RAILROAD WEEK IN REVIEW
April 10, 2020

"Ultra-low interest rates distort investment judgement, prolong the lives of profitless companies, and inflate the present values of future cash flows. Technological innovation threatens heavily leveraged established businesses most of all."— Grant's Interest Rate Observer, "Grand Tour of Junk, Feb 7, 2020

"Canadian National deployed its multi-phase Pandemic Plan on March 9, 2020. We continue to operate very efficiently and our network is extremely fluid. We continue to meet the needs of our customers, especially in the intermodal sector which is critical to the supply of goods needed to restock shelves in stores and weather this pandemic." — COVID-19 UPDATE, www.cn.ca

"We are putting together an end-to-end grassroots PPE distribution effort, where we source the equipment from certified manufacturers who meet accepted international standards, we pay for these purchases out of a 501(c)(3) foundation where 100 cents of every dollar goes to this effort, and we distribute that PPE all the way through the 'last-mile,' getting small quantities of PPE directly into the hands of clinicians and first responders who are in urgent need." Ben Hunt, epsilontheory.com, "Our Finest Hour," April 2, 2020

Last week I commented on the debt levels for the Class I railroad community. A group of readers picked up on the thread and their observations are worth repeating here. One chap looking into the ratings history was not particularly alarmed. He dug into a Moody's look-back to the 1920s on the subject that was published just last summer. This compares Baa to high yield lower-rated bonds (i.e. "junk bonds"). His report:

> Despite the supposed risks inherent to having Baa-grade bonds now accounting for 46 percent of the dollar amount of outstanding U.S. investment-grade corporate bonds, the default rate of Baa-grade corporate was exactly zero for the years-ending 2015-2018. The default rate will move higher in 2019, but only because of a special event that took the form of California's wildfires.
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> Regarding the Great Recession, the Baa default rate was 1.02 percent at the end of 2008 and 0.93 percent at the end of 2009. The record high year-end default rate for Baa-grade companies was set way back in 1938 at 1.99 percent. During 1931-1935, the Baa year-end default rate averaged 1.31 percent vs. the 0.30 percent average of the last 99 years. For comparison, high-yield's year-end default rate averaged 9.40 percent during 1931-1935.
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> Since 1920, the 0.3 percent annual average of the Baa category's year-end default rate was but a fraction of the high-yield default rate's 2.8 percent annual average. For the 35-years-ended 2018, or 1984-2018, the Baa grade default rate averaged a somewhat lower 0.2 percent and the high-yield default rate averaged a much higher 4.3 percent.

But this time I think it really will be different. We are faced with an economic slowdown the rapidity of which we have never seen before. Railroad employment is at an all time low, as are revenue ton-miles per year. Coal is gone and many manufactured products have left the railroads forever. I'm not sure automotive is ever coming back. My question is: when revenue falls enough that operating income can't cover debt covenants, at what point is the commercial paper downgraded?

Back in February, *Grant's Interest Rate Observer* put it this way: "Ultra-low interest rates distort investment judgment, prolong the lives of profitless companies, and inflate the present value of future cash flow." Ultra low interest rates encouraged railroads to use debt to buy back shares at the expense of rebuilding the customer base to fit changing supply chain requirements.

As a result, fleet-of-foot truck drivers are capturing market share that is unlikely ever to return to the railroads, further jeopardizing railroad revenue, revenue ton-miles, operating income, and the ability to meet debt covenants. That's why I think railroad debt is in for a downgrade to nearly junk status. BBs on the S&P, Ba in Moody's.

Railroad analyst Bascome Majors at Susquehanna Financial Group writes, "Our snapshot of absolute railroad volumes since October (updated weekly) vs. 15 years of seasonality shows sharp deterioration in automotive shipments (factory closures), piling on persistent weakness in port-levered intermodal. Broader industrial merchandise traffic is still holding up, but remains at risk as rails feel the delayed impact of oil's collapse and escalating manufacturing shutdowns."

The way I see it, these trends will not necessarily hold as the railroads "feel the delayed impact of oil's collapse and escalating manufacturing slowdowns." Take automotive, for example. For bit of background on what's happening to retail auto sales, auto guru Daniel Ruiz tweets that GM of offering a zero-percent, 7-year loan, but "the longer a loan goes out, the more likely negative equity is to build, which could delay or hinder a return to the market years later."

So as buyers keep cars longer, the lower the supply of used cars. The used car market price then heats up, discouraging second-tier buyers. More used cars on the lot means less space for new cars. I'm already hearing reports of new car storage lots filling up meaning fewer new vehicles are being ordered. At some point this is bound to affect manufacturing hours worked. And the same shoe fits many of the small business operators who depend on short lines.

As a group, North American Class I railroads are approaching the first quarter 2020 earnings season with equanimity. Year-to-date total revenue units through Week 13 (March 28) were off about six percent. Carloads ex-intermodal were off four percent. Coal was down 17 percent — which is to be expected — while crude oil and other STCC 29s increased 11 percent.

Fact of the matter is, Week 13 revenue units decreased 11 percent year-over-year as the effects of the COVID-19 event started to bite into commercial activity. March by itself looked OK with 10 of the 20 carload commodity categories tracked by the AAR with increases over March, 2019. Gainers included chemicals, up 4.6 percent; declines were posted in aggregates, down 12 percent. Coal and automotive also posted losses, but they matter little to the non-Class I community as a whole.

North American Rail Traffic

Week 13, 2020 – Ended March 28, 2020

	This Week		Year-To-Date		
	Cars	vs 2019	Cumulative	Avg/wk[1]	vs 2019
Total Carloads	**320,231**	**-8.3%**	**4,281,236**	**329,326**	**-4.4%**
Chemicals	46,929	-3.6%	597,103	45,931	1.8%
Coal	68,701	-0.3%	919,518	70,732	-16.7%
Farm Products excl. Grain, and Food	27,881	11.6%	337,107	25,931	7.4%
Forest Products	16,736	-4.8%	209,652	16,127	-4.5%
Grain	33,215	-3.2%	380,295	29,253	-7.3%
Metallic Ores and Metals	43,084	-0.8%	531,356	40,874	1.0%
Motor Vehicles and Parts	9,725	-66.8%	313,061	24,082	-6.5%
Nonmetallic Minerals	41,329	-10.4%	510,584	39,276	-5.2%
Petroleum and Petroleum Products	20,881	-7.5%	326,353	25,104	11.3%
Other	11,750	-12.3%	156,207	12,016	1.8%
Total Intermodal Units	**306,268**	**-14.4%**	**4,208,796**	**323,754**	**-7.5%**
Total Traffic	**626,499**	**-11.4%**	**8,490,032**	**653,079**	**-6.0%**

[1] Average per week figures may not sum to totals as a result of independent rounding.

This AAR comparison of Week 13 and year-to-date numbers tells the tale most graphically. Says the AAR's John Gray,

> This week also reminded us that the recent collapse in oil prices is hurting rail shipments of petroleum products, frac sand, and steel products. While there remain more unknowns than knowns about the next few months, there are tidbits of encouraging news. For example, year-over-year carloads of grain were up in March for the first time in a year.

To sum up, it's hard to say how bad volumes will be in the next quarter (or longer), but I think it's fair to say that things are about to get a lot worse.