar) could impact the transportation index over the course of the next 12 months,” **Baumohl** said.

Meanwhile, investors will get a clearer picture in coming weeks of the extent to which trade jitters, fuel costs and the rising dollar may have turned transports into a warning sign.

“There are a lot of wild cards out there now,” said **Baumohl**.

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