THE RAILROAD WEEK IN REVIEW
OCTOBER 3, 2008

"Fannie Mae has expanded home ownership for millions of families by reducing down-payment requirements." -- Franklin D. Raines, Chairman and CEO, Fannie Mae, as quoted in The New York Times*, September 30, 1999*

The credit crisis deepened this week as bankers clamped down on lending to long-time customers and even to each other. It's affecting short lines in different ways. Some banks that wanted to loan to short lines now can't because they're overextended in real estate. Others that were loaning now won't because the short line's cash flow is tenuous. A short line owner on the west coast writes that the bankers who tried to get him to increase his line a year ago turned off the tap. Seems the banks have loaned the money they were pushing on the short line guy went instead to real estate investors. The latter are now all under water and thus the bank is out of lendable cash. Another short line operator runs on very thin margins and writes that he had been using short-term loans to bridge between settlement checks from his connecting Class Is. Then he got turned away.

Adding to the woes, states are cutting back. Tuesday's Page One in the *Philadelphia Inquirer* says, "Facing the prospect of high income residents losing their jobs, declining tax revenues and increased demands on unemployment funds, [the governors of] Pennsylvania and New Jersey have sought to trim spending to head off deficits." On Wednesday the *Wall Street Journal* reported that "most states reported little or no [year-over-year] growth in tax revenues for July and August" and New York tax revenues could be off three and a half billion dollars due to Wall Street's recent "upheaval."

The week began with the House shooting down the rescue bill, sending the Dow Jones Industrial Average down seven percent with the record loss of nearly eight hundred points to close at 10,365. Most of the Big Six Class Is fared better, with Canadian Pacific least-dinged, down only 3.0%; CN lost just 3.6% and CSX fell 3.8%. We skipped the negative-fours entirely, moving down to UP at minus 5.6% and NS dropping 6.3%. BNSF fell 7.4%, taking last place among the Big Six. Moving to the next tier, KCS got hammered to the tune of 10.0% and GWR took an 8.7% hit.

Then came Thursday's rout. The Dow Jones Industrial dropped to 10,482, down 348 points -- 3.2 percent. Canadian National took the smallest hit, down 6.4 percent. Then came BNSF off 7.0 percent, Canadian Pacific down 7.6 percent and Union Pacific dropped 9.6 percent. CSX and Genesee & Wyoming both shed seven percent-plus, Norfolk Southern fell 11.3 percent and Kansas City Southern fared worst, down 14.8 percent.

Finally Friday the Members of the lower chamber got their acts together and passed the seven-hundred-billion dollar rescue bill 263 to 171. The Dow Jones Industrial average gapped up at the open however the gains were short-lived. By three-thirty the initial two-hundred-plus gain had vanished and the market closed down a hundred and sixty points. The rails gapped up nicely though they too pulled back as the day wore on. By the close only CSX and BNSF remained in the black, and that by slim margins. It appears the loss of another 159 thousand jobs and the reality of a prolonged economic downturn did not help.

Whether or not these sudden and drastic downward gaps in railroad stocks came as a surprise depends largely on what screens you've been watching. Technical traders saw this coming as long as a month ago. As to why they saw it coming, let's take a look at Norfolk Southern (NSC), for example (the name doesn't really matter; what we're talking about applies across the board).

We'll use the 120-day chart with the 50- and 200-day simple moving averages (SMA). Some traders (and I'm in this group) use the 50-day average as sort of a rolling support line. Cross that on the way down and it become resistance and the 200-day line is the support of last resort. NSC had been trending comfortably above the 50-day average since late January, 2008. Traders who were keeping tight stops were probably set a few bucks below the 50-SMA.

So when NSC started flirting with the 50 line in early September, traders realized attention had to be paid. Except for a brief spike above the SMA50 on September 19, NSC remained below that line. Anybody who had a stop loss set two dollars below the SMA-50 would have been out before Thursday, at which time the fit hit the Shan with NSC plummeting through the 200-day SMA and through support at around $58, closing at $56.64, a number not seen since July.

The take-away is that "buy and hold" on the fundamentals doesn't really work any more. As Jeff Tabak pointed out in his *RailTrends* presentation Tuesday (more on that conference next week), hedge funds and mutual funds now own roughly three out of every four railroad shares in circulation. You can bet they're running the charts and even if a stock is trading at 50 percent of its intrinsic value, they're not going to stick around if the name falls through the 200-day average.

Remember too that industry sentiment can account for as much as half of any stock's directional movement. I use the transportation ETF (IYT) to keep an eye on this side. By mid-September the IYT had broken through the 200-day average to the downside after pretty much tracking the 50-day average as support since late January, 2008.

