RAILROAD WEEK IN REVIEW

September 22, 2017

“U.S. steel is essentially $60 a ton less than the Chinese price. We consume maybe 110, 120 million tons of steel depending on the year. But we only really produce 80 or 90 million tons. So we need 20 to 30 million tons of steel per year.” — Lewis Johnson, Capital Wealth Advisors

Metals are turning around. The AAR reports that year-to-date thru August primary metals (STCC 33, 34) are up 5% — 7% in August alone. Short lines per Railinc are up 14% in July alone and metals make up roughly 7% of all shortline revenue units.

Wall Street seems to be noticing, too. The broad steel category is up 25% over the past 12 months whereas the S&P never got to 20%. Looking at the 5-year chart, steel shares were flat up to January, 2017, and have had a nice run from there. Steel Dynamics, Nucor, Worthington, AK Steel, and US Steel are the leaders and all have facilities on short lines.

Not everything’s coming up roses in the analyst community, however. Schwab’s Brad Sorenson writes, “The commodity price declines seen over the past couple of years may be ending, with global monetary policies helping to arrest the fall. However, rapid gains in commodity prices seems unlikely at this point, and a tightening Fed gives us caution… Chinese economic growth has slowed compared to the past several years, though it has stabilized recently. Also, a renewed strengthening of the U.S. dollar could hurt the sector, although that could be mitigated somewhat by hopes for better U.S. economic growth.”

Morningstar takes a harder line, saying the materials sector is “propped up and too expensive,” and is “pessimistic on steel,” citing “substantial global overcapacity and decelerating fixed-asset investment in China” that will weigh on steel prices. Conversely, Ned Davis Research thinks “continued momentum in industrial metals could cause us to upgrade the Metals & Mining Industry from Market-weight.”

But sometimes you have to go beyond the mainstream press and their feeders to get at what’s really going on. I prefer to look for the guys who make their livings trading shares in a given sector, because if they weren’t making money they wouldn’t be around. In the steel business, it’s value investor Lewis Johnson, co-chief investment officer at the $900 million Capital Wealth Advisors in Naples, Florida.

In a RealVision interview with Grant Williams (*Things That Make You Go Hmmm…*), Johnson says his focus is on cycles and the opportunities for investment they create, and the steel industry is one of the most cyclical. Perpend: China is more than half the global steel industry, and when ore was cheap, so was Chinese steel, and they got into a huge oversupply problem. Now the price of pig iron, the basic ingredient of steel, has jumped to about $338 a ton from $250, up 35%. Here’s where it gets interesting. Says Johnson,

> US steel is essentially $60 a ton less than the Chinese price.We consume maybe 110, 120 million tons of steel depending on the year. But we only really produce 80 or 90 million tons. So we need 20 to 30 million tons of steel per year. And if our price is lower than the Chinese price -- raw material prices are rising -- nobody's going to sell steel to the US at a loss.
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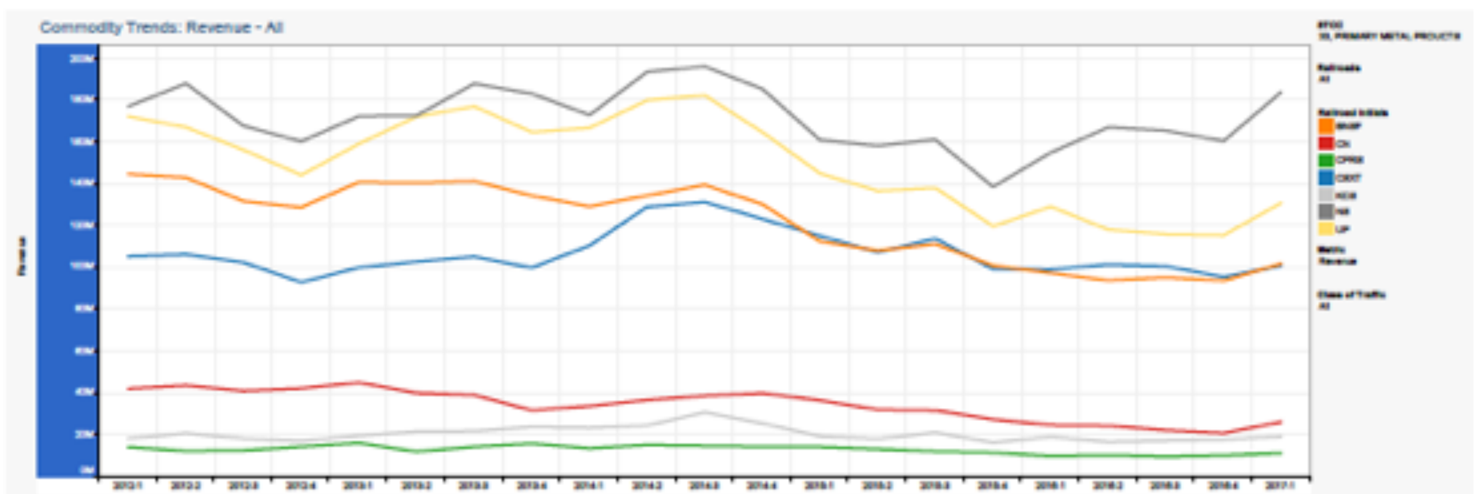
> So what this means for me, I think, when I look forward is maybe it's 3 months, 6 months -- the arbitrage is saying the US steel price has to rise -- and this is regardless of what you think about the cycle and all these kinds of things that we think and worry about, as long as that raw material price is anchored in China.

