THE RAILROAD WEEK IN REVIEW

June 1, 2012

"What could have been a bumper crop in wheat isn't going to happen." -- Bank President in Western Kansas

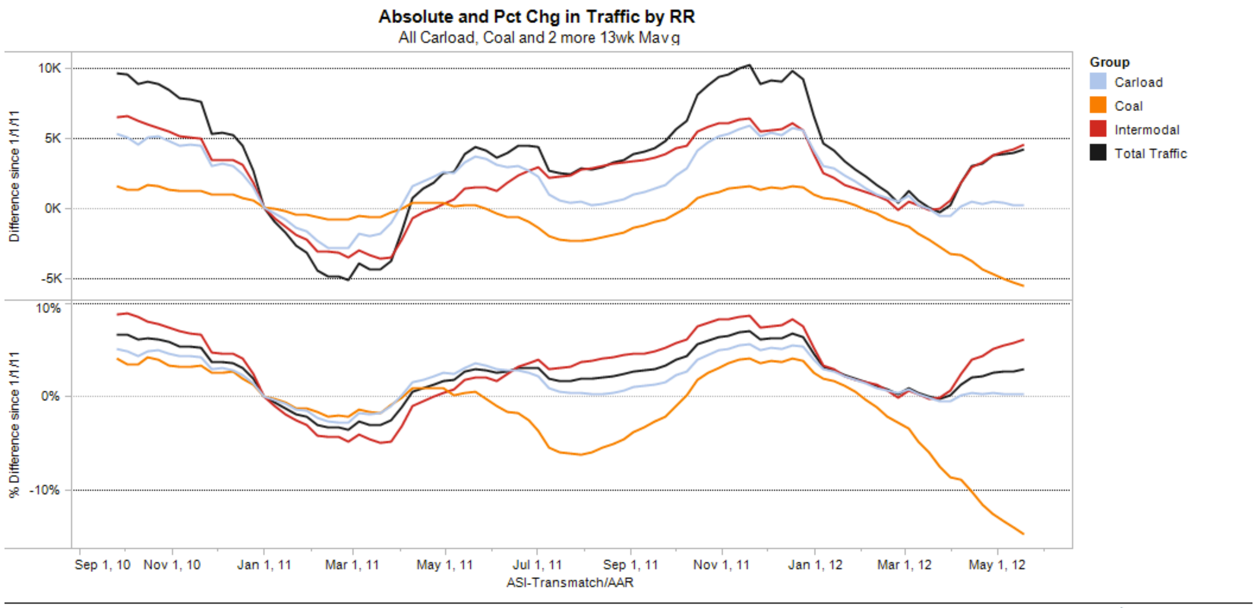
The 5th Annual Wolfe Trahan Transport Conference in NYC May 22-23 once again attracted a solid group of presenters. Over the two-day session, attendees heard presentations from 47 transport companies, seven shippers and two dozen vendors and others connected to transportation. Among Class Is, CSX and NS both noted strong improvements in export coal volumes in the second quarter to-date and that all the nat gas switching that can be done has been done -- "incremental demand" for summer power will have to come from coal.

That said, all the rails are seeing increased energy-related carloads from the oil and gas side of the house. UP, BNSF and CP are particularly well-positioned in the Bakken with a total of 150,000 or more loads of outbound crude forecast for 2012. CN's big play is Wisconsin frac sand right now but the road expects output from Alberta oil sands to increase in the future. The eastern US roads anticipate growth in loads of crude oil from the Bakken as well as supplies for nat gas drilling in Pennsylvania and Ohio.

