RAILROAD WEEK IN REVIEW

August 30, 2024

"BHP wants to be bigger in copper, an industrial metal that is arguably the most critical for the energy transition, and it plans to start producing the fertilizer ingredient potash, which it says will be needed for more efficient and sustainable farming. Today, the company makes most of its profit from steelmaking commodity iron ore. It is also the world's biggest exporter of steelmaking coal." — WSJ, August 28

"Unfortunately, some damage has been done as [Canadian] grain companies took steps to halt grain movements. The week of shipping prior to the August 22nd stoppage has been impacted, and every day of lost shipping results in approximately one week of recovery time. Grain shippers and exporters will now be working hard to re-engage with their customers and re-schedule farmer deliveries as the rail network winds back up." — Western Grain Elevator Association, August 23

Last week we looked at traffic charts reflecting the recent past. This week I want to see what the tea leaves portend for commodity carloads six to twelve months out. First we have the Institute for Supply Management (ISM). They measure manufacturing and services output; my focus is on the first because that's what fills freight cars.

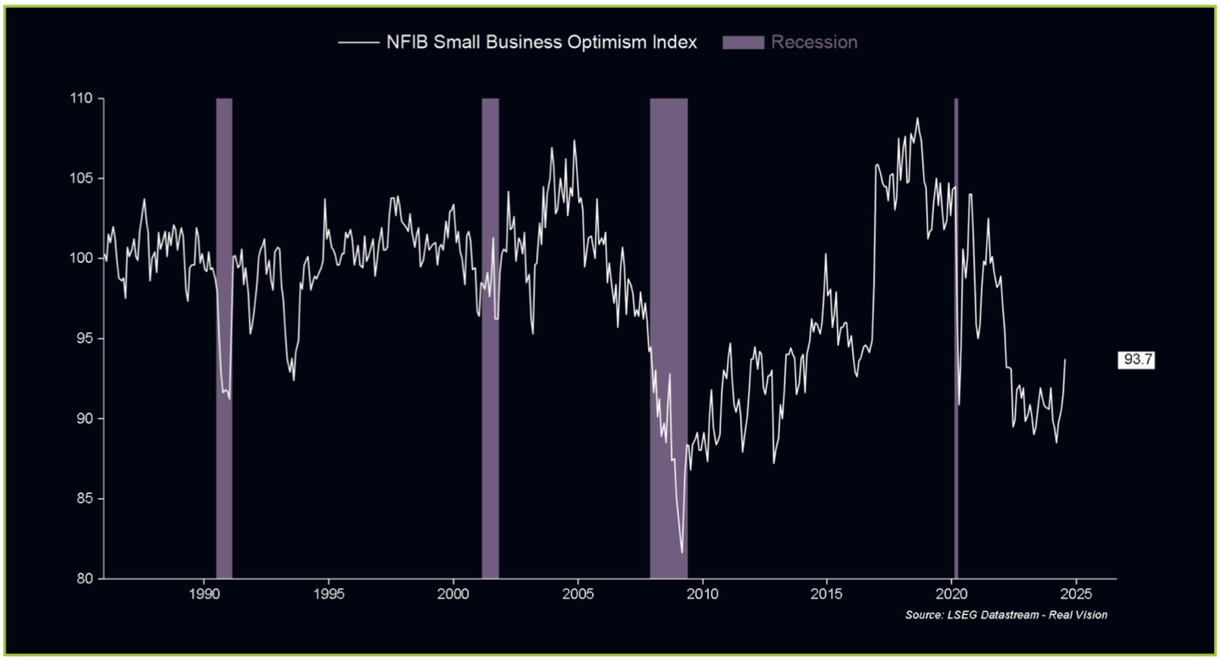
ISM's *Purchasing Managers' Index* or PMI is an economic indicator, which is derived from monthly surveys of different companies. The index helps in determining whether market conditions, as seen by purchasing managers, are expanding, contracting or staying the same. It is used to provide an advance look at how current business conditions are likely to change in the coming months.

The PMI survey is based on responses to a series of fact-based questions sent to a large number of companies by specific sector. The questions are related to five key variables with different weights: new orders (30%), output (25%), employment (20%), suppliers' delivery times (15%), and stock of items purchased (10%). The surveys are conducted on a monthly basis.

A PMI number greater than 50 indicates expansion in business activity. A number less than 50 shows contraction. The rate of expansion is also judged by the difference from the mid-point (50) and also by the previous month's data. For July, the Manufacturing PMI registered 46.8 percent, down 1.7 percentage points from the 48.5 percent recorded in June. In other words, the PMI slowdown continues.

Then there's the NFIB (National Federation of Independent Businesses), "a member-driven organization advocating for America's small and independent business owners." My sense is the NFIB is more inclusive than the ISM and as such better reflects the business outlooks for non-Class I railroad customers, and that's where I prefer to look to get a sense of potential commodity carload numbers for the smaller railroads.

Right out of the box, we see the NFIB reflecting optimism vs. the ISM's soft pedaling: the NFIB "business optimism index for July" shows a sharp increase to 93.7, significantly beating the consensus expectation of 91.5. See chart below. [1]



One of the most notable elements of the July NFIB report was the significant rise in confidence regarding the outlook for general business conditions. As you can see on the chart, the far-right uptick was the strongest monthly move since April 2020, when economic data began to recover following the global shutdown during the pandemic, with the change representing a 2.5 standard deviation event.

That said, the percentage of NFIB members reporting higher selling prices also came in lower. From this I conclude that the slightly lower NFIB sales data is just noise. Small business sales numbers will most likely improve later this year and into 2025.

The institutional investors' railroad share trading activity would seem to reflect the NFIB outlook more than what the ISM reports. Shares of the five Listed Class Is are generally

[1] Chart and data from Real Vision Macro Investing Tool Business Cycle Update – August 15, 2024.

up and the BNSF weekly AAR carload report shows revenue units up five percent through August 17, largely intermodal-driven. Coal was the biggest hit, down 23 percent, yet grain loads increased 16 percent and chemicals added another seven percent.

AAR North American year-to-date carloads have increased only two percent with intermodal up eight percent; coal continues to head south, down 15 percent, partially offset by grain and farm products, up five percent. Energy remains strong — petroleum products including crude oil and refinery output increased nine percent.

The IYT Dow Jones Transportation Average and NIFB charts track each other over the trailing six-month period. My preference is to look mainly at the six-month to one-year charts due to the cyclicality of our business and the number of variables from interest rates to shifts in production patterns. Here's the IYT:

The six(ish)-month cycle stands out. A dip in October is followed by a peak in April which in turn is followed by another dip in August. From this, one should be planning on another dip in February followed by another high in August. Bring up a chart of UNP and you'll see the same pattern. He who plans ahead stays ahead.

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