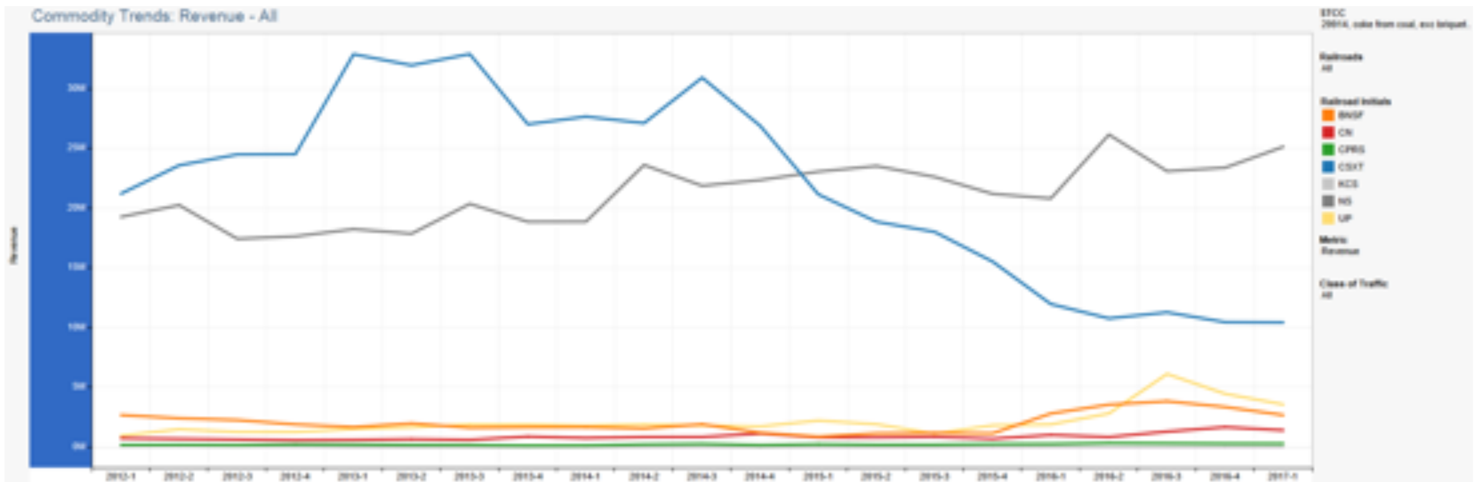
If the price of U.S. steel has room to rise, and we're currently using more than we make, and the U.S. markets can support higher margins, the U.S. suppliers will supply more of it. That will benefit the railroads, particularly NS and UP. Among short lines, GWR's strength in the Ohio rust belt and the Southbound's presence in Northern Indiana bode very well for these players.



To make steel, you need carbon, and that comes from coke (bituminous coal with the impurities burned out) or anthracite. Here, once again, NS is the dominant payer, thanks in no small measure to its presence in the steel-making core from western Pennsylvania to northern Indiana. Then there's the export market for metallurgical (met) coal. Both NS and CSX export from Virginia's Hampton Roads areas (Norfolk, Newport News) and Baltimore.

It's not difficult to find short lines in the export coal business. In northeastern Pennsylvania, Reading & Northern is originating some 350,000 tons of anthracite from six mines in 100-car trains of its own equipment to move over NS to Baltimore and beyond to the Ukraine. Further west, in the Clearfield coal district of north central Pennsylvania, The RJ Corman Pennsylvania lines (RJCP) originates export coal to Baltimore and Hampton Roads, both over NS. And in central Virginia, the Buckingham Branch Railroad (BBRR) handles CSX empties returning to the

mines from Newport News. It's an overhead move from Richmond to Clifton Forge, keeping the CSX James River line free for the eastbound loads.



The USIA says U.S. coal exports were up 58% in Q1, but it's not likely to last, with the full-year 2017 increase over 2016 closer to 20%. The R&N's anthracite may be short-lived because it's a function of the political situation in the Ukraine: a sourcing problem because of the ongoing conflict with rebels who control the coal-producing region. And though the US is the dominant exporter of met coal, RJCP's still steady stream of export coal is down from years past. Buckingham's back-haul depends on James River capacity, and if that opens up, the BBRR back-haul could be in jeopardy.

Nonetheless, there's still room for railroads in the coal business. Arch Coal, for one, recently told analysts that overseas demand and pricing are supporting continued exports in the second half of the year. The company says it will run Colorado and West Virginia mines at higher production rates in part due to strong foreign demand, helping to improve the company's cost performance.

Longer term, however, U.S. coal exports face multiple challenges. China is scaling back plans for new coal-fired power plants. India aims to produce more of the coal it consumes. South Korea's new president has plans to wean the country off coal. And so I think the CSX approach to the coal business is the right one: we will commit the assets we need to keep what we have and sustain our current customers, but adding new capacity for coal is going to be a tough sell. Short lines take note, turning the cars and maximizing margins for as long as it lasts.

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