RAILROAD WEEK IN REVIEW

March 25, 2016

"Policy-driven markets change the rules, both the formal rules of regulation and – more importantly – the informal rules of correlation, and they change these rules in predictably surprising ways." — Ben Hunt, Epsilon Theory newsletter, March 16

Knowing commodity comps for Week 10 is useful for tracking volumes up and down but not helpful for *why* commodity volumes are changing nor for what to do today to affect tomorrow's numbers. For example, Cowen rail analyst Jason Seidl writes,

> Coal suffered the biggest y/y decline in Week 10, down 34.6% on tempered demand. Metals fell 12.5%; chemicals (ex-crude) were up 1.3%; agricultural products were down 2.9%; and intermodal decreased 9.6%. Motor vehicles were up 14.6%. Three of the rails are ahead of our estimates and three are behind. CP, NSC and CNI are ahead while UNP, CSX and KSU are behind. With three weeks left to be reported, the variances could change materially.

Jason shows North American total rail vols down 4.2% and total vols ex-coal, grain, IM — essentially the cyclical single-carload stuff the short lines depend on — down 2.9%. Why? What drove chems including STCC 13 and 29 down 5.6% and why the 14.4% decline in met ores and minerals?

The AAR's excellent *Rail Time Indicators* from Dan Keen helps some. Re carloads ex-coal, he writes (Mar 4),

> Carloads in February 2015 were negatively impacted by the West Coast port slowdown and by especially harsh weather in parts of the country. It remains to be seen if the traffic gain in February 2016 is the start of a trend, or just a temporary blip…
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> U.S. steel producers claim that rather than removing excess capacity, Chinese producers are "dumping" product in the United States, unfairly harming U.S. producers…
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> Housing is a key driver of rail lumber traffic, and single family units typically use much more lumber than units in a multi-family building. For several years, new single-family homes have been falling as a percentage of total new homes built…
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> The consensus view among economists now is that no recession is on the horizon, but there's more uncertainty than there was. We often mention that each month the *Wall Street Journal* surveys a group of prominent economists. One question asked is, will there be a recession in the next year? When this question was asked in the summer of 2015, the consensus was a

10% probability. In the February 2016 survey, it was up to 21%, the highest it's been since 2012 (when it was more than 30%)

That's just a sample. As you can see, Dan gives you a glimmer of what's behind the trailing numbers and where to look for likely forward trends. However, I think we have to look globally for broader hints of where the US rail carload market is headed: why, and what can commodity-driven short lines to minimize downside risk?

The Morgan Stanley Spring Outlook: "We are no longer looking for accelerated 2016 GDP growth. The risk of a global recession has increased and we now attach a 30% probability to it. However, solid consumer spending, subdued oil prices and expansionary monetary policy argue against a recession materializing. With **monetary stimulus likely becoming less effective**, fiscal policy and structural reforms gain importance for shaping the macro outlook." [emphasis added]

I emphasize monetary stimulus because it's becoming increasingly clear that Central Bank economists think they control economies and they can make businesses and consumers do what the central bankers and their governments want. Wrong. Consumer behavior runs the economy; governments react. Perpend: government cuts interests to spur business loans and increase commercial activities. Lower interest rates cut into consumer savings so they spend less. Because they spend less, business have less reason to expand. So the government lowers rates/prints more money. Lather, rinse repeat. Clearly, businesses and consumers aren't playing the game.

Spring Outlook shows how annual growth Rates 2015E-2017E are lowest for the US plus the several G10 countries chasing negative interest rate policies (NIRP). China and India represent the other side of that coin. Moreover, the "Monsoon" countries (so tagged by realvision.com) — essentially across the southern rim of Asia from East Africa to Malaysia — sport some of the strongest country ETFs in the world, according to Market Edge.

These are the "Spice Route" countries from Greek and Roman times, supporting the world's greatest civilizations at the time. What goes around comes around, and I see the commodities grown, mined and produced in these countries — more accessible to each other and cheaper than US commodities — replacing literally boatloads of similar commodities from North America. And there's nothing the Fed or the US government can do about it.

The negative carload commodity growth rates and others are the tip of the iceberg as the Pacific Rim and European markets displace US goods with Spice Route goods. The pundits are saying the odds of a 2016 US recession are receding, but they do not say we will see the return of robust (mid-single digits, at least) GDP growth any time soon. That's why the carload franchise volume growth rate is diminishing and why carload commodity railroads must get their houses in order.

Two parts of the RR transaction cost are the time lag between rate request and getting a final rate, and the time and energy spent tracing the car. Hiring a truck is a lot easier. How to bring truck and rail transaction costs closer together?

Constance Hunter, Chief Economist for KPMG, says having "digits around widgets" does just that. Her message is, the more you know about the customer, the less time you have to spend figuring out what the customer wants — wrapping data (digits) about the buyers around what (widgets) they buy. For example…

Amazon knows non-fiction book buyers tend to come from higher-income households and they tend to buy more books. That's why Amazon can say, "Customers who bought this item also bought…" or, "Frequently bought together…" Getting you to buy that second book while already logged in lowers the transaction cost. Yours AND theirs.

Uber gets around the transaction cost of a cabbie waiting for a fare by having the fare come to the driver closest to the fare's location, and by tracking drivers' customer ratings to pre-qualify the riders. In both cases, the seller knows about the buyer before the transaction even starts.

That's why another piece of added transaction cost of doing business with the railroads is finding somebody who speaks your language. Like a forest products market manager who speaks in board-feet or a trainmaster who speaks in queuing theory and supply-chains. So… if the customer can get Uber-like rates the same time he punches in commodity OD pairs, get a trainmaster who knows paper or frozen food supply chains, and be assured the shipment will arrive per trip plan, you've lowered the transaction cost for that customer.

The Constance Hunter interview is on realvisiontv.com, an on-demand, subscriber base on-line service with an extensive video library of exclusive and timely content on economics and investing. Interviews typically last 30-60 minutes and get you stuff you'll never see on the mainstream media. It's the brainchild of Raoul Pal (globalmacroinvestor.com) and Grant Williams (Things That Make You Go Hmmm, ttmygh.com). I'm a charter subscriber and listen to about 5 interviews a week. Rarely do I go away without some new way of looking at something old — like using the Amazon and Uber models to lower transaction costs.

End Paper: I just participated in a conference call with rail customers who negotiate rates. I got the sense that customers have not by and large asked their serving short lines to assist in rate request strategies. This is unfortunate, as any shortline not involving itself in customer rate negotiations with the Class I is missing a unique opportunity to add competitive advantage.
Call me for more on the subject.

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