RAILROAD WEEK IN REVIEW

March 17, 2017

"We're taking on more and more of the wrong type of debt. From 1952 to 1999, $1.70 of debt generated $1 of GDP. From 2000 to 2015, it took $3.30 of debt to generate $1 of GDP. And in the latest four quarters, it took $5 of debt to generate $1 of GDP. We added about $2.6 trillion of this debt category. And the nominal GDP growth was only about $530 billion." —Hoisington Management Chief Economist Lacey Hunt on RealVision

GWR North America revenue units for Feb 2017 increased 0.8% over Feb 2016. Five of the seven commodities comprising 80% of GWR revenues are down. Same-railroad carloads excluding P&W (started counting in Jan) are off a point. From the press release:

*Agricultural products were off by 1,140 carloads in the Midwest and Coastal Regions, offset somewhat by increased volumes in G&W's Mountain West and Central Regions.
*Pulp & paper traffic decreased 1,028 carloads in the Southern Region as the result of the temporary shutdown of a customer facility in late January 2017. Restart is expected in 2Q017.
*Coal & coke traffic increased 4,895 carloads on utility coal in the Midwest Region.
All remaining traffic decreased by a net 3,982 carloads.

As for the P&W, GWR incorporated their car-counts in Jan. In Feb, P&W contributed 340 carloads of autos and auto parts; 413 carloads of chemicals; 664 intermodal platforms; 159 carloads of metals; 239 carloads of minerals & stone; and 452 carloads from all other commodities.

In a footnote, GWR says severe weather and flooding in the western U.S. negatively affected volumes in G&W's Pacific Region in February 2017 and into March 2017, and other lines in the region also may have suffered declines. Moreover, with more than 100 railroad names spread across the US and Canada, I think GWR is a decent proxy for the non-Class I community as a whole. Others please take note and run your own comps.

The Lacey Hunt quote above is worth heeding because it bears on future transportation demand. He posits that increasing non-productive debt harms economic growth rates now and in the future. The rate of growth in terms of output per hour is falling and, as a result, consumers are buying less stuff, pushing demand into the future — if it ever comes at all. He continues,

> We're in a late-stage expansion, and pent-up demand is exhausted. This expansion has been the poorest since the end of World War II, is now in a late-stage expansion, and pent-up demand is exhausted. The Federal Reserve is tightening, restraining reserve growth, and pushing up interest rates — a risky strategy given the underlying frailties of the economy.

Since pent-up demand is exhausted, consumers are pulling back, and we'll see it in durable goods from refrigerators to finished vehicles. Moreover, since we're in a global market, emerging markets have choices. No longer must they buy their cars, corn or computers from the US. We've seen the shift in auto and ag trends; the tech shift is accelerating as US companies decide to go where the knowledge workers are rather than try to get them into the US on visas.

Patrick Watson writes in the March 14 "Connecting the Dots,"

> Many start-up companies and venture capital investors from other countries don't want American customers. They have no interest in competing with US businesses; they're focused on their own countries. Rather than importing stuff from the US, they want American customers to export dollars for their goods.

Moreover, the increasing difficulties non-US citizens face just getting into this country encourage them to take their holidays — and business ventures — elsewhere. Watson's take is such that the implications for freight transport in the US are not good: Fewer visitors from other countries mean fewer goods and services flowing into the markets they visit to support them. Fewer goods going to visitor destinations in the US mean less moving in trucks, intermodal boxes, boxcars or even tank cars for everything from industrial chems to ethanol.

And with the US absorbing a smaller piece of the global production pie, it follows that as other countries are buying more stuff from other countries, our exports for everything from chemicals to agriculture start to shrink. Fewer export goods means even less stuff to move by train or truck. The reason I mention this is to encourage short lines to scour their customer lists for those making durables destined for major US markets and anything for export, from corn to coal to cars, and to make plans to replace those customers. With what becomes a serious question.

The Mexican Economic Competition Commission has released a preliminary report on its findings, and KCS objects. The Commission seeks to make sure there exists "effective" freight rail competition for "interconnection services, trackage and switching rights," and concludes it's "lacking in the market of trackage rights in the rail networks operated by Kansas City Southern subsidiaries operating in Mexico."

> KCS-Mexico respectfully disagrees with the Commission's reasoning and preliminary conclusions, and will exercise its rights within the next 20 business days to file evidence and arguments to support its position. After the end of the aforementioned 20 business-day period, the Commission has an additional term of up to 110 business days to issue a final report in connection with effective competition conditions in the Relevant Market.

KCS says in its press release that "no remedy, sanction, penalty or other alteration of the rights of KCSM is imposed by the Preliminary Report," and that "any such action could only be considered subsequent to the issuance of a final report by the Commission and then only separately by the Regulatory Agency of Railway Transportation."

In other words, KCSM continues to operate as usual. Even if the Commission's findings are confirmed, there are many steps between final findings and actions to constrain KCSM operations. And here's the kicker: "KCSM will exercise all of its rights under its concession and the law to ensure that any actions considered by the Agency are workable and consistent with KCSM's rights under law and under its concession."

As of this writing, KCS shares trade at $90, 20 times earnings and a 17% "margin of safety" below the firm's discounted cash-flow fair value of $108, the only railroad with a positive margin of safety (CSX by comparison is pushing $50 against a DCF value of half that). Tom Wadewitz at UBS suggests a $99 ticket price a year out.

Stifel's John Larkin writes in his March 15 Transportation Outlook, "Consumers drive freight, and population growth drives the consumer; global population still rising, but growth is slowing." His graph shows population growing at a 1.8% CAGR 1950-1979, 1.5% 1980-2015, and and 0.7% 2016-2050. Larkin also shows how the Fed's current GDP growth rates have slowed from 4.5% 20 years ago to 1.8% now, with a forecast 1.9% through 2019.

The railroads on their earnings calls are predicting sub-2% growth out two years, a further indication that freight demand expands about the same rate as GDP. Finally, Larkin shows how the labor participation rate has slowed from 67% to the present 63% — from waves of women entering the work force then to tailing off now, compounded by the number of retiring baby boomers. All of which impacts household formation rates and housing market activity, now about where it was at the end of 1976.

Combine the decreasing US growth rates with the slowing global trade with the US (above), and the outlook for a robust railroad industry begins to fade. The overarching question thus becomes, what are we going to do about it? Slow-moving big trains on unpredictable schedules at uncompetitive rates aren't the answer. Being nimble like Amazon is. How do we get there?

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