RAILROAD WEEK IN REVIEW

March 24, 2017

"The U.S. economy continues to expand, although there are signs that first quarter growth could be on the weak side largely due to continued seasonal issues. We believe that economic growth is generally accelerating, a thought bolstered by the Fed's confidence to raise rates again." — Schwab Market Perspective, March 17

The AAR reports North American revenue units through March 17 increased 3.2%, boosted by a surge in coal, up 14.2%, diminished a bit by auto, down 4.6%, and intermodal lackluster at mere 70 basis point gain. Backing out coal, cars and intermodal, merch carloads enjoyed a 3.9% increase with particular strength in metallic ores and non-metallic minerals. Forest products and industrial chems including ferts lagged.

Taking a closer look at CSX, given all the commentary about the improved results Hunter Harrison is expected to deliver, we find total revenue units YTD thru Mar 17 are up 40 basis points over last year at this time. Ten of the 18 merch commodities including auto are down. Merch carloads comprise 44% of the total; within this group the top three contributors are, in order, auto, chems, ag. Coal is down to 13% of total, intermodal is now 43%, a point behind merch.

On the Q4 earnings call in late Jan, CSX said 1Q2017 vols would be flat to slightly up. They predicted chems down on crude by rail; as it happens, STCC 28 chems are essentially unchanged, up 0.2%, and petrol prods down 17.7%, for a combined minus 2.4%, the number the Street's using.

That's somewhat misleading because industrial chems plus ferts are nearly four times more volume than petroleum products, and, within petrol, STCC 29 petro-chems are three times as big as crude, per my QCS sample. And since short lines are strong in ferts, industrial chems, and petro-chems, I don't see the reported decline in chems hurting that much. Moreover, what I call "shortline commodities" — ag, industrial, forest products, metals, etc. — are up 2.7%.

Elsewhere on the January call, forest prods and intermodal were "neutral." Through Mar 17 forest products were flat as the gains in lumber offset the loss in paper-related products. Intermodal drifted south 1.2%. Which leaves the rest with "favorable" outlooks. And with most individual merch lines line accounting for 2% or less of total revenue units, getting vols and revs up enough to support a sub-60 OR will be a challenge.

The Street still isn't impressed. Share prices remain at a high multiple on speculation about what Hunter can do; however, the sideways pattern since the Jan gap-up suggest buyers are on the sidelines waiting for the next shoe to drop. By way of comps, CP shares are off 5% since mid Jan

when Hunter left (meanwhile, CNI shares are up nearly 3%). CSX shares are off 65 basis points in the same period.

The economic measures for the week ending March 17 were a mixed bag. The Producer Price Index gained 0.3% vs the 0.1% official estimate, while the consumer price index held steady at 0.1%. The NAHB Housing Index for March was 71 vs. the 65 estimate; Feb housing starts were up 1.9% but building permits dropped 5.7%. Business inventories for Jan were flat, and capacity utilization for Feb remained in the 75.4% range. Says Schwab's Randy Frederick,

> Across the economic spectrum, there's almost no data that's not at least moderately positive. This week's examples: the NAHB number is at a 12-year high, the year-over-year PPI is at a 3-year high; retail sales, while not strong, are at least positive; the quarterly average of the Consumer Sentiment number remains very near a 17-year high; and the year-over-year CPI is now at its highest level since March of 2012.

I noted above that the automotive category makes up 7.4% of CSX total revenue units. GE Transportation's RailConnect Index has automotive at 2.4% of shortline volume. It's on shaky ground, and I've warned about it in this space before. And now, during Tuesday's market sell-off, Art Cashin wrote that pundits "were flailing about looking for a trigger," and they found one in auto:

> For decades, auto loans tended to be about three years in duration. With the recession, wage growth began to stagnate and to keep the business, banks began to "help" car buyers stretch their limited dollars by increasing duration from three to four, then to five and even six years. Thus, you still had to pay back the $5,000 but in many smaller payments.
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> While it's not the size of the mortgage problem, it is a huge, huge pile of doubtful debt. So that's why the Ally call [auto loan maker reports weaker used car sales] set off alarms, aided and abetted by recent reports of growing auto loan delinquencies. That also hit regional banks, many of whom have auto loan portfolios… The loan concern spilled into a flight to safety.

The AAR's Dan Keen writes in his March *Rail Time Indicators* that U.S. light vehicle sales in February were an annualized 17.5 million, "the same as in January and down 1.1% from February 2016. Year-to-date sales through February 2017 were down 1.4% from 2016." He concludes that's not a big decline, but "it's looking increasingly like auto sales have at best plateaued and at worst are heading down." And it's not only vehicle sales that can affect short lines; it's everything that goes into them — steel and other metals, plastic, glass, etc.

Canadian National on Wednesday launched "Grain Insight," a podcast that provides agricultural players with the latest updates on getting grain to market. The podcasts are two-to-three-minute interviews featuring industry observers providing up-to-date information on grain transportation issues. Listeners will benefit from answers to commonly asked questions, learn

about factors that affect how quickly their grain gets to market, and the latest news on grain movement.

The first podcast is available now and focuses on the current state of "Grain on the Move," with David Przednowek (sounds like chen-OH-vick), CN's director of grain marketing. My good friend Doug MacDonald, CN vice-president of bulk, says CN wants to have "a better understanding of the needs our customers, the grain companies, as well as our customers' customers - the producers."

It's a given that getting grain to market quickly and efficiently is the key to profitability for growers. "The better everybody understands each component of the grain supply chain, the better positioned we all are. When our customers win, we win." And so it is CN created the podcast to get timely information to farmers. To download or listen to Grain Insight, visit cn.ca/grain or find it on iTunes. You can subscribe today to receive every episode as soon as it's published.

I listened to the first podcast and Przednowek provides insights and examples of how grain farmers are using more CN trains — even in the middle of the winter — by building bigger trains, enlarging load-out facilities, and setting record volumes. It's a chatty, informative segment and well worth one's time to tune in.

Meanwhile, CN will repurchase 1.2 million shares as part of the Normal Course Issuer Bid for up to 33 million shares announced on Oct. 25, 2016.

Norfolk Southern's 2016 Annual Report is now up in the Investors page at *www.nscorp.com* and can be downloaded as a PDF. In the report, titled "Delivering On Our Commitments," CEO Jim Squires tells shareholders that the company finished the year "a stronger, faster, lower-cost, and more profitable railroad." Accomplishments include rationalizing 1,000 miles of secondary branch lines; an all-time best operating ratio of 68.9 percent; operating expense reductions generating savings of $250 million, surpassing a targeted $130 million; and increasing operating income and net net income by seven percent each.

Benefits from the above include an 11 percent decrease in operating costs and increasing year-over-year earnings by ten percent. Citing shifting markets and industry dynamics, Squires says, the company is "more focused than ever on services that will help convert freight from highway to rail." To that end, NS is actively engaged with customers "about initiatives from e-commerce platforms to developing shared performance indicators to measure service." And I hope that extends to prospects, too.

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