RAILROAD WEEK IN REVIEW
April 7, 2023

"Either mortgage rates need to come down, or house prices need to come down, or both. You can't just jump from $47k in qualifying income to $86k and play make believe that everything is just going to work itself out. Housing will be ice cold until this spike stops being a spike." — Jeff Weniger, WisdomTree Head of Equities on Twitter

"First-time home buyers are really locked out. Existing homeowners with mortgages are effectively locked into their homes. Investors have gone to the sidelines, so they certainly cannot digest the current mortgage rates, given the current high house prices and where incomes are." — Barrons, April 2

"The category 'lumber and wood products' consists of finished wood products such as lumber and dimension stock, millwork, veneer and plywood. Most of lumber and wood products is used for building construction, which is why there's a clear positive correlation between rail carloads of lumber and wood products and U.S. housing starts. We combine U.S. and Canadian carloads for this category because much of the lumber consumed in the U.S. originates in Canada or in areas served by the U.S. subsidiaries of Canadian railroads." — AAR Rail Time Indicators

The direction of railroad share prices is a Dow Theory Leading Economic Indicator of the direction of the broader economy. And since customer activity drives railroad prosperity, the major commodity groups' prosperity is a Leading Economic Indicator of railroad productivity. Conversely if railroad share prices are down a close look at commodity behavior will give us a clue as to why railroads are economic under performers.

Take stick lumber and related wood products from plywood to engineered wood products (any other panel or composite product where wood is a component part as in OSB). According to the AAR, most of lumber and wood products is used for building construction, which is why there's a clear positive correlation between rail carloads of lumber and wood products and U.S. housing starts.

Since much of the lumber consumed in the U.S. originates in Canada, the Canadian roads are included in the AAR reports. And among the Big Six Union Pacific carries more STCC 24 than anybody else with the others all about equal in carloads per year.

The non-Class I railroads play a major role. STCC 24 carloads represent about four percent of national non-class I railroad volumes — call it something approaching 150,000 cars a year. AAR STCC 24 loads for 2022 came to about 320,000 units. Ergo non-class Is touch about half of all lumber and wood carloads in North America. And their customers can be sizable, as you see with this northern Pennsylvania distributor on the Delaware Valley Railroad.

The year 2023 is not off to a great start, lumber-wise. Per the AAR, U.S. plus Canadian carloads of lumber and wood products fell three percent in February 2023, their sixth straight decline. Carloads averaged 5,809 per week in February, the fewest for any February since 2014. And, as noted above, there is a clear correlation between the health of the home builders and that of the railroads.

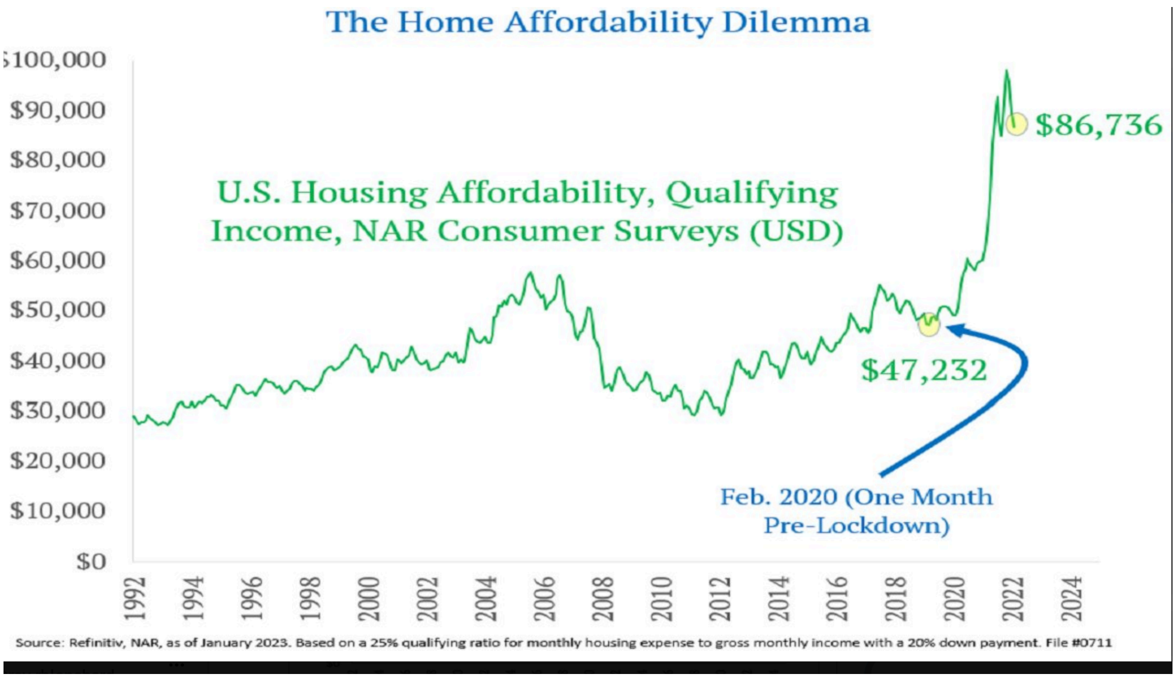
The consensus is that the housing market continues to be dismal, but the worst might be behind us. Total U.S. housing starts were 1.31 million in January 2023, the fewest since June 2020 and down 21 percent from January 2022, and January was the ninth straight year-over-year decline. But the NAHB says they have seen "consecutive solid monthly gains for builder confidence, spurred in part by easing mortgage rates."

As one would expect, not all regions of the country are affected equally. According to the March 31 *Barron's* roundtable on housing, "For new home builders, the Southeastern markets are particularly good; Florida and North Carolina, South Carolina, in particular. Land is relatively inexpensive compared with the rest of the country, and importantly, it's relatively easy to build.

The markets that are likely to struggle this year are the ones that we often see struggle when the housing market is soft; places like Phoenix, which tends to get overbuilt very quickly. The Denver market is tough. Boston has gotten much more difficult."

Then there are the supply constraints. States from the Carolinas around to the Gulf states have experienced significant population growth. The massive amount of inflows in terms of capital and investment dollars was the catalyst for a lot of supply and railroads benefitted. CSX 1Q2023 lumber carloads were up six percent, for example. So there's a lot of inventory to work through in a softening market.

One final thought: affordability. The chart says prices have increased 83 percent in the past three years. So even if mortgage rates are moderating, the acceleration of home prices isn't. And that's going to limit housing mobility for those families with more limited means.



The AAR has already said the rate of change in STCC 24 carloads is slowing. Combine an impending recession with uncertain Fed interest rate actions and slowing purchases of consumer durables; maybe we won't be seeing full lumber yards like the one pictured above for a while.

The Railroad Week in Review, a compendium of railroad industry news, analysis, and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 million annual revenue are $175. Subscriptions for Class I railroads and short line/regional operators with more than $12 million annual revenue are $599 per year. To subscribe, click on the Week in Review tab at www.rblanchard.com.