THE RAILROAD WEEK IN REVIEW
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"The ability of the American farmer to overcome anything that Mother Nature tosses at him/her is nothing short of amazing." – Gartman Letter January 13

American farmers grew 13.2 billion bushels of corn in 2009 against the Street consensus of 12.8 billion bushels according to Dennis Gartman. Says he, "We've lived through a lot of these reports over the past 30+ years and we cannot recall a miss of this magnitude." Beans also over-produced by some 27 million bushels, a tenth of the corn spread. So, says Gartman, being stuck long of corn "led to very material losses" as people tried to short beans as a partial hedge. I expect to see an uptick in both beans and corn loadings as producers and distributors work through these overages.

"Railroads are happy to have 2009 behind them," says AAR Senior Vice President of Policy and Economics John Gray. "Last year saw declines, most of them quite steep, in every major category of rail carload traffic as well as intermodal." This is in connection with the AAR finding that total carload traffic on U.S. railroads is at its lowest levels since at least 1988 when the AAR's data series began. Intermodal traffic in 2009 was at its lowest level since 2002.

As for how this translates into dollars, Tony Hatch writes, "Earnings for all seven Class I carriers will drop about 30 percent for the quarter. Full year earnings will be down a third, and "only" 27 percent if KCS (-2/3 drop is excluded). But all of the rails will report year-over-year gains in 2010 (by a fifth, again excluding KCS which should about double); I don't expect much guidance. No rail will top 2008 until next year, however, but earnings will likely again beat consensus in this last downturn quarter and into the recovery, whatever the pace."

Over at UBS Rick Paterson takes the ton-mile view. "Ton-mile volumes for 2009 were down 15 percent year-over year, making it the third largest collapse in rail traffic since 1932. Since the Great Depression, only the recessions of 1938 and 1949 produced steeper annual declines in railroad tonnage. Arguably, the 2009 period deserves a higher perch on the medal podium as the drop-off in the late 1940s was caused mainly by the US war machine going cold, not by normal cyclicality.

"The recession of 1957-58 comes close with a drop of 15 percent, but over two years rather than one. EPS proved surprisingly resilient last year due to pricing discipline and enhanced (IT driven) cost flexibility, and with the price story still better than average, fluid operations, and easy comps, we expect a strong rebound in earnings this year. A first half coal headwind [see below – rhb] in the US and valuations that no doubt price in some of this good news are our only concerns. For new money we continue to see the most value in the East (CSX, NSC) and Canada (CNR, CP) in that order.

Electricity output declined nearly four percent in 2009 according to a piece in the *WSJ* Thursday. It's the steepest drop in 70 years and the crystal-ball watchers don't see it getting much better for another two or three years. Bad as this is for short lines that originate coal from secondary producers, the regulators are pressuring utilities to use "greener" sources of heat, taking down coal demand another notch.

The Energy Information Administration counts 43 coal-fired gen plant cancellations and predicts coal's market share of the electricity market dropping to 43 percent from today's 48 percent by 2035 while the "renewable" source share nearly doubles to 17 percent from today's nine percent. Natural gas holds at about a 21 share.

It remains however that for the near future natural gas is cheap, abundant, cost-efficient and in the ground waiting to be tapped. It requires no scrubbers or transportation to take away waste products and at these prices hurts wind farms, so much so that T. Boone Pickens has taken his Texas Panhandle wind project off the table. So if you're making money moving wind turbine parts today take the money and run because it may not be there tomorrow. Still not convinced? The EIA "Annual Energy Outlook 2010" shows electrical power consumption increasing at a meager one percent or less per year for the next 20 years.

Continuing our outlook theme, from *The Motley Fool* come the annual January economy and market predictions from Black Rock's Bob Doll, vice chairman and global CIO of equities. Herewith a sampling that shortline railroad investors may wish to consider. He thinks US equities will see high single-digit total returns but with recessions occurring more frequently during this decade, rather than only once a decade as occurred in the last 20 years.

Health care, information technology, and energy alternatives are leading growth areas for the United States [not hard goods, not housing, not commercial construction, not extraction – rhb] and the US dollar continues to become less dominant as the decade progresses. Interest rates will move irregularly higher in the developed world, world growth is led by emerging-market consumers and emerging markets' weighting in global indices rises by ten percentage points.

