RAILROAD WEEK IN REVIEW

March 31, 2023

“History says railroad stocks will bottom when volume trends show signs of bottoming and it’s tough to have confidence here with renewed fears of a hard landing. But volume comps get easier starting in 2H, just when cost headwinds (headcount and wage inflation) should start to moderate as well.” — Scott Group, Wolfe Research

“The February Manufacturing PMI® registered 47.7 percent, 0.3 percentage point higher than the 47.4 percent recorded in January. The New Export Orders Index is still below 50 percent but continuing to improve. However, in the last two months, the Manufacturing PMI® has been at its lowest levels since May 2020, when it registered 43.5 percent.” — Institute for Supply Management

“They have the payroll survey of corporate company payrolls. The household survey is a separate survey and it’s the one they base the unemployment rate off of. Obviously the household survey tends to pick up more small business employment because there are a lot of smaller companies that don’t run a payroll through one of the big payroll processing companies so they don’t get included.” — Steph Pomboy, MacroMavens

Through Week 11 (March 18), railroad revenue units are badly lagging year-to-date. It’s been a lost year for the rails after the Wolfe Research Rail Index peaked in March a year ago — now down 26 percent over the past year — right in line with historical average pullbacks over the past two decades or so.

Wolfe lead rail analyst Scott Group has been watching these things for more than 20 years and has observed that rail volumes rails have historically outperformed materially in the 12-month period after they bottom. He notes that relative to the present 26 percent pullback, his Rail Index has historically rebounded 44 percent on average in the 12-month period after bottoming.

There is one clear difference right now. In the past, the rail commodity mix has skewed strongly toward intermodal over carload ex-coal. For example: in 2015, year-over-year carload volumes declined eight percent while intermodal volumes were up three percent. But we’re seeing something very different today with rail carloads tracking up four percent year-over-year and intermodal boxes down six percent. The tea leaves suggest volume comps will be more favorable in the 2023 second half so there’s hope.

Scott has been doing this for as long as I’ve known him — goes back to Bear Stearns days — so really knows the history. I hope he’s right about rails rebounding after a pullback. The carload vs. intermodal story is instructive but you have to read between

the lines. I think intermodal is down due to China boxes decreasing and the trucks out there cutting rates to gain share. And I'm still seeing signs of rail customers leery of service improvements really sticking.

We also have a softening economy where more household money goes for services than for goods. That said, I'm still hearing about short lines winning significant new business thanks to available space, having access to more than one Class I, and aggressively managing the Class I contacts they have. (And going ISS rather than Handling Line sure helps the cash box.)

Cowen's Jason Seidl is rightfully reluctant to read too much into 2022-2023 comps, citing 2019 as the better comp as it's before things got COVID-screwy. Looks like we have a way to go to get back to "normal." He writes, "Carloads in Week 11 were down eight percent vs. the same period last year and down two percent sequentially. Compared to 2019, revenue units were down nine percent."

Separately, Seidl writes that CSX may be about to use its newly updated carbon calculator as a marketing tool. The update "promises to offer shippers more detailed insights into their GHG emissions as well as to shine light on each customers' emissions savings relative to OTR alternatives."

