THE RAILROAD WEEK IN REVIEW
July 3, 2014

"The consensus of market watchers appears to be that a correction is overdue, thanks to a combination of factors, including elevated optimistic sentiment—a contrarian indicator. " — *Liz Ann Sonders, Schwab & Co.*

The being a short week, and with many folks escaping to the beach or mountains, I'm going to indulge in some market commentary as it may affect short lines. To begin, there are those market-watchers who say shares are getting a bit "frothy" — overbought if you will. Schwab's Chief Investment Strategist Liz Ann Sonders writes about "elevated optimistic sentiment, a contrarian indicator."

The argument is that investors tend to get spooked at market tops and sell puts for downside protection. Sooner or later the correction comes and as the bottom nears these investors get more optimistic and start writing calls to juice upside returns. Thus a high ratio of puts to calls signals a downturn; a low ratio — more calls relative to puts — flags an upturn.

Sonders then gets closer to home: what market newsletter writers (and in that group I put the stock analysts that mostly tell you to Buy, sometimes say Hold, but rarely come right out and say Sell) produce can be another contrary indicator.

> Newsletter bullish sentiment is above 60 percent for the fourth straight week, something not seen in nearly 10 years. Bespoke Investment Group looked at every streak since 1970 when bullish sentiment was above 60 percent for at least four weeks. The average subsequent three-month and six-month returns for the S&P 500 were not impressive.
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> Over the next three months, the S&P 500 averaged a respectable gain of 1.7 percent with positive returns 54 percent of the time. Six months later the returns were a paltry 0.8 percent, with positive returns less than half of the time. Based on these results, a near-term pullback may be in the cards.

The June 30 *McClellan Market Report* (no relation to our NS friends that I know of) calls the low CBOE equity put/call volume ratio a sign of complacency, strongly suggesting "that a down move is needed to reintroduce the notion of worry into investors' minds. That notion seems to have been forgotten, and the length of the quiet period is suggestive that the remedial correction will be more violent, since it is going to be a bigger surprise to more people."

You can see the same level of complacency in rail shares. The rail analysts see good times just around the bend — their views based largely on energy (drilling materials in, crude oil out), intermodal (domestic having a field day) and ag products. Put/call open-interest ratios are generally under 1.0, a positive sentiment. Canadian National (CNI) is at the low end with 0.48, meaning roughly twice as many calls as puts. The Norfolk Southern (NSC) ratio stands at 0.77, and Union Pacific scores 1.39 — more puts than calls and perhaps it's time for a pullback.

Railroad price/earnings ratios are becoming rather heady as well. CP and KCS are in the 30s; UP, GWR and CN are in the 20s; NS and CSX are the low-balls in the mid-17s. This against a traditional railroad multiple in the low teens. Personally, I see full-year total volumes up a couple of points at best, with crude oil, ag products and drilling-related aggregates and pipe the drivers. Operating ratios will stay pretty much where they are because ops costs are under much better control and I'm not sure how much upside elasticity remains in pricing.

My commodities outlook for rails, even with the second-quarter boost, remains in the 2-3 percent range. There is one qualifier, however. The June 30 Oppenheimer *Investment Strategy* letter favors cyclical over defensive sectors, a positive for rails. The cyclicals include consumer discretionary (think motor vehicles and furniture), energy (coal and petroleum-related), industrials (Deere farm machinery through Trinity tank cars), and materials (aggregates, plastics and steel, e.g.)

Second quarter carloads are just now coming in, at least in terms of vols through June 28. A year-to-date sampling:

Union Pacific			
Revenue Units	**YTD 2014**	**YTD 2013**	**Delta**
Total	4,726,468	4,429,679	**6.70%**
intermodal	1,962,578	1,813,281	8.23%
coal	838,135	805,407	4.06%
auto	234,219	235,026	(0.34%)
pet prods	147,126	166,280	(11.52%)
SL Carload	1,544,410	1,409,685	**9.56%**
CSX			
Revenue Units	**YTD 2014**	**YTD 2013**	**Delta**
Total	3,399,154	3,228,536	**5.28%**
intermodal	1,335,083	1,254,233	6.45%
coal	578,724	599,545	(3.47%)
auto	212,897	218,943	(2.76%)
pet prods	99,694	60,902	63.70%
SL Carload	1,172,756	1,094,913	**7.11%**

The good news is the commodity groups most prevalent in the shortline community as a whole are up nicely in my sample, and I have no reason to believe NS and BNSF will be much different. The table starts with the total volume as reported on the respective websites. I then back out the commodity groups the majority of short lines and regional carriers don't see. (NS says the number of their non-Class I connections handling crude-oil trains could be counted on the fingers of one hand with several fingers left over.)

The only flaw in the chart is it doesn't separate crude from the STCC 29 group including LPG, asphalt, and the whole natural-gas-liquid family. However, that doesn't change the end result much because the STB's Quarterly Commodity Statistics (QCS) waybill sample says vols in this group remain fairly constant quarter-to-quarter at each railroad.

Dennis Gartman, he of the eponymous and useful daily Letter, has this to say regarding investors marching in lock-step:

> Such unanimity of direction usually happens at the end of long, sustained movements, for interestingly we see this sort of unanimity on the downside at the end of bear markets and this sort of unanimity of to the upside at the end of bull markets and this has our attention. We are, it seems, in the midst of a melt-up of some sort as those who've been on the sidelines, un-invested, rush in finally to become invested and as those who've been involved in the market on the short side are forced to cover their positions as panic sets in.
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> Psychology is an ugly "fundamental" in markets. It always has been. It always shall be. The public remains hard upon the sidelines in any and all bull markets, entering only in the bull's final stages and the public remains long of bear markets all the way down, exiting only amidst panic and despair. It has always been such and it shall always be such, for such is the nature of human psychology.

South Carolina's Lancaster & Chester Railroad, a Gulf & Ohio property, has won a $560 million, 1.8 million square-foot, tire manufacturing facility for its Chester County industrial park. Giti Tire Group, a Singapore-based company, picked the site based on having equal access to both CSX and NS, being close to I-77, I-26 and I-85, and having the ability to use the railroad for movements to and from the Port of Charleston.

This is Giti's first plant in the United States, making passenger and light-truck tires for the original equipment and replacement markets. The first phase of annual production capacity is expected to reach five million tires; further capacity increases are in the works to meet future market demand. Wall Street is expecting 2014 to be a 16-million vehicle year, and with the growing Greenville BMW plant not two hours away, one might expect some of those new BMWs will come off the line wearing Giti tires. Congratulations, all.