CII

MAY

2005

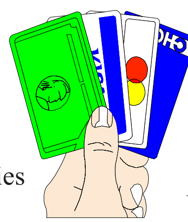
Announcements

Inside This Issue:

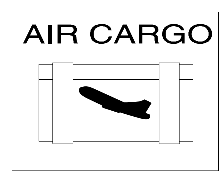
Are We Becoming A Service Economy?

Defenders of the growing number of U.S. manufacturers outsourcing their operations overseas claim everyone will benefit from moving jobs abroad. "Globalization" is the mantra of those who advocate unrestricted free markets. They assert that eventually, the U.S. will profit with the expansion of better paying jobs that call for greater skills and higher education. While we're waiting for this millennium, the U.S. is becoming a service economy to an even greater degree than ever before. Walk into any Wal-Mart store and almost 90 per cent of the goods on the shelves are foreign made. Adding to this witches' brew is the explosive growth of consumer and business credit, now reaching the astronomical sum of $5 trillion. Credit and finance are the fastest growing sectors of the economy. Twenty years ago, financial companies accounted for only 4 per cent of all corporate earnings. Today, they account for 40 per cent. Back in the seventies, financial companies accounted for just 5 per cent of all stock market capitalization. Today, they represent 25 per cent of total market value. It seems that more and more Americans are making a living selling credit to each other. Manufacturing companies like GM who once towered like Colossus over American industrial empires, now face the ignominy of having their bonds reduced to almost junk status.

There is little question the U.S. financial system is dangerously stretched and vulner- able. The Federal Reserve's ability to contain a serious break in any part of our highly connected financial system has become very limited. The mantle of growth has passed to the Continent of Asia. The great expansion years of the U.S., Europe and Japan are over.



Can we continue our prolifigate ways permanently? Can we run up $500 billion trade deficits forever? The U.S. has been living under a lucky star for many years. I expect that star will be dimming in the not too distant future.



Contradictory Signals On China Trade:

There are mixed signals coming out of China. Most indicators still reflect continued growth this year in trade volume between China and the U.S. But there are a few troubling signs that slowdowns may be occurring in that "factory to the world." U.S. cargo airlines are spending millions of dollars to expand their operations in China. UPS is launching new service between the U.S. and Guangzho, the big industrial city in China's southeast, with six daily flights. FedEx is considering establishing a new hub in that city. Polar now flies nine flights per week into Shanghai. But are these airlines chasing elusive pots of gold?

> *"...the last month in which figures are available, the deficit in shipped goods to China reached almost $14 billion."*

Other airlines are watching nervously as once full aircraft now fly out of China with space to spare. Lufthansa is reporting a small but worrying drop in China traffic. And airline execs are beginning to take seriously the huge imbalance between load factors in ex-China and ex-U.S. flights. How will they cope with this very weak backlog? In February, the last month in which figures are available, the deficit in shipped goods to China reached almost $14 billion. The $14 billion amount is hardly pocket change. This deficit cannot continue while at the same time airlines are ramping up cargo service. Something's got to give. That something inevitably will be rates. Air cargo is not a commodity business. We don't move raw steel or barrels of oil. We fly generally high value manufactured and semi-manufactured products that require rapid, precise delivery schedules. With all this outsourcing, the U.S. is becoming less and less a manufacturing bastion. Perhaps to alleviate this imbalance of trade, we should ship, as cargo, the thousands of consultants and 3PL executives who now clutter up the air cargo landscape.

Will Panalpina Resume Its Growth With Beatson Out?

The overhaul was abrupt. The announcement was brief. The high brass at Panalpina's Swiss headquarters decided that David Beatson, head of North American operations for the freight forwarder, had to go. Panalpina's CEO, Bruno Sidler, obviously had no wish to repeat the mistakes of Emery and Circle Air Freight who allowed Beatson, when he was their top man, to run those companies into the ground. In addition to his crude "take no prisoners" managerial style which was bitterly resented by the Panalpina staff, Beatson began implementing extravagant and costly sales and marketing programs which disconcerted and shocked Panalpina's conservative executives back in Switzerland. Perhaps equally as important as the ouster of Beatson himself was the removal at the same time of four of his cronies who aped his chaotic methods of management. They included Gary Dittman, exec VP of sales & marketing, Doug Brittin, VP of sales, Bruce Spear, VP of business development and David Burnell, VP of domestic service.

Now that Sidler has cleaned house, he faces the tough task of rebuilding the company's key North American operations and restoring morale in a shaken work force. He's made a good start in elevating Hans-Peter Merath, a 42-year veteran at Panalpina, to head North American operations and Daniel Trafzer to oversee finances at the Foster City, CA headquarters. These management changes come at a critical time in Panalpina's long history as a freight forwarder. The company is preparing for an initial public offering on the Swiss Stock Exchange. It is trying to respond to the rapid expansion and fierce competition of companies like Exel, DHL, Danzas, Kuehne & Nagle who have outpaced Panalpina's growth in recent years.

It will be interesting to follow Panalpina's progress under its new management. It also will be interesting to watch the fate of Beatson after his abrupt departure from Panalpina. Will another cargo organization ignore his "damaged goods" and hire him? Stay tuned.

