RAILROAD WEEK IN REVIEW

February 4, 2022

"New freight car orders in 4Q21 increased nearly 300 percent to 13,477 railcars vs. 3,397 cars in 4Q20 and are up 57 percent sequentially from 8,607 cars in 3Q21.That implies the highest quarterly order number since 4Q18's 19,955 railcars". — KeyBanc Capital Markets analyst Steve Barger in Railway Age

"Shippers, long frustrated that the STB and its Interstate Commerce Commission predecessor acted as a wholly-owned subsidiary of the railroads, are optimistic a leadership baton has been passed to a chairman predisposed to interpret rail regulatory statutes more in their favor." — Frank Wilner, Railway Age

"The thesis of 'there's not enough oil' remains intact and I do think the only thing that can derail it is a total economic collapse. You're looking at global demand for oil eclipsing pre-COVID highs at the same time where the industry is underinvested and the ESG pressures remain." — Doomberg, Feb 1, 2022

It is instructive to compare quarterly results of the Class I railroads. Because I put every railroad's report in the same format, it's a simple matter to see who moved the most of what for how much and for what margins. Here's what I found for the five Class Is holding earnings calls[1], comparing year-over-year percentage changes in half a dozen categories.

Union Pacific took the honors with the best percentage changes in total revenue, revenue units, merchandise carload revenues and car counts, operating income, and operating ratio. Canadian Pacific had the most merchandise carload revenue as a percentage of total revenue volume but fared least well in changes in total revenue, merchandise carloads, operating income and operating ratio. CSX ranked last in merchandise revenue as a percentage of total revenue.

The way I see it, the railroad with the best performance in these areas adds the most value to its railroad transportation product offering. Upward changes in these metrics bespeaks greater customer acceptance of the service offering, and that in turn is reflected in share prices. UNP shares closed the year at $251.93, up 28 percent for the year, outflanked only by CSX with shares up 32 percent; in 2022 UNP has sustained that level whereas CSX share prices are now back to where they were in October.

The sudden increase in new freight car orders bodes well for the industry. An increase in freight car orders means one of two things. Either transit times are getting worse so you need more cars to move the same tonnage, or the price/value ratio of rail freight vs other transport options is more attractive..

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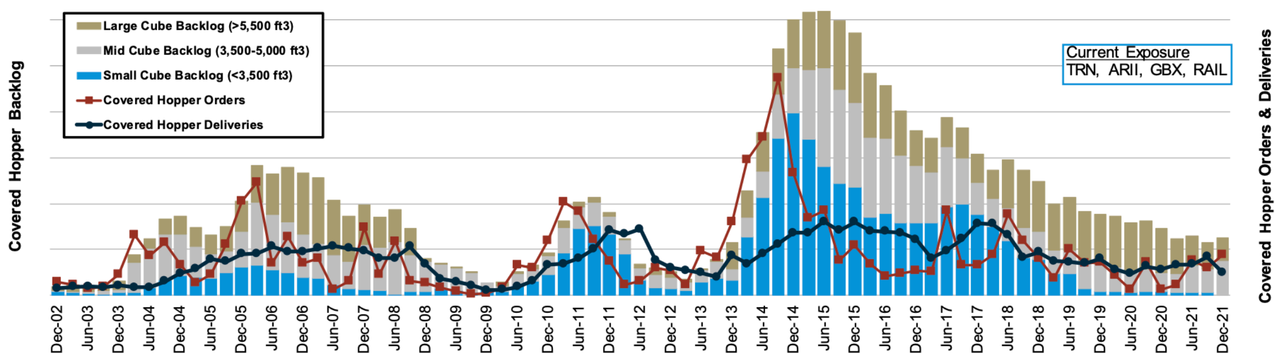
[1] *BNSF has no earnings call as such. Numbers are reported with Berkshire Hathaway, which I expect in a few weeks.*

I'd like to think it's the latter. This would be a good time to start keeping an eye on the age of the cars placed at customers' locations. You could also start keeping tabs on trends in leased cars, particularly in agriculture and chemicals. Borger (quoted above) continues, "The industry delivered 8,161 railcars in the quarter, higher than the 6,216 railcars delivered in 4Q20 and lower than last quarter's 8,298 figure. The backlog now stands at 42,993 railcars, up from last quarter's level of 37,779 railcars."

Railroad analyst Bascome Majors of Susquehanna Financial Group tracks these things closely. In his January 31, 2022, note he writes that railcar orders "reached their highest level since 2018" and cites steel gons in particular. Grain hoppers are a close second. Majors' covered hopper chart is particularly revealing:



Large-cube covered hoppers dominate, not surprising given the increases in plastic and grain loadings. Small-cubes lag, again not surprising given the fall-off in frac sand loadings.

Railroad Financial Corporation President David Nahass puts it the way: "2022 is likely to be a mix of tentative behaviors as equipment consumers try to balance economic concerns about ongoing growth versus the possibility of long-term inflationary pressure and the potential for rising interest rates." Can't argue with that.

The STB's proposed reciprocal switching regulation is causing quite a stir. The ICC's 1986 "Midtec" ruling said anti-competitive behavior occurs only when an incumbent carrier had "used its market power to extract unreasonable terms on through movements" or "because of its monopoly position . . . shown a disregard for the shipper's needs by rendering inadequate service." That's being changed.

Under the proposed rules, "There would be no need to show anticompetitive conduct, as had been required in the ICC's Midtec decision. Rather, under the Board's proposed regulations, the Board would require the establishment of a switching arrangement when the switching

arrangement either was practicable and in the public interest or was necessary to provide competitive rail service."

To me, the ground rules were established in the 1998 Railway Industry Agreement signed by AAR and ASLRRA. "Rail networks should be operated to maximize the efficiency of the network for ALL its users. A law or regulation that requires a Railroad to put the needs of the few ahead of the overall needs of the network is not sound public policy." Does the proposed STB ruling meet that test? We'll see.

Tracking the iShares Transportation Average ETF (IYT) can be useful for positioning the transports in general against the broader market. There are 51 names in the IYT and UP, CSX, and NS are all in the top five, comprising 32 percent of net assets.

As you know, January was not kind the stock market in general, using the SPY (dotted blue line) as a gauge. The IYT tracked the SPY thru the Jan lows, bouncing back nicely Tuesday.

This is a good sign. The tried and true Dow Theory holds that "the market is in an upward trend if the transportation or industrial average advances above a previous important high," in this case the 20-day moving average. Further, an increase in transports suggests shippers shipping more to build inventory in advance of THEIR anticipated uptick in sales.

That's why the transports as a group are considered a indicator of market direction. Want proof? See how the IYT is now above its SMA-20 (red) while the broader market has yet to break through the SMA 200 (yellow). Looks like the IYT is leading the way.

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