THE RAILROAD WEEK IN REVIEW

December 10, 2010

"Debates are still raging as to whether the economic recovery is on a sustainable path." -- Liz Ann Sonders, Chief Investment strategist, Charles Schwab & Co.

Last week I posited that ethanol is a chemical, not a grain product, for carload volume reporting purposes and the feedback has been helpful. To begin, the AAR's Clyde Crimmel is the one who tracks these things for the Association and he is most unequivocal: "STCC 28 includes all chemicals and allied products (incl. ethanol and fertilizer). RailAmerica's James Shefelbine writes, "We use 12 commodity groups in our monthly carload reports because they best represent our diverse mix of commodities. Ethanol is in the chemical group."

And Janet Weiss, AVP for Investor Relations at CP notes, "Ethanol is currently captured with the "energy" segment of our Industrial products segment." [CP's market segments for the analyst community are Grain, Sulphur/Fertilizers, Industrial and Consumer, Automotive, Coal and Intermodal.] So if it's reported as chemicals, why isn't it marketed like chemicals? Grain for export or chicken feed is one thing, grain as a fuel additive is another. STCC 29 anybody?

It turns out there are other anomalies. UP includes auto parts in its automotive category, logically enough, though much of it moves in intermodal boxes to and from Mexico. Scrap paper and metal are classified as scrap along with municipal solid waste even though they are ingredients for new paper and other metal products. But these are minor quibbles compared to ethanol. Readers are invited to share their thoughts on the matter for posting in a future Week in review.

Intermodal's year-over-year volume changes for the North American Class Is continue to run well ahead of carload gains including coal and grains, says the AAR. For Week 48 ending Dec 4, intermodal was up 14.8 percent to carload's 9.3 percent. The biggest year-over-year deltas are metallic ores 57.3 percent and metals & products, 43.1 percent. Chemicals -- including ethanol -- gained 13.1 percent and aggregates increased 14.6 percent while coal continues to languish at a meager plus 1.6 percent. Grain, another biggie of short lines, treads water at plus 6.4 percent.

RMI's RailConnect Index with 341 roads reporting has Week 48 revenue unit volumes up 10.7 percent; ex-intermodal carload loads were up 11.3 percent. As with the Class Is, the short lines' big winners were ores, up 64.1 percent; metals and products, up 33.9 percent; and aggregates, up 18.8 percent. Grain held its own at plus 11.2 percent. Coal slipped 4.8 percent. I was surprised to see chemicals up only 7.1 percent. Lumber and other STCC 24 items have slipped to less than four percent of shortline carloads and represent the lowest positive delta of any shortline commodity group.

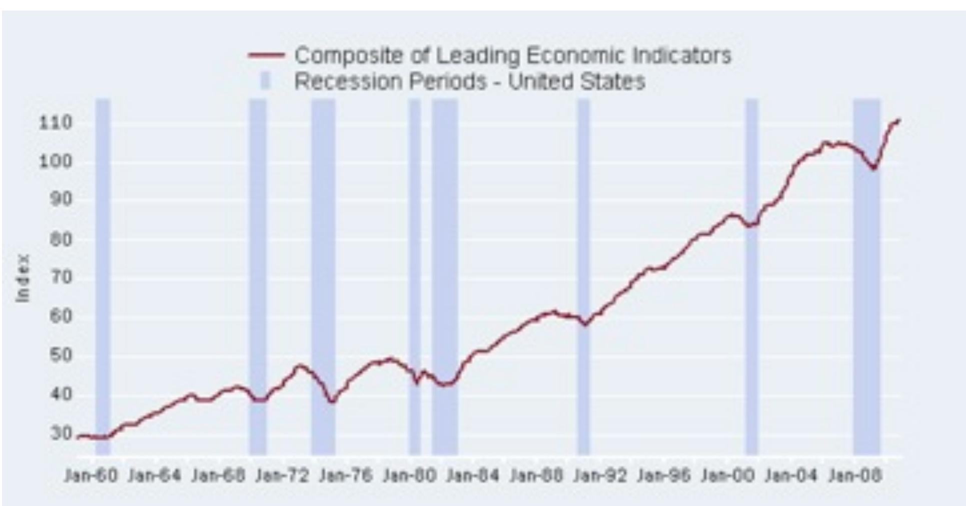
But let's get back to the metals group for a minute. It continues to confound me how we can be in a down economy yet the metals group -- including ores -- continues to gain in volumes. Metals are in the S&P Materials group, along with chemicals, construction materials and forest products (both wood and paper). The group is up 21.6 percent year-to-date vs. the S&P's 10.7 percent gain.