South Pacific Airlines Showing Good Growth:

The two major flag airlines serving the South Pacific; Qantas and Air New Zealand, have reported solid operational and financial results for the six months ended December 31, 2004. All indications point to those gains continuing into 2005. Improvement at Qantas was particularly strong with revenues up 11 per cent to $6.4 billion (Australian) with profits rising 28 per cent to $484 million (Australian). At both airlines, cargo traffic is providing a solid underpinning to passenger revenues. Of course, these increases reflect the currently strong economies of both countries. While far less publicized than the Chinese "miracle," the South Pacific is enjoying its own quiet boom. Fueled by the declining value of the U.S. dollar, the U.S.-Australian Free Trade Agreement taking effect last January and the greatest growth in GNP of any developed nations, Australia and New Zealand (at least currently) present two bright spots in a very mixed international air freight picture.

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There is an interesting sidelight to the overall South Pacific airline scene. Virgin Blue, which started with such fanfare a few years ago to serve the Australian domestic market after the demise of longtime carrier Ansett, is finding it easier to talk the talk than walk the walk. Qantas' domestic carrier, Jetstar, is eating Virgin Blue's lunch with a rapidly growing share of the market. Virgin Blue's Board foolishly rejected Patrick Corporation's bid of $1.1 billion (Australian) to control 100 per cent of that airline as "inadequate." Virgin Blue will be lucky to get half that amount next year as its share of the market keeps dropping. Adding to the airline's troubles was the abrupt resignation of co-founder and Deputy COO Robert Sherrard who left to "pursue other interests." Smart man to step aside from the Virgin Blue mess while there was still time.

Domestic Air Freight Losing Out To Trucks:

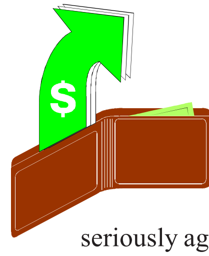
While CII as an international freight wholesaler is not directly involved in domestic air cargo, we are naturally concerned with the health, or lack of it, of our entire industry. And the health of the domestic air cargo business is not good. Within U.S. borders, the world's largest single market for air freight, the truck is the winner and the airplane is the loser. Shippers, freight forwarders, airlines and trucking companies; all are being pulled in a jet stream heading straight down to the highways of our nation.

What began a decade ago as an effort by shippers to cut costs, has evolved into a huge business for LTL truckers. They always have offered lower rates. Now, they have combined these far cheaper tariffs with excellent service. In fact, the LTL market has become so efficient, it has negated the need for two day or deferred air freight for just about every section of the U.S.. Air has a clear advantage only for trans-con traffic and even that is being eroded by express trucks. Many shippers simply will not pay air's double rates just to save a day.

Domestic Air Freight Losing Out To Trucks -cont-:

The decline in moving domestic cargo by air is occurring with all kinds of cargo and across all weight breaks. While FedEx' domestic ground operations are expanding at an almost exponential pace, its air express volume is decreasing. Ditto for UPS. They had disappointing financial results in their next to last quarter although the company's most recent quarter did improve. The disappointing results were the direct result of lack of growth in the overnight domestic package business. Kitty Hawk and BAX Global, the two major domestic cargo airlines for heavyweight freight, are quietly expanding their surface operations. Even when shippers and their forwarder agents are willing to pay a higher price for air, they are finding less options. The financially strapped airlines are eliminating frequencies and substituting smaller aircraft on domestic routes. These narrow bodied airplanes simply can't handle heavyweight and/or odd-shaped cargo that the wide bodies could in the past. The growing reliance by shippers for expedited, dedicated LTL ground service is such a sweeping, profound trend, it will be tough to reverse. How can air freight compete with surface rates that start at 15 cents per pound? Currently, international forwarders are benefiting as both passenger and cargo airlines are scheduling more non-stop flights overseas, particularly to the Asian Continent. In our fast changing industry, however, nothing is permanent.

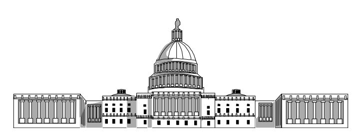
Whatever Happened To The Economic Recovery?



President Bush is facing a political dilemma that has bedeviled Presidents throughout U.S. history—the second term jinx. FDR's second term was disastrous after his failed attempt to "pack" the U.S. Supreme Court. Nixon's second four years ended in Watergate and disgrace. The current "soft patch" in the U.S. economy which shows every indication of widening, may well be President Bush's Achilles heel. All indications point to a weakening U.S. economy. Housing starts dropped almost 20 percent in March. The growth in jobs has been persistently anemic. Our trade deficit continues to balloon with higher negative numbers being recorded each month. Perhaps our most important and often most accurate
Only corporate profits continue to put on weight. But corporationshave not flexed their muscles. They are not using the gusher of earnings to expand plant and equipment or to generate new jobs. Rather, they are holding onto their cash like the most fervent misers. Corporate cash is at record levels. Exxon Mobil has a tidy $27 billion tucked away. IBM has more than $5 billion. United Technologies with $3 billion. CEOs, once kings of the jungle, have become pussy cats.

"Unless and until companies lose their timidity and begin expanding production; start hiring seriously again—our economic :recovery" will go nowhere."

Unless and until companies lose their timidity and begin expanding production; start hiring seriously again—our economic :recovery" will go nowhere. As a nation, the U.S. is consuming and investing in various financial instruments 6 per cent more than we are producing. That 6 percent shortfall is made up by money imported from abroad—some $2 billion a day. In the process, we're absorbing a mind-boggling 80 per cent of the world's net flow of capital. Obviously, this imbalance can't go on forever. How much longer will the central banks of China and Japan accept our paper in return for their nations sending to us automobiles, computers, TV sets, toys, apparel and hundreds of other kinds of real products? If this "recovery" turns into a recession, Bush will continue the second term tradition of a failed presidency.



Sincerely,

Julian A. Keeling