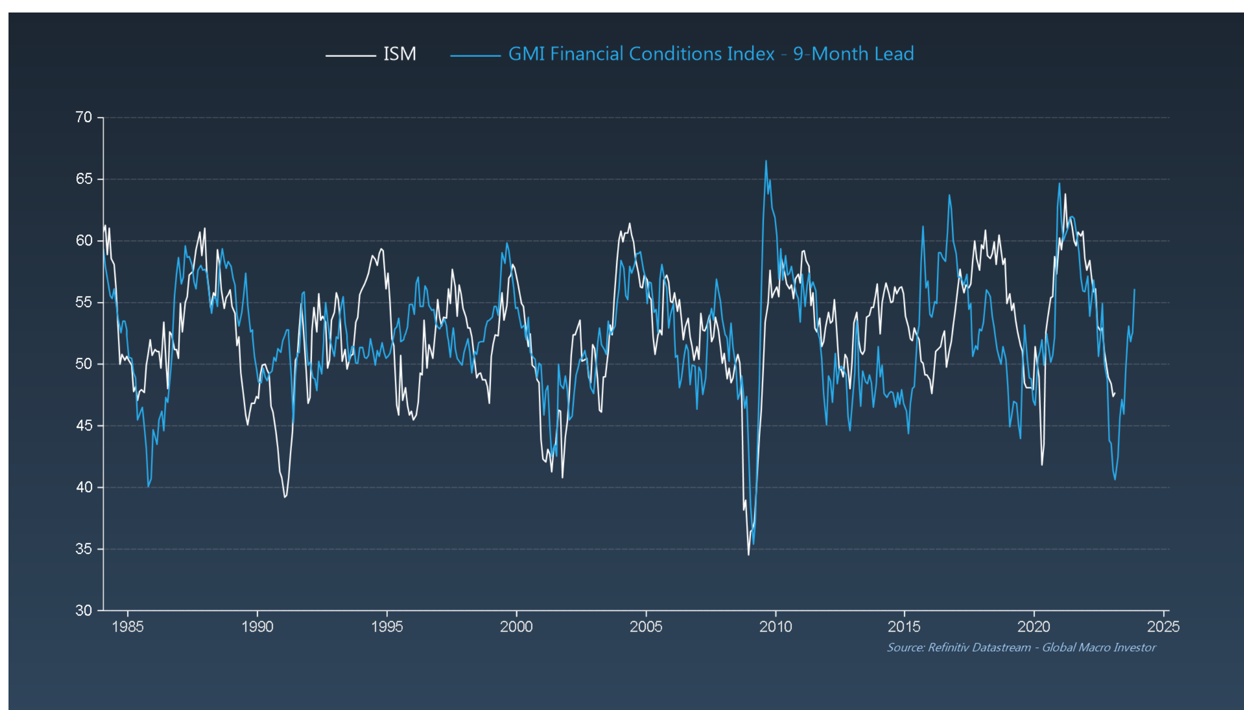
He adds, "All the U.S. Class I rails have invested in emissions visibility to support their sustainability initiatives and to capitalize on ESG considerations. Our conversations with shippers suggest that ESG factors are gradually growing in importance among both larger and smaller shippers but still not the main component." ESG as a way to express the railroads' competitive advantage — great!

The question keeps going around: why is business not coming back to the rails? Briefly, service sucks. Weekly revenue units are essentially unchanged from where they were in October, 2020. System train speeds have improved from slightly below the historical average to slightly above average over two years but it's a mixed bag. CP, CN, CSX are slightly up; UP and NS continue to deteriorate. The dwell curves present nearly identical patterns by railroad.

Meanwhile, truckers, brokers, and third party logistics providers are being very flexible on pricing to keep volumes up — not by much but still up. Cowen's Jason Seidl writes, "Carriers' expectations for business growth remain low at 2.1% on average, below the 3.3% survey average… Confidence in the economy remains low and unchanged from the previous quarter with 78% of participants responding that they are not more confident in the economy compared to last quarter."

The ISM Reports On Business – The Manufacturing PMI and the Services PMI – are two of the most reliable economic indicators of forward business trends and railroad carload volumes. This chart from Global Macro Investors compares *what is* with *what could be*.

They write, "The ISM continues to skyrocket higher on the back of recent dollar weakness, plunging commodity prices and lower bond yields, which will be a tailwind for the ISM in a couple of months. The momentum Index (blue line) currently suggests that the ISM could be up as much as 2.7 points year-on-year by September, targeting an ISM of around 54." Recall the break between good times and bad is the ISM 50 line.



Full disclosure: I am often asked if I own any railroad industry stocks. I do not — directly. I have interests in BNSF, Marmon, and Xtra by dint of my Berkshire Hathaway shares. I started building the BRK position before the BNSF acquisition, although I was following BNSF closely because of my shortline relationships.

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