The metals & mining group (including both ferrous and non-ferrous metals plus mining outfits like BHP and Rio Tinto) represents two-thirds of the market cap of the group and stock prices within the group are up an average of 22.6 percent. (By way of comps, construction materials shares are off 20.4 percent.) Within the steel group, the best large-cap stock price runs year-to-date have been in the international names like the Russian steel-maker Mechel OAO and ore-producer Cleveland Cliffs. Major US steel-makers have fared less well -- Nucor and US Steel shares are off 22 and 15 percent year-to-date respectively.

As for the state of the steel industry (which Schwab ranks as a D) Credit Suisse sees little change in output for 2011, thus the depressed stock performance. Nucor, for example, saw total shipments drop by a third 2008-2009 with estimates for 2010 up 25 percent over 2009, still 12.8 percent off the 2008 number. The note suggests 2012 tonnage will still be off 1.3 percent from 2008 production.

So the big 2010 carload volume deltas have little to do with increased steel production and a lot to do with a dismal 2009. Looking at US roads alone, the AAR puts the 2007 Week 46 "metals & products" volume at 596,695 loads; for the 2010 Week, the total for the commodity group was 421,347, down 29.4 percent. (The 2009 count was 285,086, off 52.2 percent.) If Credit Suisse is right, it could be 2013 before the rails are back to the 2007-8 peak numbers.

My favorite economist, Charles Schwab & Co's Chief Investment Strategist Liz Ann Sonders, writes in her December 3 note, "Debates are still raging as to whether the economic recovery is on a sustainable path. However, zeroing in on several recent economic data releases reveals a clearer picture, and one that appears to be brightening. Manufacturing data, a leading indicator, continues to paint a largely positive picture.



“The recent Philadelphia Fed Survey indicates robust activity and it’s confirmed by another positive reading of the Institute for Supply Management's Index, which came in at a slightly lower but still-strong 56.6 for November. Additionally, the Index of Leading Economic Indicators (chart source: FactSet and the US Conference Board, as of December 1, 2010) rose again, moving up 0.5% in October and continuing to reaccelerate from the soft patch we saw in the middle of the year.

“Finally, we remain optimistic on the market's prospects heading into 2011. It appears that confidence among consumers and businesses is building, which should lead to higher consumption and investment that we believe will get money flowing through the system again—increasing the velocity of money.”

Yet on the other hand the *Wall Street Journal* reports a fair degree of uncertainty about taxes and the regulatory environment on the part of lenders and would-be borrowers. The paper concludes that those who can meet the strictest possible federal requirements for borrowing won’t, and those who need money but are in a weaker financial condition can’t. As a result, nobody’s hiring.

Kansas City Southern has begun a new branding initiative that will use the original railroad logo, plus others based on the historic emblem. Under current Executive Chairman Mike Haverty, the company expanded into Mexico and Panama. As the company expanded, new logos based on the old design were created for Kansas City Southern de Mexico, and the Panama Canal Railway.

The new branding will group the original logos for Kansas City Southern Railway, Kansas City Southern de Mexico, and the Panama Canal Railway Company, and adds the statement, “Business Without Borders.” The original logos and new tag line, along with the red, gold, and black colors of the “Southern Belle” heritage paint scheme, will be featured on marketing material, video, print advertisements, and a new website now being developed.

This is a brilliant move. Companies work long and hard to develop their “brands,” names and images that connote instantly who and what the company is. Names like Union Pacific, Atlantic Coast Line, Strasburg Railway, Central Vermont, Virginia & Truckee said all that needed to be said about what the company did and where it went. The Kansas City Southern goes south from Kansas City. I like that.