The Railroad Week in Review
August 14, 2009

"I hope Dan Elliott studied some undergraduate economics." – Larry Kaufman on the Senate STB confirmation hearings

Week 31 carloads slid another 18 percent for the third week in a row after dropping 19 percent and 21 percent in Weeks 28 and 27 respectively. Says Chris Ceraso at Credit Suisse, "We don't want to count our chickens, but it looks like we are on the brink of what could prove to be a rebound in the industrial economy." He adds, "Auto volume has consistently improved on a sequential basis for the past six consecutive weeks." The flip side is that the surge could be an artificial demand for new cars coming on the heels of the cash-for-clunkers gimmick. And everybody knows auto sales can goose or degrade demand for everything from steel to chemicals to met coal.

This week's declines showed up in nearly every commodity. Ceraso highlights weakness in metallic ores and minerals (minus 48.2 percent), forest products (minus 26.4 percent), non-metallic minerals and products (minus 23.8 percent), motor vehicles and equipment (minus 23.5 percent), intermodal (minus 17.2 percent), and coal (minus 11.8 percent). By railroad, the downward drift ranges from minus 15.5 percent at CSX to minus 24.4 percent at CN.

RMI's RailConnect Index has Week 31 shortline carloads down 28 percent for the week and 27 percent year-to-date. The only commodity down less than ten percent is "farm & food ex-grain" (essentially all but corn, wheat and beans) at minus seven percent. The next least bad is coal with chemicals three-tenths of a point behind, both in the 13s. At the other end of the scale are motor vehicles and parts (no surprise here) at minus 53 percent, metals & products (minus 49 percent) and ores (minus 44 percent.)

The outlook for corn, beans and wheat is encouraging, reports the US Department of Agriculture. Clearly, BNSF and UP will be the biggest beneficiaries, thanks mainly to greater export exposure than the eastern roads. Of the three grain groups, corn has the best upside and UP will benefit thanks to its central corn belt franchise where Wadewitz and the USDA see crops up 6.8 percent. Wheat's outlook for 2009, while still down from 2008, is improving with the August estimate up three percent since July. BNSF, with the stronger Northern Plans franchise, will see a three percent grain production increase. The estimate for beans calls for eight percent more production.

"Demand tends to be more stable in the east as the rails are primarily transporting grain for use as feed (chicken farms) in the Southeast. Growth in ethanol transport (reported under the agriculture segment on a quarterly basis) remains robust and has provided a meaningful boost for the Eastern rails and has been a source of modest growth for the Western rails." It's also one of the commodities fueling the UP's corn advantage. Iowa is the world leader in bushels-per-acre and UP (ex-CNW and others) is the dominant Class I. For proof, one need look no further than the UP-Iowa Northern relationship at Manley (see my news item in the August 2009 *TRAINS*, page 6).

Picking up on the ethanol theme, a note from Jeffries & Co tells us, "The USDA increased its estimate for corn use in ethanol due to favorable ethanol returns and improved blender economics. Ethanol imports could also come in below expectations due to the sharp run-up in sugar prices. A favorable EPA blend rate decision [pushing the ethanol requirement for motor fuel to 15 percent from ten percent] by Dec 1 could increase annual ethanol demand by more than ten percent."

The economy still takes top billing in the financial pages, though the stress on the number of people un- or under-employed is misleading. If ten percent of folks available for work aren't working at all or as much as they'd like to, then ninety percent of workers are fully engaged. We still have rush hour traffic jams and long lines at the grocery store, even Whole Foods, I might add. So just how bad is the effect of 20 million souls out of work if 180 million still have paychecks?

Liz Ann Sonders, Charles Schwab & Co, said in a webcast, "Companies continue to maintain extremely lean inventories, leading to the real possibility that production will have to expand to meet even modest demand growth. Governments and central banks in the United States and around the world are committed to keeping accommodative policies in place for the foreseeable future. Although we are positive on the near-term market outlook, risks remain and we have not abandoned the possibility of a double-dip recession coming down the road, illustrating the continuing importance of risk tolerance assessment and diversification...

