RAILROAD WEEK IN REVIEW

March 6, 2020

“While monetary policy cannot directly address many of the problems that the virus poses (only a vaccine can do that), it can help mitigate some of the second-order risks to the economy, such as growth slowing around the globe, businesses struggling with broken supply chains, and financial conditions tightening.” — Kathy Jones, SVP, Chief Fixed Income Strategist, Schwab Center for Financial Research (SCFR).

“When you look at volatility regimes, once you get above 31 on the VIX you have an uninvestable environment… There’s no valuation as a catalyst. It’s the prevailing conditions of growth, inflation and the market signal. If my market signal doesn’t give up greater than 31 on the VIX I’m not buying a damn thing.” — Keith McCullough, Hedgeye.com

The Chicago Board of Exchange (CBOE) uses its Volatility Index ($VIX) to track how wide or narrow swings in share prices are running. The $VIX normally runs in the 12-18 range, but it spiked to a high of 50 late last week. Small business operators, shortlines included, ought to care because the more volatile the market, the less stable the demand for freight services.

The Dow Jones Transport Index ($DJT) is a good place to start. Here you can see the $DJT hitting lows not seen since Dec 2018.

The index is based on share prices of the companies that comprise the $IYT Transportation ETF; the table below is its top ten holdings. All are in the red YTD and the pundits are saying the coronavirus could at some point start affecting the supply of parts used in manufacturing, automotive being one of the biggest.

Symbol	Description	% of Net Assets	Sector	YTD%
NSC	Norfolk Southern Corp	11.80%	Industrials	-6.07%
UNP	Union Pacific Corp	10.23%	Industrials	-11.60%
KSU	Kansas City Southern	9.76%	Industrials	-1.62%
FDX	FedEx Corp	8.89%	Industrials	-6.64%
LSTR	Landstar System Inc	6.63%	Industrials	-9.75%
JBHT	JB Hunt Transport Services Inc	6.20%	Industrials	-17.42%
UPS	United Parcel Service Inc Class B	5.78%	Industrials	-22.70%
CSX	CSX Corp	4.62%	Industrials	-2.64%
CHRW	C.H. Robinson Worldwide Inc	4.47%	Industrials	-11.89%
EXPD	Expeditors International of Washington Inc	4.42%	Industrials	-9.74%

If parts shortages stifle production, it follows that movements of both inbound parts and outbound finished goods will slow. Moreover, slowed productions could lead to more layoffs, further dampening consumer demand for staples from autos to Amazon to Walmart.

The S&P 500 index components in energy, materials, industrials, and consumer discretionary have all traded down mid-Nov 2019 to present. We're in a period of negative rates of change in GDP and the inflation rate, boding ill for just about everything the railroad touches. (See the WIR Feb 21 discussion of the Economic Quadrants and the rates of change in inflation and GDP expansion/contraction.) As of Friday morning, the consensus still seems to be for continued economic slowing and a gradual recovery starting late in the third quarter.

This week's Schwab Sector Overview has Energy, Industrials, and Materials — all very important to the railroads' merchandise carload franchise — showing varying degrees of weakness in fundamentals, values, and relative strength. Analyst notes from UBS this week cite risks to export pulp and paper thanks to offshore overstocks and a pullback in steel demand from demand from the auto, construction, and energy sectors.

Of course, your results may differ according to location. I know of a new steel transload on a regional non-Class I railroad doing very well in steel coils arriving in coil cars. Another is keeping busy with a recently-built pulp distribution center. Just last week I noted the new Iowa Northern/Watco intermodal project and I have since earned of more IANR new business projects.

So if the Class Is are shrinking their sales staffs and running fewer, bigger trains, it follows that the non-Class I feeder railroad community will be increasingly important to the Class Is. I think the handling line structure for short lines has lived past its sell-by date and it's time for short lines to use their marketing muscle to move from handling lines to Interline Settlement railroads. That way they can better control cash flow, resource allocation, and avoid the Rule 11 tack we're hearing about from Class Is such as Norfolk Southern.

Perhaps the best commentary on the transportation impact of the coronavirus comes from Tony Hatch. He writes that the biggest long term risk is yet another attack on globalization. However, "Judging by the Mexican market's outperformance, there are some bets that the China-to-Mexico production move may accelerate. That would of course be pro-rail, but most of the news is bad, short term, and potentially bad, longer term, for this trade-dependent industry."

He concludes, "This is, of course, a derived demand business – if the virus hurts global supply chains (autos, etc), or imports from China (electronics, furniture, clothing, etc) or consumer confidence in general, that's bad."

There will be no CSX Short Line Conference next week. Tom Tisa, Head of Business Development, writes, "In an abundance of caution regarding the current coronavirus situation, CSX has determined that postponing our March 8-9 Conference is in the best interests of all involved. We will continue to monitor the coronavirus outbreak to determine when the conference may be scheduled this fall." Sigh. I was so looking forward to it.