THE RAILROAD WEEK IN REVIEW
February 7, 2014

"Cyclical sectors [transportation is one] have been underperforming more defensive sectors, while value is underperforming growth. These are signs of a deteriorating economic growth outlook and possible continued market weakness." - Liz Ann Sonders, Schwab Inc.

Liz Ann reminds us that her Schwab writings have been alerting investors of the likelihood of a correction since late last year. She attributes this view to the "frothy sentiment" that grew out of a stellar 2013 investing year and the beginning of monetary policy normalization via the Federal Reserve's tapering of quantitative easing.

Brad Sorenson, Schwab's Director of Market and Sector Analysis, sees a brighter side:

> Although the global manufacturing picture still appears a bit murky, we continue to believe the Industrial Group will outperform. The national ISM Manufacturing Index has moved back into expansion-mode recently and regional surveys have been better. US political concerns appear to have lessened as a budget agreement was reached, likely taking the possibility of another government shutdown off the table.
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> We believe corporations have been cautious, but the investment picture appears to be brightening. Corporate balance sheets are relatively cash rich, which could help push management to invest in new, more-efficient equipment to help offset production losses due to layoffs. Lending standards, while still tight, have started to loosen, which should help boost capital spending. And inventories in much of the manufacturing area appear relatively low, leading to the possibility of a demand-inspired rebuilding phase.

Which leads us to the rails and how their Q4 performance positions them to participate in any economic turn-around first in North America and then in global markets.

The fourth quarter railroad earnings season spread the first place awards around pretty evenly among the six Class Is reporting. CN and KCS tied for greatest increase in total railroad revenues, 8.3 percent. CP, NS and UP had revenue increases in the seven-percent range; CSX lagged at 4.7 percent, though leading the pack with a 6.1 percent revenue-per-unit gain and coming in second only to KCS in RTM gain, 7.2 percent to KCS's 7.7 percent.

Union Pacific took the honors in carload (ex-coal, ex-intermodal, including crude and auto) revenue percent change, up 12.7 percent, and, most encouraging for Class II and III carriers, all rails' merch carload revs were up 10-12 percent. CP had the greatest system RPU increase, 6.3 percent. CN, KCS and UP were all in the sixes, while NS and CSX lagged at plus 3.3 percent and down 1.3 percent respectively. KCS gets more revenue from its merch carload sector than anybody, 72.6 percent, with CN a close second at 71.5 percent.

NS increased merch carloads by 7.6 percent, best of class, with UP a close second at 7.3 percent; CN took first place in merch carload price gains, 9.7 percent. Only CP was close, 8.5 percent; others remained in the low single-digits. CN had the lowest operating ratio, 64.8, while CP had the greatest OR improvement, down 887 basis points to 66.0.

Take-aways for the non-Class I connecting lines: merchandise carloads are coming back, though unevenly. Crude is a big percentage gainer, though it's still only two percent of total merch revenue units. Auto, too, though part of the merch carload total, is six percent of total. Grain, seven percent of Class I merch carloads, is coming out of its funk and we're seeing some growth in both forest products STCCs - lumber for housing and paper for packaging.

Operating expense gains were mostly held to the low mid to low single digits (NS held to less than two percent) as RTMs went up faster than crew-starts or gallons of fuel consumed; dwell hours went down and car-miles per day went up. Cars and locos are turning faster, and, done right, that can lead to shorter-haul moves in the carload sector.

As was noted at our Union League pif Philadelphia railroad panel Monday night, the carload business takes trucks off *all* highways by eliminating drays between customer and ramp. We just have to reduce avoidable cost and time out of the present model. Turning the cars faster is a start.

Cherilyn Radbourne at TD Securities sums up the quarter with several key take-aways. To begin, severe weather "clipped the upside from what was otherwise shaping up to be a very strong quarter," however, she found encouraging the way "merchandise and intermodal volume growth exhibited better strength and breadth" in the quarter. And "execution continued to be very strong industry-wide" in spite of the harsh December weather.

I was particularly pleased to read in her note the way winter impacts train ops. None of it is any surprise to WIR readers, but you'd be surprised at the number of railroad investors I meet who don't get any of this. Says Cherilyn,

> Cold weather affects capacity by necessitating shorter train lengths and reducing velocity, adding operating expenses in Q1/14 in the form of higher labour costs, lower fuel efficiency, and higher purchased services. Some traffic not moved during periods of bad weather is lost permanently (typically intermodal) and some is simply deferred (typically coal, grain, and some types of merchandise traffic). First quarter 2014 results will hinge to some extent on how much of that deferred traffic the rails can catch up on in February and March.

She concludes with a word of caution concerning CP. Whereas CP has exceeded expectations in its operational turn-around, the rapid share-price appreciation leaves "little-to-no cushion for risks that management cannot control," such as changes in the global economic growth rate. She mirrors my thoughts that you can only drive costs down so far and it takes new revenues to move the needle on the denominator of the operating ratio formula.

Crude oil by rail is a really big deal, right? The January *Rail Time Indicators* publication from the AAR says December, 2013 carloads of petroleum and petroleum products rose 17 percent year-over year and that about half of the petroleum and petroleum products category consists of crude oil, up from a third in 2012 and an eighth in 2011.

The US and Canadian Class Is did a million carloads of "petroleum and petroleum products" in 2013, implying 500,000 units of crude oil. Total volume, including coal, auto, and intermodal boxes, came to 34.3 million units, making crude oil less than two percent of of the total.

Total Class I revenues including intermodal and demurrage will run something north of $80 billion for all of 2013. Two percent of that is $1.6 billion across seven railroad names. Round it up to $250 million per name. I've seen estimates that the total tab for the Lac Megantic incident could run $800 million to a $billion and change. Do I as a Class I CEO really want to bet the farm every time I run trainload of crude oil?

What Goes Around, Comes Around Dept. This tidbit came in Wednesday from Art Cashin, he of CNBC fame and UBS Director of Floor Ops:

> The economy was struggling. There was a Democrat in the White House. Congress was divided and squabbling, hostily and uncivilly. Some thought the debates were so coarse and rude they spoke of forming a new political party. Technology was the new mantra even after a bumpy start and telecommunications were exploding (in use if not profitability). Much of the country was in the grip of unusual and extreme weather. And suddenly folks had begun talking about gold....can you imagine "gold!"

Look familiar? Well, it's what was happening on Wall Street in Feb, 1895, and it was J.P. Morgan himself to the rescue, buying government bonds issued to buy more gold for the Treasury. But today, nobody's buying gold because we don't need it to back up the currency. Pity. Old JPM must be rolling over in his grave.