"While keeping drastic measures largely in place, the Fed's recently released Beige Book confirmed its belief in the economy's modest signs of improvement. However, there remains little appetite among the Federal Open Market Committee (FOMC) members to remove some of the extraordinary measures until the recovery becomes more entrenched... Jobs will continue to be lost and consumer de-leveraging is likely a long-term story. However, consumer spending has historically led job growth, not the other way around. While the savings rate has increased, it tends to level off in the second phase of de-leveraging, and consumer spending tends to turn positive."

As a measure of the consumer's reluctance to spend the Big Bux, Goldman Sachs on Monday downgraded Best Buy according to a note on Bloomberg.com. Shares immediately dropped 5.3 percent to $37.66 as Goldman reduced its recommendation on shares of the world's largest electronics retailer to Neutral from Buy, citing competition, "erosion" in entertainment software and "aggressive" spending to fuel growth.

For anecdotal intelligence indicating an economy on the cusp, see the Jeffries & Co note sent out Thursday re their Buy ratings on Home Depot (HD) and Lowes (LOW). As to the former, "Despite realizing some of the 'easier' gains in HD recently, signs of improvement in the business and housing overall keeps our rating favorable at a Buy. Our target multiple is predicated on continued improvement in housing prices, better turnover and continued improvement in comp store sales."

As for LOW, "Signs of improvement in Lowes' business and housing overall keeps our rating favorable at a Buy. Macro data is pointing to improvements in housing turnover, inventory and pricing, which is the primary reason we are raising our price target rather than lowering our rating as we hit old price targets."

The UBS *Daily Economic Comment* for Tues Aug 11 offers some support. "Productivity likely surged in the second quarter as business output fell much more slowly than in earlier quarters but hours worked continued to plunge. The employment trend index, which is a composite of eight indicators related to the labor market, was unchanged for the second consecutive month, although [still] down 20 percent year over year." Could be we are getting closer to the point when employers are no longer cutting their workforce.

And Tuesday's *Daily Market Notes* from Dominick & Dominick LLC says, "Most economic forecasters say the recession will end this quarter, but most also believe a U.S. recovery will be subdued, according to the monthly survey of economists published by Blue Chip Economic Indicators. The panel of 51 economists predicts that the economy will contract by 2.6 percent in 2009 and that gross domestic product will grow 2.3 percent in 2010, according to the median forecast.

Most of the forecasters look for subdued inflation and stubbornly high unemployment through the end of 2010. Specifically, the consumer price index is expected to rise 1.9 percent next year and the 2010 unemployment rate should average 9.9 percent."

In sort of a railroad roundup note this week Ed Wolfe gave GWR particularly high marks for its $26 million acquisition war chest coming off a "strong track record of accretive deals." Moreover, "using historical multiples of seven times trailing debt/EBITDA, we estimate the full $262 million of acquisition powder could add $0.39 of annual EPS accretion." Also, Wolfe figures only about six percent of GWR freight revenue is directly consumer-related and GWR "has the least consumer-related exposure of all 30 companies in our coverage universe. We believe this positions GWR well for an industrial-led rebound as the consumer likely lags." Upgrade to Outperform.

Elsewhere, Wolf upgraded KCS to Outperform thanks to signs of a turnaround in weekly revenue units, having reached a level not seen since last Thanksgiving when -- like everybody else -- KCS revenue units fell precipitously. "This rebound seems largely company-specific into improving cross-border traffic (i.e. grain and chemicals) and auto production in Mexico.

"KCS' Mexican volumes are highly-leveraged to automotive and industrial demand yet in 2008 the railroad generated 44 percent of its sales and 55 percent of its EBIT in Mexico. However, Mexican EBIT for the first half of 2009 was down 75 percent year over year on a 28 percent revenue-unit decline. The largely fixed Mexican labor force pressured EPS in the first half of 2009 but should eventually provide strong operating leverage to a rebound in volumes."

