RAILROAD WEEK IN REVIEW

May 19, 2017

"US automakers now seem to have passed a turning point from several years of robust sales to what looks to be a multi-year decline in demand for new and used vehicles and a huge buildup of unsold inventory." — Harald Malmgrem, Global Market Commentary, May 2017

Every Friday Schwab's Randy Frederick sends out his "Weekly Trader's Outlook" and from it one can glean insights as to the direction of the economy as well as where the market may be heading. This week he pays particular attention to market volatility and the retail sector. And since consumer behavior affects 70% of the economy, it behooves transportation providers to position themselves appropriately.

Frederick's highlights: Both Nordstrom and JC Penney reported earnings last week that missed the estimates and overall retail sales came in at +0.4% vs +0.6% forecast. The SPY (S&P 500 ETF) Put Open Interest is up 6.3%, indicating a bearish outlook generally; and the VIX (Chicago Board of Exchange S&P Volatility Index) closed below 10 for the first time in 10 years, and usually when it dips below10 the S&P 500 finishes the year in the red.

The chart below summarizes Frederick's note. "Moderately Bearish" is the general tenor. From which I take it the outlook for railroads in general is more of the same: the 2% economy I've been talking about for some time. Even though consumers drive 70% of the economy, you still have to Heat and Eat.

Composite Market Sentiment

Indicator	*Change	Short-Term	*Change	Long-Term
Index OI Change		Moderately Bullish		N/A
Equity OI Change	-	Neutral		N/A
Index OI Participation		N/A		Bullish
Equity OI Participation		N/A		Neutral
VIX OIPCR	-	Moderately Bearish	-	Neutral
SPX OIPCR		Moderately Bullish	+	Moderately Bullish
Equity OIPCR		Moderately Bearish		Moderately Bearish
CBOE VIX VPCR	+	Neutral		N/A
CBOE SPX VPCR	+/-	Moderately Bearish		Moderately Bearish
CBOE Equity VPCR	-	Moderately Bearish		Neutral
ISEE		Volatile		Volatile
OCC Index VPCR	+/-	Volatile		Volatile
OCC Equity VPCR	+/-	Volatile		Volatile
VIX		Bullish		Moderately Bullish
VIX IV Gap		Neutral		Neutral
VIX Futures		Neutral	-	Moderately Bearish
VIX Hedging Effectiveness		Poor		Moderate

Past performance is no guarantee of future results.

As Morningstar puts it in their recent Consumer Defensive Sector note: “Consumer defensive sector valuations have edged higher, with shares trading about 5% above our fair value estimates, reversing the approximately 4% discount we saw in the last quarter.” Ag and energy support commodities (Raoul Pal on RealVsion sees oil prices dropping still further as plays like the Permian keep growing) ought to be strong in the carload sector.

Perhaps the auto sector as much as anything else mirrors consumer sentiment. Malmgrem:

> Much of consumption for automobiles and other consumer durables was enabled by new forms of credit, with auto sales especially boosted by subprime lending which in turn was transformed into collateralized loan obligations (CLOs)…
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> Thus, one of the most systemically important industrial sectors of the US economy is at risk of significant decline, with new financing drying up and the existing automotive CLOs falling in value as a result of climbing delinquencies. Against this briefly-depicted backdrop, a strong surge in consumer spending does not seem plausible.
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> In our previous commentaries we suggested that the much touted 2% US annual rate of growth was a manipulated figure with optimistic bias built in. Our view is that the US economy in recent years has really been running at around a 1% percent annual rate, but is now drifting toward an even slower pace.

And for that reason I don’t see the US economy — or railroads — setting any records this year.

UBS has come up with the best explanation I’ve seen for the recent upsurge in coal loadings and what we can expect from here. Among other things, coal accounted for 40-50% of the Q1 revenue growth for US railroads. More specifically, April coal moves were up 149% year-over-year at KCS thanks in part to low stock piles, while NS seems to have seized the lead from CSX because a major utility shifted its coal contract to NS from CSX. In the west, BNSF and UP saw month-to-month declines of 9% and 16% respectively for Mar-April.

The report doesn’t mention export coal, which I think is a crap-shoot. China is cutting off North Korea (or so they say), but there’s always South Africa, Indonesia, Australia, and India, along with other countries along the Silk Road, regardless of shipping rates, etc. Like utility coal, US railroads should take what exports they can for as little incremental cost as they can.

It’s a mixed message. The Class Is were telling us how coal ain’t never coming back and how they’re banking on the carload sector to help fill the void. I still think coal will settle at less than 15% of total vols and will stay there or slip even more. And carload *will* have to make up the diff. So even though UBS may be saying the coal picture isn’t as bleak as once thought, I wouldn’t be devoting any real capex to it. I *would* be devoting capital to making carload more competitive by taking out dwell time and unplanned events between OD pairs. See HH, below.

We haven't heard much from CSX about changes since the arrival of Hunter Harrison, however if we look at his *Modus Operandi* at IC, CN, and CP we may find some clues. To begin, "Precision Railroading" entails a great deal of local control. "Service" is the first of his five Guiding Principles and it's all about doing what you say you'll do (*How We Work and Why*, page 11), and one of the worst sins is leaving a customer hanging.

From this I think it's safe to say Hunter pushes a lot of things down to the local ops people and holds them accountable for running to plan. Train starts must start and end on plan to be sure the assets are in place for the next turn. Thus the local supervisors own things like yard dwell, asset management, and encouraging customers to turn loads into empties (and vice versa) without delay.

One short liner I know (and who's longer in business) never pushed customers hard to turn the cars quickly. He never told the receiver that when the railroad placed loads they wanted them all empty the next day. That way you can do one pull and not switch empties from loads and re-spot the remaining loads back. You also want customers to do stuff like closing doors and hopper gates before cars are pulled.

Which by extension goes to loading blocks by destination so the railroad can do one pull that can move directly from the receiving yard to the departure yard and never go over the hump. As a result, local operators have a major part to play in the Service element of Precision Railroading.

But you and I know the jobs that are done best are the ones the boss watches. So not only must leadership put lots of authority on local ops people, but there also must be score cards on how long cars have been sitting independent of whether they have railroad or private marks.

How Hunter approaches Keeping Score is clear from the Six Metrics he used in his CP and CN analyst presentations: average network (not train) speed in MPH; system terminal dwell in hours; gallons of fuel burned per 1000 GTMs (the Holy Grail is 1.0; CSX is at 1.14); average train length in feet (a subset of this is voids per hundred intermodal platforms); car-miles per day (BNSF actually counts car-days from customer release on short lines, the only way to know what you really have).

And that's what I think we'll see from Hunter Harrison. We'll get our first glimpse when COO Cindy Sanborn presents at the Wolfe Transportation Conference May 23.