RAILROAD WEEK IN REVIEW

March 18, 2016

"The Dow Jones Transport Index has been below its 200-day SMA since May." — Nathan Peterson, Senior Derivatives Analyst, Schwab Center for Financial Research

On a screen before me I have a list of all six North American Class I rails plus BRK/B as a proxy for BNSF. On the same screen are GWR, PWX, four car builders, GATX, four suppliers, and the IYT iShares Transportation Average. Every name is below its 52-week high by double digits, save Berkshire, off 6.3 percent. Among the rails, CNI is least worst, down 14.0 percent, with CP and GWR bringing up the markers, down 34.2 and 44.2 percent, respectively. Suppliers run the gamut from down 26.4 percent (GATX) to FSTR, down 66. 3 percent.

Most are overpriced, too. I run a Benjamin Graham screen as a simple proxy for fair value: PE 15 or less and no more than 1.5 times book value. Do the math: price/earnings times price/book = 22.5 max, or price squared. So, for any name, the fair price (my Graham Number) is the square root of PE times PB. I want to buy shares at prices 25-50 percent below the Graham Number, but, except for TRN, I can't. The lowest pure-rail is GWR, 95 cents on the dollar, with the rest from 102 cents on the dollar (NSC) to CNI (175).

Then there are the technicals. MarketEdge (R) ranks shares by Long, Neutral and Avoid, based solely on moving averages and price trends. Tech signs for all rail stocks are looking better: six rails and BRK/B Long; CSX and NSC Neutral from Avoid. There are four Long suppliers, two Neutral from Avoid, and two (TRN, RAIL) Avoid. Sorted by relative strength vs. the S&P over 50 days, KCS scores the best among rails and FSTR among suppliers. Remember, rankings reflect what Mr. Market is willing to pay for these names, irrespective of the intrinsic value of the underlying company.

I use a combination of value and tech screens, plus Recognia (R) for most likely future values over the near term (two weeks to six months). Here I can see events that are likely to affect a change in direction for a given name (crossing the 21-day average, head-and-shoulders, etc.). So, putting it all together, at the moment I'm not rushing off to buy any of them, and I'm still long NSC because (1) my cost basis is low enough that my dividend yield is north of three percent; (2) NS has the lowest Graham Number of any Class I; and (3) NS is possibly "in play" with CP.

Throughout all of this, I try to keep tabs on the general direction of the stock market, using the Dow Jones Transportation Index ($DJT) as a leading indicator. Schwab's Weekly Trader's Outlook is excellent in this regard. Last Friday, Nathan Peterson wrote,

> The recent rally in the DJT has been just as impressive as the SPX (S&P 500) but the index still remains in a downtrend (lower highs, lower lows), is having trouble clearing some

congestion from back in December, and remains below its 200-day SMA. Because of these technical headwinds I'm cautious and would take to the sidelines until the index closes above its 200-day SMA (which it hasn't done so since last May).

In other words, the trend is your friend and, irrespective of the Graham Number, Market Edge, and Recognia, attention must be paid.

The downward trend in commodities continues, now with frac sand and steel. An item in Tuesday's WSJ says 60 percent of the fracking equipment deployed in the US is now idle, and, even if WTI prices jump to $50-60 tomorrow, it would take weeks to turn those machines back on. Oil production in Feb was off six percent from last year's high of 9.7 million BPD, and we're hearing noises of another ten percent cut in 2016, never mind the build-up of un-fracked wells.

Dennis Gartman, he of the eponymous Letter, also writes on Tuesday, "WTI crude is likely to trade $5 either side of $37 in the spot market. If at the upper end, banks will force drillers to hedge production from the older wells, drilled previously but capped. Further, the polyurethane makers and the fertilizer producers, among others, will be pleased."

So the economy giveth and the economy taketh away. The rails will see low-rated sand carloads slack off, while higher-rated plastics and other items using nat-gas feedstocks will add vols. However, with ferrous scrap prices off a third year-over-year, and 60 percent of steel in the US being molded from scrap, finished steel tonnage is down 11 percent. The AAR's March 4 *Rail Time Indicators* has both YTD metals and ferrous scrap down 12 percent year-over-year as of Feb 27. Loss of steel pipe carloads for frackers doesn't help.

Another ex-Con joins the Reading & Northern. Rian Nemeroff, most recently VP Marketing for Connecticut's Housatonic Transportation Company, a short line treading the ex-NH rails between Danbury, Conn., and Pittsfield, Mass., joins the R&N as VP-Forest Products, effective last Monday, responsible for managing the R&N forest products sector, now more than a third of the railroad's business.

This brings to three the number of former Big Conrail marketeers at R&N: Wayne Michel, R&N President, whom I met when he ran the Conrail Short Line group, Rian who was my Conrail contact for shortline matters in — what else — forest products — and Dan Gilchrist, who is now the commercial EVP. Rounding out the ex-Con circle is ops guy Tom Cook under COO Tyler Glass. It's always nice to see old friends landing well and re-united.

A friend who tracks railroad pricing practices writes, "It's true that as transit times get longer, rates go up; i.e., more money for worse service. The longer the transit time, the fewer the turns of any railcar. Fewer turns means more equipment needed to move the same amount of product. More cars means higher investment cost for your RR to run the larger fleet, or higher per diem costs paid to another RR if you use more of theirs. History confirms that higher RR costs mean — wait for it — higher rates to shippers." So as trains get longer and less frequent, rates *must* go up and market share *must* go down. That's why the single-car business as we know it is toast.

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