THE RAILROAD WEEK IN REVIEW
October 9, 2015

“The link between stocks and bonds is much higher these days because of companies’ reliance on debt to fund repurchases and dividends, even as the bond market’s appetite for risk is fading.” -- Stephany Pomboy, MacroMavens Research

“Forecasting, n. The attempt to predict the unknowable by measuring the irrelevant.” -- Jason Zweig, The Devil's Financial Dictionary

"Corporations want to be able to maintain the fiction that earnings are rising, so that price-to-earnings ratios don’t come under stress and cause stock prices to fall." John Mauldin, “Outside the Box” Letter

"Each step forward by the yuan is an incursion into the dollar’s dominance of the global monetary scene." Lawrence Williams, SmarterAnalyst

The third quarter earnings season is shaping up as one of contraction. Thomson Reuters this week published a study showing how market-watchers have gone from bullish to bearish about the third quarter in their successive estimates from January 1 to now. What started out as a consensus expectation for third quarter S&P growth of 7.4% in January dropped nearly 800 basis points to minus 0.4% by July 1 and to minus 4.2% by the Sep 30 end of the quarter.

The Energy sector took the biggest hit, from minus 26.4% January 1 to minus 64.7% October 1, with prices for crude oil the big driver, followed by the EPA war on coal. The Materials sector — sand, steel, plastics, aggregates — was another double-digit loser, falling to minus 15.4% from 6.4% in January. The Industrial sector, where railroads live, dropped 12.5 points to minus 3.7% from plus 8.7% in January.

AAR year-to-date commodity carloads for all of North America through September are down 4.4% including coal; total revenue units including intermodal are down 1.2%. Coal, met ores/metals and petroleum products including crude oil and nat gas liquids were down big; aggregates were off more than a little. As Cowan’s Jason Seidl points out in a note to clients,

> Total traffic declined on a year-over-year basis every week this quarter, except Week 35, which benefited from an easy comparison with Labor Day week last year. With only one week left to be reported in 3Q15, it is unlikely that we will see any material improvement in the quarter-to-date results.

Shortline and Regional rails report total revenue units down 5.8%, though — if you back out coal, intermodal, and auto — the commodity carloads that support most non-Class I properties (and make up three-quarters of total RailConnect vols) are down 4.4% year-to date. Within the commodity groups ores, waste & scrap, and metals were hammered hardest.

It's not going the get better any time soon, either. Randy Frederick, Schwab's Director of Trading and Derivatives, writes,

> By virtually any measure, last week gave us a lousy set of employment reports. Non-farm payrolls not only came in 47k below estimates, July and August numbers were revised downward by another 59k combined. The labor force participation rate dropped to its lowest level since October 1977, and, if not for the drop in participation, the unemployment rate would likely have ticked up; the last time that happened was in May.
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> Additionally, there was no increase in hourly earnings, so that means no wage inflation, something the Fed has been looking for. The only positive part of the report, from my perspective, is that the U-6 underemployment rate dropped from 10.3% to 10.0%; meaning some part-time workers are finding full-time work.

I'm betting Capex 2016 will be a major thread of the conversations in and around this month's earnings calls. My baseball buddy Tony Hatch says in a recent dispatch,

> The lower load-weight environment that goes with the loss of so much coal has economists beginning to discuss the so-called stranded-asset theory of energy. This could be *the* bear super-cycle for commodities, and if you look to parts of Appalachia you might think it's happening already. [*Note: NS will abolish all rail traffic on a 50-mile coal-hauling section of its ex-Virginian Railway Princeton-Deepwater District in West Virginia for starts*. - rhb] Certainly the railroad of tomorrow will be lighter in terms of gross ton miles (GTMs), with all sorts of implications for operating ratios, returns on investment, and MoW capex.
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> The discussions begin with the third quarter earnings calls and continue on to Railway Tie Association (RTA) conference next month (ties are the building blocks of MoW), RailTrends, (www.railtrends.com) Nov 19-20, the National Rail Construction (NRC) conference in January, and then we anticipate actual answers on the Q4/15 calls in January 2016.

Speaking of RailTrends, the preliminary agenda is out, and it gets better every year. Tony Hatch and *Progressive Railroading* magazine first hatched (you should pardon the expression) the concept in 2005, bringing together all the railroad disciplines from ops to engineering, from fiscal to commercial, and from short lines to mechanical. I've been to almost every RailTrends outing, not only to hobnob with my fellow wizards, but also to come away with bits of critical knowledge I didn't even know I was lacking. W Hotel, Lex at 50th.

Linda Bauer Darr has just completed her first year as President of the ASLRRA, and what a year it's been. She's made the ASLRRA a daily presence on Twitter, highlighting short line and supplier members. Her regular Facebook posts show her out and about visiting short lines, from loading docks and warehouses to maintenance shops and loco cabs. In short, she's progressed quickly from being an outsider looking in to an insider looking out.

Her September 30 Letter to the Membership is particularly well done, and highlights a number of association initiatives designed to add value to membership. I quote:

> From my perspective the primary level of complexity lies in the challenge presented by operating in a closed network with collaboration forced at every turn. I have never experienced an industry where the level of collaboration is so critical to success while, at the same time, the competitive spirit remains alive and well.
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> Toward that end, we have been reinventing our convention and our regional meetings to build a stronger, more hands on, collaborative experience for our members and industry stakeholders to reflect the needs, and the inherent personality, of this industry.
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> The ASLRRA exists to help short lines understand and tackle the enormous challenges we are facing as an industry… We are in discussions with the FRA on the scope of the training rule mandate. We've formed a PTC Working Group to explore how we can support even the smallest railroads in coping with its mandates. And we have taken the steps to initiate a legal challenge to the ECP braking rules based on a general lack of sound research and the impracticality of mandating these costly and unproven systems.

I've spoken with several ASLRRA leaders who were involved in the selection process and they've been quite candid about what they were looking for and have clearly found in Linda. The organization is indeed fortunate that she in turn chose us.

End Note: Next week is NEARS here in Phila, CSX opening the olive jar of third quarter earnings, and the annual fall weekend Providence & Worcester Fall Excursion between its namesake cities. I'm going to do them all, with the consequence that next Friday's WIR will be delayed, probably until Monday evening. Then it's off to Fort Worth for the BNSF shortline meeting and to Newark for the Lexington Group the last week of the month.