Clearly, this is not to be the decade of the short lines in the traditional sense but one of opening new doors, starting with the privatization of BNSF. Though Warren Buffett is properly characterized as a hands-off owner, he remains that only as long as everybody behaves (WIR 11/6/2009). Part of that is sticking to and making gobs of money in the core business.

The core business of BNSF is running a high-speed, high-density heavy-haul railroad. It is not running a network of under-performing branch lines that consume scarce assets with no chance of ever regaining the cost of capital expended on them. Without the eagle eye of quarterly results watchers on Wall Street, BNSF will be freed to put its money into the plant where the return on cost of capital and economic benefits are there in spades.

Short lines will either do very well in this environment or become irrelevant. Buffett himself has said in effect, if I have to hire managers to run your business then I don't want to own your business. If I am BNSF and if I want to see rapid branchline growth with no or low capital expense I know the best way to get it is to hire a well-run short line to do it. If on the other hand, I am paying $300 a car in handling fees and see no new business or expansion of the existing franchise, then I'm paying the wrong guy.

Privately held or not, BNSF is still competing with other railroads for certain types of business. And if under Buffett BNSF has greater flexibility than the other guys, you can bet the other guys are going to catch on – some sooner than others. Thus the key to shortline success is more than ever UPOD – under promise, over deliver.

Scotia Capital's new 114 page book, *Rail Renaissance Still on Track*, begins by giving CN its best rating, calling the railroad "a well-run machine." Lead rail analyst Cherilyn Radbourne writes, "We view CN as well positioned to benefit from inventory re-stocking in the manufacturing sector with its merchandise-weighted business mix.

"In our opinion, CN's network is advantageously positioned as the only North American railroad whose network provides access to all three coasts, a configuration that we believe offers offensive and defensive qualities. While CN arguably has fewer opportunities for improvement than its peers, the company has by no means exhausted all avenues. In particular, CN has barely started to tap the potential of the Elgin, Joliet & Eastern Railway Company (EJ&E) acquisition to increase network speed and fluidity, and reconfigure its U.S. yard network."

Here's where Radbourne launches into her thesis: "A return of pricing power to the railroads following a prolonged period of declining rates was a key driver of the last business cycle. Rail volumes, as measured by carloads and revenue ton-miles (RTMs), increased rapidly following a downturn in 2000/2001, driven by economic recovery and a trend towards offshore sourcing among North American manufacturers and retailers. Importantly, those volume increases occurred in the context of a relatively fixed amount of rail capacity, whereby the supply/demand balance tightened and the railroads gained pricing power.

"That critical turning point in the supply/demand balance was reached sometime in early 2004 and corresponded to a decisive upturn in the S&P 500 Railroad Index, which then began to outperform the S&P 500. We believe it is highly significant that the railroads managed to sustain pricing power in 2009 in the context of unprecedented volume declines and aggressive price competition from truckers as a result of excess trucking capacity.

"Looking ahead to 2010, the rails are confident they can achieve 'inflation-plus' pricing in 2010, which we interpret for modeling purposes as 3 percent rail cost inflation, largely driven by labor costs, plus an additional 1 percent to 2 percent. Importantly, 'inflation-plus' pricing naturally drives margin expansion, all else being equal." And that's the kind of writing we like to see in this space. Thanks, Cherilyn.

Art Cashin's note for Tuesday carries some daunting insights regarding stock market directions as a function of the Volatility Index or VIX. It's a measure of the market's expectation for near-term volatility as reflected in the options prices of the S&P 500 Stock Index and, as everybody knows, stock prices vary depending on economic expectations. Thus changes in the VIX can be an indirect measure of economic expectations.

Back to Cashin. He cites work by Robert McHugh of Mainline Investors -- a "respected technician" who's been following the VIX forever and has detected "reliable and significant" sell signals in the VIX. After recounting the technical aspects and "major damage" following three such signals over the past two years, Cashin concludes, "We are at a very dangerous juncture. If we get a sell signal over the next few days, it does not mean stocks cannot rally another 2 to 4 percent before dropping hard. But it means there is a very good chance that prices will be substantially lower than they are the day this coming sell signal occurs, several months from now." In other words, we're not out of the woods yet and short lines depending on single-carload manifest traffic had best stay hunkered down.