There wasn't much chatter as to why the roads took the hits they did, though we can take a look at the geography they serve, the way they run their railroads, their commodity mix and what's been happening to the industry in general. As you know, volumes have been dropping for months and the only thing saving the earnings picture is higher prices and better asset management. The question remains, how long can the Class Is continue charging more and more for less and less?

Short line owners would be well-served by doing a little technical analysis of their own on their connecting railroads (WIR is going to try to keep you ahead of the curve in this regard). Generally speaking, a stock moves up or down on what people think the future share value is likely to be at some time in the future. That number reflects the trader's perception of the revenue-generating potential of the company. And if the stock is trending up or down it behooves the shortline owner to know why and what can be done to protect one's own interests.

Taking a page from the trucking side, JB Hunt says they're using more intermodal but overall volumes are down. Soft trucking volumes are a leading indicator of soft merchandise carload volumes in the non-bulk areas -- manufactured goods primarily -- where dry vans already have the dominant share. Grains for animal feed and food ingredients will continue to do well, as will coal -- we gotta heat and eat, as it were. But the other stuff?

Short lines are big in construction and demolition debris these days but as shipments of building supplies slow so will the need to get rid of the remains of old buildings. Scrap steel is another big shortline commodity, but have you looked the stock prices of the steel makers of late?

Percent changes for the five-day, twenty-day, one-month, six-month and year-to-date charts are all in the red. In fact, the rails themselves are one of the few bright spots with numbers in the black in the six-month and year-to-date columns. Then it gets grim. I mention this once again in terms of short lines that are too dependent on the kindness of strangers to make ends meet.

Unfortunately, I sense a certain amount of head-in-the-sand-ism in the short line community. The most recent Railroads of New York newsletter acknowledges "the difficult times that most governors across the nation are presently facing" and the need for a new surface transportation act "addressing the needs of all modes." However, it was noted that the state of NY has to "trim about a billion dollars" in expenses budgeted through 2010. And, just for grins, they want to replace the fifty-year old Tappan Zee Bridge at a cost of eighteen billion dollars. Stay tuned.

An investor friend of mine has two rules for stock pickers that ought to apply to short lines as well. Rule Number One: if the company needs to borrow money to stay in business, set it aside. Rule Two: if the company makes something you can't live without - like food and fuel -- then hang onto it. Into the first group we put short lines that are on the government dole with rehab grants and other goodies. Into the second group we put those lines that move grain and coal and pay their own way.

I call it heat and eat. Coal and natural gas drilling supplies fall into the first group; grain for everything from Cheerios to chicken feed goes into the latter. Both are good for short lines. Let me dwell on a couple of useful insights about coal for a moment, though. Speaking at *RailTrends* on Tuesday, Jason Hayes of the American Coal Council spoke on the continuing mix of policy, economic and environmental matters impacting coal supply and demand and the railroads' role. He did warn, however, that the forces of darkness "will have significant negative impacts."

Then -- almost on cue -- Wednesday's *Wall Street Journal* published a Letter to the Editor from one William Anderson, Ph.D., Associate Professor, Department of Economics, Frostburg State University, Frostburg, Maryland, under the caption "Follow the Green before Killing Coal." Dr. Anderson points out that Al Gore is a partner in Kleiner Perkins, "an investment fund that seeks to bankroll 'alternative energy' projects."

The good professor goes on to say that without government subsidies Mr. Gore would see only minuscule profits if not downright losses if these KP projects "had to compete head-to-head with coal-fired plants." One can get very rich hamstringing the competition if one can get the government to set market forces aside. Just ask Mr. Raines.

Elsewhere, Canadian Pacific won the Surface Transportation Board's blessing to take control of the Dakota, Minnesota & Eastern. This is a strategic end-to-end transaction. CP customers get access to Midwest markets and the Kansas City Southern's Mexico Gateway. And customers on the DM&E get single-line access to all of Canada. The DM&E is expected to deliver double digit top-line revenue growth and EBITDA in 2008.

Genesee & Wyoming has added yet another shortline name to the fold, this time the 220-mile Georgia Southwestern (GSWR). It's a perfect tuck-in, connecting as it does to the Chattahoochee Industrial Railroad, further strengthening Genesee's "contiguous railroad" model. Originally comprised of spin-offs from both Norfolk Southern and CSX Transportation, GSWR operated as a division of RailTex' South Carolina Southern Railroad. In 2000 GSWR went to RailAmerica as part of the latter's acquisition of RailTex.

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