Looking To The Future

Middle-of-the-Roader, Optimist, Pessimist? It's All Good For Railroads In The New Decade

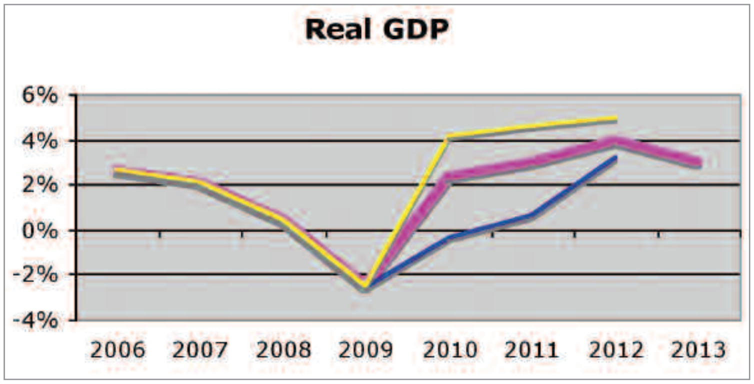
By Jim Gauntt

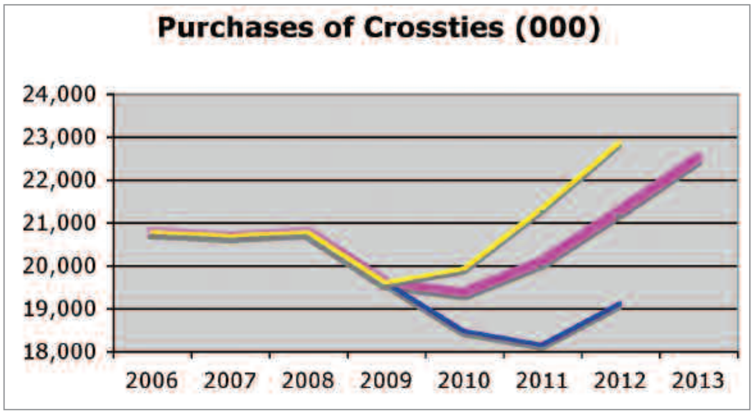
For those who have read this year's forecast article for tie demand (pg. 8), it is apparent that the future holds great things for both railroads and crosstie suppliers. The baseline scenario that RTA has projected for the next four years contains a fair measure of optimism, with caveats, even if the immediate outlook for 2010 is not as robust as one would wish it to be.

Still, the forecast does project that 2010 tie demand will suffer only mild softening from 2009. The final tally for 2009 is that 19.6 million new wood ties were purchased by all railroad market segments. The forecast for 2010? North American railroads will require 19.4 million new wood ties. Not a significant difference.

This bears further inspection. As previously noted, RTA has settled onto the Standard and Poor's forecast for the U.S. economy as being one of the most reliable models available for use in forecasting future US GDP. Thus, RTA used S&P's baseline forecast as the basis for the assumptions built into RTA's econometric model's forecast of tie demand.

S&P Chief Economist David Wyss wrote in the Jan. 5, 2010, issue of *The Outlook* that S&P's "baseline forecast assumes a gradual recovery after a few quarters of bouncing along the bottom, which [will make the recovery look] like a stretched out 'U'…[and believing] that the imbalances in the world and U.S. economies will keep [future] expansion slow."





Wyss continues, though, by saying "the risk of another downward leg on the recession remains real, [which could produce] a 'W' [shape to the recovery]." In other words, the risk of a double-dip recession is still a scenario one cannot ignore.

On the other hand, Wyss presents yet another more optimistic scenario. This scenario postulates that the American consumer may be the economy's savior once again and produces a 'V' shaped expansion. Wyss states that this scenario would produce a more "typical" shape to post-recession expansions.

Each of these scenarios has its merits and produces different results in the tie demand forecast. Exploration of the details behind the rationale for the scenarios is in order.

Wyss states that S&P's "baseline forecast indicates that the deepest and longest recession since the Great Depression ended in the third quarter of 2009." This is not news per se, but it does imply that the baseline forecast is relatively conservative to start with.

Table 1: Forecast Table - Baseline
New Wood Crossties (in thousands)

Year approx.	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	PCT
2006	2.7%	15,937	4,848	20,785	11.1%
2007	2.1%	15,285	5,396	20,681	-0.5%
2008	0.4%	16,761	4,003	20,763	0.4%
2009	-2.5%	15,853	3,751	19,604	-5.6%
2010	2.4%	15,341	4,032	19,373	-1.2%
2011	3.0%	16,108	3,976	20,084	3.7%
2012	4.0%	17,305	3,977	21,282	6.0%
2013	3.0%	18,357	4,138	22,495	5.7%

Out of this modest U.S. GDP forecast the RTA model forecasts a tie demand of 19.4 million ties for 2010, as previously stated. So, if the baseline forecast seems conservative and produces relatively stable tie demand, what does the pessimistic forecast suggest?

In a double-dip "deep recession" forecast, Wyss assumes that the "financial markets freeze up again…oil prices rebound to triple digits…consumer and investor confidence weakens further, keeping the economy in recession until late 2010…stock prices drop back near their March [2009] low, and a deeper downturn in Europe and Japan keep [U.S.] exports low."