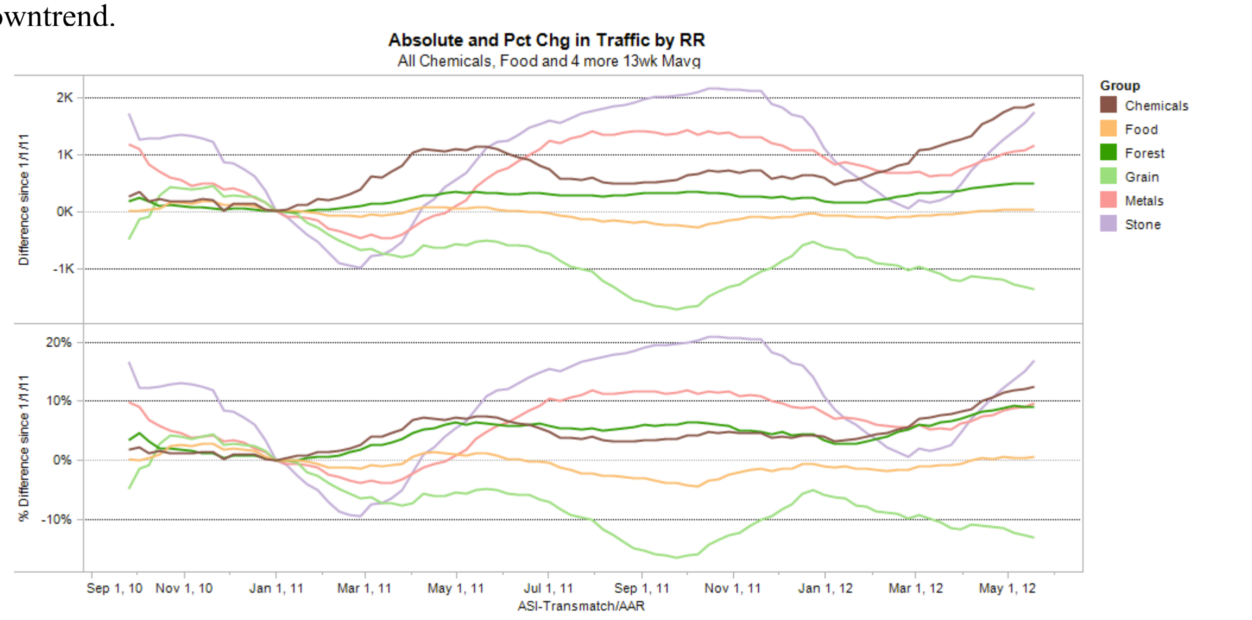
The shortline panel included Rick Webb (Watco), Tom Hoback (Indiana Rail Road) and Jack Hellman (GWR). No real surprises here, though W-T moderator Scott Group did a great job drawing out the panelists on mergers and acquisitions. He cited Patriot Rail having just been sold for a reported ten-times ebitda and now Fortress "seeking strategic alternatives" for its RA stake. Naturally, nobody was going to step up with any major prognostications, however one got the general sense that the three panelists did not see a Class I acquirer, even though BNSF/Berkshire had been mentioned more in passing than anything else.

Summing it all up, freight vols are still not tearing up the roads and rails and everybody I heard speak was guarded in their outlook. I'd say the rails are better off because they control their own roadways and capacity and are farther up the safety learning curve with hours of service, drug-testing, training and the lot. Operating ratios are in the 70s or better whereas the truckers are happy to hit 90. And shippers -- the ones that pay the bills, remember them? -- are looking for low-cost (not just cheap rate) supply-chain solutions. Recall what Verso said (WIR 5/11) about service reliability and consistency being 60 percent of the selection process.

That coal weakness continues to drag down weekly revenue unit volumes comes as no surprise. The diving yellow line on the first chart from ASI-Transmatch makes that quite clear. The top chart in each frame is absolute AAR unit difference week-over-week; the lower chart is percentage difference. You can also see how intermodal (red line) is pulling up total revenue units (black line) and that merch carloads (gray line) are evening out.



The chart following shows the relative strength of each merchandise commodity group (automotive omitted as few short lines have any significant movements in this commodity group). Whereas chemicals represent the biggest change by volume, stone (where frac sand lives) is the biggest percentage grower. Metals and forest products (wood and paper) show a slight uptick while food (canned goods, beverages and such) is flat and grains continue their downtrend.



With respect to grain, Dennis Gartman tells us in his May 29 letter that wheat in particular is threatened by drought in the western reaches of Texas, Oklahoma and Kansas. He quotes a bank president in western Kansas on the prospects for grain crops there:

> What could have been a bumper crop in wheat isn't going to happen. My guess for the western two-thirds of the state is that yield will be reduced by 50 percent in the western half and 30 percent east of that. Corn and soybean crop conditions are dismal. Even though sub-soil moisture is good, early planting and lack of rain have not helped tender, young plants.

[*Today's WSJ says the July spring wheat harvest will be up 13 percent over last year's. Winter wheat -- what Gartman's on about -- expectations have been "tempered"by lack of rain. -- rhb*]

Agriculture bell-wether ADM has earned an Under-perform rating from Credit Agricole Securities. The note acknowledges the company's "solid momentum in its core business" and recent initiatives to eliminate redundant facilities and cut costs but also expresses concern that these efforts "will take many quarters to pay off."

On the plus side, increased livestock production on the Pacific Rim means increased demand for corn, beans and meal. A large domestic corn crop has the potential to help ADM Ag Services earnings as well as higher export high-fructose corn syrup prices. On the negative side,

> US ethanol markets will continue to be weak for the foreseeable future, as gas and export demand tail off, E15 implementation has been slow to get off the ground without incentive regulation, ethanol stocks have accumulated, and cash corn prices remain elevated. Sugar prices have declined considerably off peak levels, which will challenge the relative value of higher-priced HFCS. And overall domestic protein supply continues to decline, which will pressure feed demand in the US.

Buy in May and Go Away? On Thursday I added Canadian National to my IRA holdings. Schwab gives the shares a B (buy) rating and the Road & Rail sector a B rating as well. At Wednesday's close CN was just 8 percent off its 12-month high and 30 percent above its 12-month low -- only UP has numbers even close. Moreover, CN and UP are the only names trading above their 50-day moving averages.

First quarter total revenue at CN was up 13 percent on 5 percent more revenue units and 6 percent more RTMs (CP was up 11 percent; others were up small, flat or down). Merch carloads (non-coal or intermodal) account for 65 percent of sales, even with CP and lagging only KCS (74 percent). And of course CN's operating ratio still leads: the only one beginning with a six. My target price is $100.