RAILROAD WEEK IN REVIEW

May 6, 2016

“When business debt is allocated to financial operations, it does not generate an income stream to meet interest and repayment requirements.” - Grant's Interest Rate Observer

“First-quarter earnings at BNSF were down significantly, and that trend will continue for the balance of the year.” -- Matt Rose, BNSF Executive Chairman, Berkshire Hathaway Annual Meeting Q&A

Picking up the Auto Thread. Last week I warned that “subprime loans comprise an increasing share of total car loans.” This week, I’m digging a little deeper into why railroads should care.

In 2015, the AAR Motor Vehicles and Parts category did 906,000 units, up three percent over 2014, and represented about three percent of total revenue units — intermodal, coal and merch carloads. To get a break between finished vehicles and parts, I used the 2015 full-year QCS for NS as a Class I proxy, and finished vehicles represented about 75 percent of all loads, with parts the remainder.

As for the non-Class Is, GE Transportation’s full-year 2015 Rail Connect Index has automotive at a bit over two percent of total volumes, 161,000 carloads, and essentially flat year over year. My hunch is short lines carry more parts than finished vehicles — boxcars, not auto racks in single-car service. So any diminution of vols is going to be noticed across the board.

A 20-year Week in Review reader and contributor from Connecticut picked up the Stephanie Pomboy quote and observes, “You can pretty much take Stephanie to the bank. She gets it. Dealers are plugged with cars. A very large percentage of cars from the Big 3 went to fleet sales. This causes good things in the short term but eventually screws things up for everyone. Just think what all that supply will do to used car prices in two years. And to the leasing companies that may have set their residuals too high based on less supply.”

Three weeks ago the *Wall Street Journal* said March sales to fleet customers such as rental agencies, “in some key cases,” boosted new-car tallies, while sales to individual buyers held steady. Six weeks ago the Journal ran a story (“Subprime Flashback,” March 13) that said record auto lending — not the economy — is creating record auto sales, and that “demand for auto debt has led lenders to systematically loosen underwriting standards, which they predict will result in higher loan delinquencies.” J.D Power says that car loans stretching 84 months or longer and the share of vehicles leased both increased.

I mention all this because the first quarter carload vols for all roads have auto carloads motoring along at a faster rate than just about anything — BNSF was up 21 percent, e.g. The early predictions were for annual sales in the 17 million range. But if subprime loans and fleet sales are the motivators, sustainability must be in question. The AAR's *Rail Time Indicators* for April says the full-year sales was revised down to 16.5 million in March. Says the AAR,

> There's concern that automakers are starting to have to turn to higher discounts to keep up the sales pace. According to Autodata, a market research firm that follows the auto industry, automakers spent an average of $3,110 on incentives per vehicle sold in March 2016, 14 percent more than in March 2015, and up slightly from February. Rebecca Lindland, an analyst with Kelley Blue Book, told Bloomberg, "There are certainly reasons for concern. We're seeing more incentives and longer loan terms. I'm a little concerned that some consumers could be overextending themselves."

But the AAR remains upbeat. Sorta. "Still, market fundamentals — low interest rates, good job growth, consumer confidence that's holding steady, a decent housing market — are still positive and lead most analysts to continue to believe that total sales this year will be close to, if not slightly higher than, 2015's record sales."

I'm not convinced. For consumers to consume new cars, they have to have the discretionary income to do so. Yet, according to a paper by Research Affiliates, the four biggest household expenses go to rent, food, energy, and medical care. These account for roughly three out of every five household dollars for the general population; as you go down the income chain these four approach 90 percent of total spending; the inflation CAGR since 1995 has been three percent. (The Bureau of Labor Statistics conveniently omits this data point because it doesn't fit the Official Narrative.)

The RA paper one of the most powerful indictments of central bank policy that I've seen. Consider the policy effects on the future cost of capital, which is now unknown, but presumed to go up over time. That not only puts a damper on new-business starts, but also on capex and hiring for existing firms. Why plow funds into long-term, non-fungible capex or payrolls when company stock is available for buybacks and can be funded with near-zero-rate financing?

Financial engineering, a fancy name for cooking the earnings report with share buy-backs, is getting closer scrutiny. In his May 1 "Thoughts from the Front Line" letter, John Mauldin offers up a few words on productivity. Last year, says he, productivity grew (!!) at a meager 0.6 percent, the smallest increase since 2013. Worse, productivity's 5-year CAGR is less than one percent. By comparison, productivity expanded at more than two percent a year 1946-2015 — the last eight years dragging down the average.

Part of the reason for the present malaise is a Federal Reserve that makes it cheaper to buy your competition than to compete and cheaper to buy back your shares than to invest in new productivity, is it any wonder that productivity drops? To which I add, as productivity drops, so does the need to move stuff. Since the rails exist to move stuff, the implications are not good.

Matt Rose, BNSF Executive Chairman, rose to his feet at last week's Berkshire Hathaway Annual Meeting Q&A to field a question put to Warren Buffet about BNSF's prospects.

> We still have a lot of headwinds, specifically as the commodity super-cycle is really coming to a close. The strong dollar is a headwind. Certainly the coal business is a headwind. I've seen natural gas prices in my period of stewardship of the company go from $13 and change to now $1.75, and that is really what is hurting coal today. What will hurt coal tomorrow is the Clean Power Act that is percolating through the EPA and the court system.
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> The rest of the economy on the consumer side actually feels pretty good. A lot of growth in domestic intermodal and agriculture should be pretty good for us. So that's the great part about us having a balanced portfolio. And capital is the lifeblood of any railroad. We had the all-time safest year in our railroad. A lot of that is due to the very strong infrastructure and capital we've been able to put in.

David Kotok of Cumberland Advisors this week put the state muni bond market under a microscope, looking at New Jersey and Illinois in particular. The nub of the matter is who gets paid first when the state is insolvent: the investors who funded the very projects that got the state in trouble, or pensioners who have been promised their checks?

> Bubbling up beneath the surface is a political force aimed at mounting a legislative attempt to avoid payment on bonds. It is a growing risk in the United States. We have already seen it in cities like Detroit and Vallejo, California. We see it in Puerto Rico, and we see political movement in that direction in Illinois and New Jersey.

And if states stiff holders of their muni paper, what's the likelihood they will continue to offer sustenance and subsidies to their short lines? Reminds me of something Noel Perry said about "meds for grandma." When a legislator is forced to make a funding choice, say between elder care and track work, it's pretty clear which gets the nod. Concludes, Kotok, "We don't trust governments, and we want our clients to get paid."

A final thought. The 2015 full-year RMI RailConnect Index has total shortline revenue units at 6.9 million units; for 2011 it was 6.0 million units. Now whip out your ever-ready HP 12C and do PV -6.0, FV +6.9, n = 4 and get i = 3.6 CAGR. With inflation running 3.0 percent for the four biggies in household expense, and since we're all households, I can't really say that anything growing at 60 basis points a year is a growth business. Let's see what NS has to say at their Short Line Meeting May 15-18.