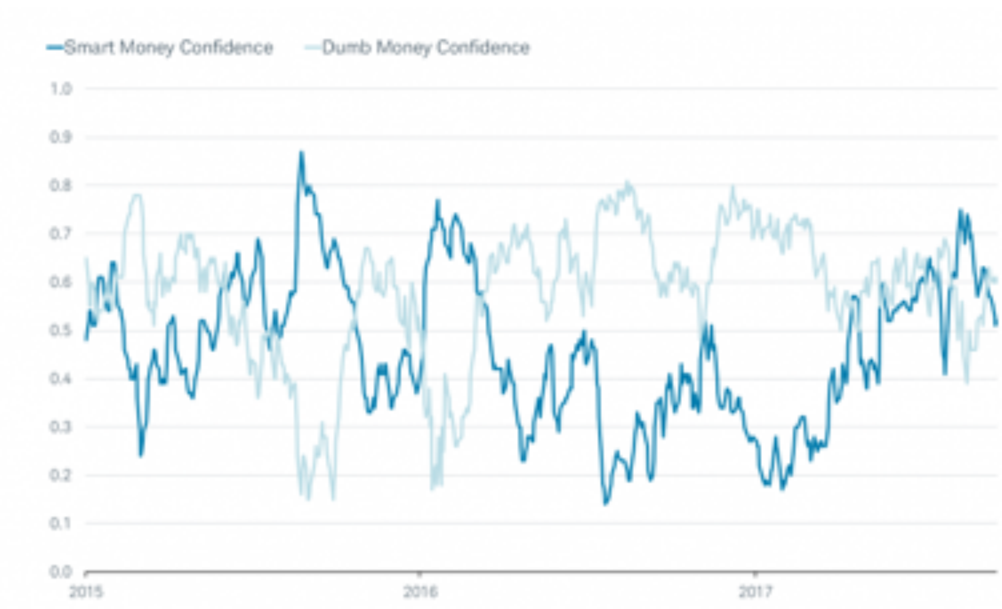
RAILROAD WEEK IN REVIEW

September 29, 2017

"It's time again for an update on investor sentiment, and the latest update of surveys and indices takes into consideration the stock market's new highs; the nuances are important." — Liz Ann Sonders, Chief Investment Strategist, Charles Schwab & Co.

Schwab's Liz Ann Sonders writes that she follows the "Smart Money" and "Dumb Money" Confidence indices put together by SentimenTrader (ST). Here you can quickly see what the "good" market timers are doing with their money compared to what "bad" market timers are doing.The Smart Money index has been getting more pessimistic, while the Dumb Money has been chasing stocks higher and has become more optimistic."



Says Sonders, "Generally, investors should follow the 'Smart Money' traders when they reach an extreme and do the opposite of what the 'Dumb Money' is doing when they are at an extreme. Watching shares of the railroads ratchet up as volumes are falling is some cause for concern. Can the action be dumb-money driven?

FTR economist Noel Perry last week told the assembled multitudes at the annual FTR Freight Transportation conference in Indy that the changing economy is likely to create long-term challenges "as the economy and the supply chain become more efficient, more digitized and, thus, less reliant on transport needs." That said, Perry still maintains freight volume will increase into 2018, and begin to soften thereafter. Perry sees

> a substantial reduction in international movement of finished goods over the next decade and a half, as low-cost labor in places like China and Mexico is increasingly replaced by automation and cutting into truck freight in the U.S. Some of that freight will be replaced with domestically produced goods, but it won't make up for the losses, Currently, about 30 percent of U.S. truck freight stems from imports.

This WSJ graphic perfectly supports Perry's observation that "the number of inventory holding points for both online and brick-and-mortar retailers will drop dramatically due largely to the trend of consumers wanting goods ordered online within hours, not days." Moreover, retailer on-line margins are double what they are for store-bought goods.

The way I see it, even though on-line sales may account for less than ten prevent of total retail sales (thank you, Tony Hatch), the large number of store closures means fewer places to truck goods to. On the other hand, goods still have to come to the U.S. from beyond our own borders, and they largely move in intermodal boxes, and the rails dominate here.

Even if a lot of the retail moves go away, the playing field is hardly level for railroads. A recent *Journal of Commerce* study notes that intermodal's historical value proposition has been to look like truck and offer a discount to encourage diversion. But to offer the discount, there has to be an operating cost margin spread favoring boxes on platforms rather than on rubber tires.

Ted Prince, Chief Operating Officer of Tiger Cool Express, has a Rule of Thumb that you can offer a 5-15% discount where intermodal dock-to-dock transit time is truck plus a day. True, intermodal fixed cost is higher — think of all that private right-of-way — but sports a lower per-mile operating cost, with fuel a big factor.

Says Prince, the higher the truck price of fuel, the steeper the rail-truck cost spreads, and the higher the truck fuel cost, the sooner intermodal is competitive. The relationship works out so that, at $5 per gallon, intermodal's cost equals truck at 500 miles and the cost benefits of intermodal increase steeply the longer the length of haul. At $2 per gallon, intermodal doesn't cost the same to produce as truck until lengths of haul exceed 1,250 miles.

Against this, single-carload freight doesn't stand a chance. Intermodal stands a chance in 500+ mile lanes thanks to large blocks of cars running between fixed points with no local switching, virtually no car hire, no car replacement cost, no classification yard expense. Merchandise carload service, on the other hand, uses an average of three trains between OD pairs, plus locals on both ends. Way freights block main lines while they do their work, impeding progress of the through trains and, if they outlaw, forcing other trains to hold out of the next class yard.

Happily, there are ways to minimize this interference. Short lines originating traffic must always turn cars in three days or less, pre-block for the distant node, and report events as they occur. I still hear horror stories of shortline cuts being held out of class yards "because we're busy," blocking the Class I's own trains from making OT arrivals and further slowing down the network. Interline Service Agreements can help, but the best way to assure OT arrivals (and OT departures) is to run to plan. And the short line has to be part of that plan.

Tony Kruglinski's Rail Equipment Finance Conference returns to the La Quinta resort south of Palm Springs March 4 - 7, 2018. Once again, shortline railroad attendees will get a 50% registration fee discount. Registration opens October 15, 2017, and, as new investors pile into the rail market and interest in rail assets continues to expand, we are expecting another excellent year with large attendance.

Note REF conflicts with the CSX Shortline Workshop in Florida March 4-6.

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 million annual revenues $150. Corporate subscriptions $550 per year. To subscribe, click on the Week in Review tab at www.rblanchard.com.