RAILROAD WEEK IN REVIEW

August 26, 2016

"Investors and the Fed all presumed that the pre-crisis economic framework was still intact. Five years of steadily decelerating growth and inflation demonstrate things are fundamentally different." Stephanie Pomboy, Barrons, August 20

Share prices for industry-specific ETFs provide an excellent tool for staying ahead of rail traffic trends. The top four gainers in percentage change from their 50-day moving averages are XOP (oil & gas exportation and production), XLE (generic energy), IEZ (US oil & equipment services), and IYM (US basic materials from steel to cement). All four have commodity groups that are railroad friendly; the share-price leadership is a clear signal things are looking up.

Actually, you can find signals (to draw a theme from Pippa Malmgren's book of the same name) of rail trends in many places. For example, UBS publishes its Morning Meeting notes every day and, within the notes, there are updates about the corn crop and home-building that could flag traffic trends.

Monday's note on Deere was mainly on recent price activity, but buried in the third paragraph is "We think further outperformance of DE stock will require materially higher corn prices which we see as unlikely in the near term." Going to the CME Group corn futures page, we see the highest open interest in Sep-Dec-Mar. Prices range from a $309 low (Sep) to a $378 high (Mar). Sep 2016 corn is now $332 after hitting $440 in June and as high as $800 in Jul 2012.

Re home builders, the encouraging news here is younger buyers are beginning to shop. That's especially good news because DoubleLine's Jeff Gundlach for one describes Gen-X-ers as "broke," whereas their parents at that age had at least a down-payment stashed away. In his remarks on a recent RealVision interview, he reinforces WIR comments made about how the younger generation craves experiences more than stuff, and you can't stuff a vacation in a boxcar.

For the home-builder rail angle, AAR's Dan Keen writes in his August *Rail Time Indicators,*

> June's modest gains in housing starts are consistent with a residential construction market that's been in a steady but not vigorous, recovery for several years… Homebuilders are facing a variety of headwinds including a cohort of potential younger buyers who, in many cases, lack the money and the desire to be typical homeowners with a single-family home, a lawn, and a grill in back.

His accompanying chart shows 5-year housing-starts highest by far in the south (Texas to Virginia and north to roughly I-40) and west (the coast and east to the Rockies states). All five US Class Is ought to benefit.

Another set of signals comes from the UBS *House View* for August. The subject is “behavioral finance,” and the comments are directed to investment portfolio managers. However, with a few word substitutions, they apply as well to the carload freight business. “When managing a balance sheet (railroad) to provide the highest probability of meeting a family’s (the railroads) goals and objectives, it’s important to consistently take a holistic view and ensure that all parts are working together as effectively as possible rather than worrying about each individual asset.”

In other words, one must look at the mix of carloads on the line not only in terms pf absolute revenue per car, but also contribution to fixed costs and overhead. As Class Is have downsized, they’ve run off carloads that were low-yielding on a strict revenue/variable cost basis but which none the less contributed to indirect cost recovery and kept rates in line for the remaining, better-yielding carloads with higher RVC ratios.

Anacostia & Pacific’s Louisville and Indiana Railroad (LIRC) and CSX have announced the start of increased CSX ops over LIRC. The two companies agreed back in April that CSX would fund some $100 million in infrastructure enhancements in exchange for the option to run more trains over the line between Louisville and Seymour, Ind., about half way between Louisville and Indianapolis and where the CSX ex-B&O Cincinnati-St Louis line crosses LIRC’s ex-PRR Indianapolis-Louisville line.

The arrangement gives CSX a short cut between Detroit/Toledo and Nashville/Atlanta/Birmingham and gets them off the old L&N Cincy-Louisville line. It’s a classic “keep two sides of the right triangle and eliminate the hypotenuse” move, increasing volumes on the two legs and keeping the third side for back-up. CSX had said in the initial filing, which won STB approval last April, it intends to move “heavier and faster trains” on the LIRC line.

The actual implementation will start on or shortly after Sep 1, raising train speeds from the current limit of 25 mph to 49 mph at many locations. CSX currently runs up to four trains a day on the line and that could more than double with train lengths up to 14,000 feet.

Economist Stephanie Pomboy has probably one of the sharpest eyes on the Where the Money Goes. She argues that a crisis-chastened U.S. consumer retards global growth, which is why any significant US recovery remains elusive, and why Japan and Europe continue to lag. In her August 20 *Barron’s* interview, Pomboy posits that investors and policy-makers are deluding themselves about second-half economic growth, and “today’s low rates could cause another financial crisis, bankrupting pension plans, putting retirees at risk, and hurting stocks.”

> We’re dealing with an aging population. This is another great flaw in the logic of monetary-policy makers. They’ve pushed rates to and below zero in an effort to boost growth. But they

> did so against a population that is aging and needs more than ever to get returns on what they've set aside. By lowering rates, they've actually intensified the saving urge.
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> The statistics bear this out. Over the last four years, U.S. nominal GDP growth has gone from 4.3% to 4.1% to 3.0% to 2.4%… What greater proof do you need that lower rates aren't helping and, to the contrary, are making things worse? Growth and inflation are slowing, and it has to do with this aging demographic. Add the emotional and financial scares from the housing-bubble bust, and policy makers have really got it ass-backwards. They're taxing the economy, not stimulating it.

Moreover, she says, the overly optimistic view of the near future encouraged companies to increase production levels, leading to the excessive inventories (and partially explain the present downward trend in railroad revenue unit volumes.) The rails talked about upticks in construction spending in the 2016 second half, with public highway projects increasing STCC 14 loads. What she calls "repressive interest levels," cause state and local governments to be hard-pressed to meet pension obligations, proving out once again that meds for grandma trump transportation when the politicos have to dole out the dollars

Pomboy's odds are on a second-half GDP growth rate in the one-percent range, half what the consensus is forecasting. But if half the GDP growth is in goods and services, then half is in hard goods that need transportation; if the rails have 25 percent share, then rail vols can grow only at a rate of 25 basis points. Pomboy continues,

> Nominal GDP growth for the full year should average around 2%. It is currently 2.4%. This will trigger a major move to risk-off when it becomes clear that the weakness in the second half, and in 2015 and 2014 before that, wasn't temporary. Investors and the Fed all presumed that the pre-crisis economic framework was still intact. Five years of steadily decelerating growth and inflation demonstrate things are fundamentally different.

Steph wraps by saying consumer discretionary (cars, refrigerators, big-screen TVs, e.g.) names have a "monster inventory overhang," and the resultant share-price decline could well dampen the present uptrend for stocks and shares, possibly back to the 2009 lows. "I could see 2017 being a pretty nasty year." Which suggests the rails had best stick to what they do best, and that's the carload sector, generating more than half of total North American Class I railroad revenue.