Larry Kaufman writes in the Journal of Commerce, "There was some interesting colloquy at Daniel Elliott's confirmation hearing to be chairman of the Surface Transportation Board on July 29." Following a brief history of rail regulation beginning with the original Interstate Commerce Act, Larry reminds us that intermodal "was one of the first classes of freight to be exempted from economic regulation [and] has been the fastest growing rail segment in recent years, proof that the railroads' price and service package meets shippers' needs."

[To me the red flag to all short lines was where Kaufman points out that Senator John D. Rockefeller IV, Democrat from West Virginia and namesake one of the most egregious early manipulators of railroad rates, said he "intends to revise the Staggers Act."]

Larry concludes, "I hope Dan Elliott studied some undergraduate economics." And in a subsequent e-mail exchange with me on the subject, Larry adds, "I have little hope of anything that really will encourage railroad profitability and/or capital spending. I might pose the question to the President: How can you develop a meaningful environmental policy without simultaneously doing everything in your Administration's power to encourage the shift of freight from the stressed highway system to the railroads?"

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RailConnect Index of Short Line Traffic

Traffic Type: All

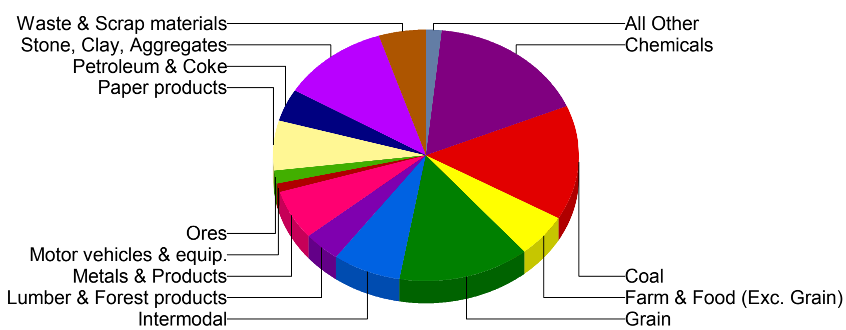
For the week ending: 8/8/2009

Week Number: 31

Carloads Handled	Current Week			Year-To-Date		
	2009	**2008**	**% Change**	**2009**	**2008**	**% Change**
Coal	12,437	15,922	-21.89%	406,060	467,744	-13.19%
Grain	12,931	15,912	-18.73%	381,490	458,846	-16.86%
Farm & Food (Exc. Grain)	5,035	5,322	-5.39%	155,205	167,317	-7.24%
Ores	2,097	2,504	-16.25%	49,829	88,209	-43.51%
Stone, Clay, Aggregates	11,924	14,788	-19.37%	320,700	397,116	-19.24%
Lumber & Forest products	3,673	5,394	-31.91%	109,786	153,299	-28.38%
Paper products	5,621	7,741	-27.39%	177,062	235,229	-24.73%
Waste & Scrap materials	4,544	7,133	-36.30%	134,582	202,736	-33.62%
Chemicals	15,640	17,525	-10.76%	469,315	542,507	-13.49%
Petroleum & Coke	3,625	5,649	-35.83%	109,624	180,515	-39.27%
Metals & Products	5,027	11,833	-57.52%	175,751	347,180	-49.38%
Motor vehicles & equip.	1,157	2,034	-43.12%	29,512	62,212	-52.56%
Intermodal	6,186	11,987	-48.39%	201,513	392,640	-48.68%
All Other	1,311	3,157	-58.47%	42,542	94,068	-54.78%
Total	**91,208**	**126,901**	**-28.13%**	**2,762,971**	**3,789,618**	**-27.09%**

RailConnect Index

Year-To-Date



All Other	1.5%
Chemicals	17.0%
Coal	14.7%
Farm & Food (Exc. Grain)	5.6%
Grain	13.8%
Intermodal	7.3%
Lumber & Forest products	4.0%
Metals & Products	6.4%
Motor vehicles & equip.	1.1%
Ores	1.8%
Paper products	6.4%
Petroleum & Coke	4.0%
Stone, Clay, Aggregates	11.6%
Waste & Scrap materials	4.9%
Total:	100.0%