If that happens, what occurs in the tie demand forecast? Well, surprisingly, not as much as one might think, as seen in the Forecast Table. Yes, the market softens as freight traffic on railroads erodes further, but tie demand only drops another 5.9 percent in 2010 and only 1.6 percent in 2011. All in all, not too bad, and potentially survivable for most, if not all, tie suppliers. Plus, the recovery in 2012 sees tie demand back near 2009 levels.

No one is suggesting that tie producers would wish this upon themselves. However, if one had an option as to what business to be in, in a deep recession scenario, crosstie manufacturing versus other industries ➤

like auto manufacturers or homebuilders, most bets would be placed on business owners opting for ties. Maybe Warren Buffet does know a thing or two when it comes to recession-proofing his portfolio.

What about the upside potential in an optimistic outlook, is it even a remote possibility? To follow Wyss' thinking here one would need to count on "an improving housing market (something that seems to be showing life in some places right now)…better consumer and business confidence, an improving job market, stronger growth abroad (ditto)…and a more rapid calming of the financial markets…[coupled with] a revival in productivity increases…[and a bounce back in] consumer spending…[to] help reduce the current strains on the U.S. economy."

That's a lot of things that need to go right to produce an optimistic outlook. But, were it all to occur as suggested, a rosier prognosis emerges. In this upbeat scenario, tie demand increases in 2010 by 300,000 ties, bounds to 21.3 million in 2011, and approaches 23 million in 2012 (Table 3).

RTA members, however, appear to favor the more middle-of the road baseline scenario from what *Crossties* has learned. *Crossties* contacted several members to ask what they felt 2010 held in store for their businesses.

Table 2: Forecast Table - Deep Recession
New Wood Crossties (in thousands)

Year approx.	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	PCT
2006	2.7%	15,937	4,848	20,785	11.1%
2007	2.1%	15,285	5,396	20,681	-0.5%
2008	0.4%	16,761	4,003	20,763	0.4%
2009	-2.6%	15,853	3,751	19,604	-5.6%
2010	-0.4%	14,831	3,617	18,448	-5.9%
2011	0.6%	14,830	3,322	18,151	-1.6%
2012	3.2%	15,674	3,410	19,083	5.1%

Table 3: Forecast Table - Optimistic
New Wood Crossties (in thousands)

Year approx.	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	PCT
2006	2.7%	15,937	4,848	20,785	11.1%
2007	2.1%	15,285	5,396	20,681	-0.5%
2008	0.4%	16,761	4,003	20,763	0.4%
2009	-2.5%	15,853	3,751	19,604	-5.6%
2010	4.1%	15,632	4,278	19,910	1.6%
2011	4.6%	16,905	4,401	21,306	7.0%
2012	4.9%	18,428	4,413	22,841	7.2%

RTA Executive Committee members were the first to weigh in. "Projections are for 2010 to be a smidge under 2009 in regards to total ties produced," said Bill Moss of MiTek Industries, adding that "the global market continues to keep steel prices volatile."

Jeff Broadfoot, speaking for Thompson Industries, said, "Thompson Industries is cautiously optimistic concerning 2010," he said, adding that "…tie demand may be slightly down in the Class 1 market…but regional, shortline, government, commuter and contractor…purchases are expected to remain stable." Broadfoot also suggested that in these times, and "as responsible suppliers, Thompson remains committed to watching expenses to remain one of the industry's low cost producers."

RTA President Buddy Downey of Stella-Jones is very upbeat about the future as well. He states that "Stella-Jones believes there will be an upturn in late 2010 and early 2011, and we plan to be in a position to capitalize on this growth and continue to invest in research to improve the wood tie." Downey added, "The recent news of larger private investments in American railroads highlights the positive future of the railroad industry."

Whatever the demand scenario is, supply of ties is the issue that has most industry observers concerned. Broadfoot noted "there are plenty of ties available, but in 2010, unfortunately, many of them may still have leaves on them," he said. "That's because our logger and sawmill friends continue to struggle to find ways to operate profitably."

RTA Executive Committee Member Frank S. Beal of Beal Lumber Co. in Little Mountain, S.C., offered a sawmiller's perspective. "Already in 2010, the hardwood sawmill industry is under continued stress. In short, we are experiencing shortages—shortages of customers, bank financing, working capital and timber. The crosstie portion of the industry is woven in the larger context of the economy. Many products come out of a log. A crosstie is just one. In order for mills to succeed, we need a healthy economy to support our many products," Beal said. "Mills need a healthy housing market for our grade lumber and robust domestic manufacturing for pallets and trade. A healthy economy supports our chip buyers, loggers and transportation (rail) component. In order to have a healthy sawmill base, all components of these industries must be synchronized. Based on the shortages that have occurred so far in 2010, prices could rise. However, large price increases are not healthy in the long term for sawmills as consumers substitute other materials for hardwood lumber."

Gary Williams of Koppers Inc. said he believes the recent purchase of the Burlington Northern Santa Fe by Warren Buffet should prove that railroads will play an ever-increasing role in the country's economic recovery. "The one wild card in the equation may be the future health of the sawmill industry that supplies the raw material," Williams said. "These small businesses are, by and large, family-owned operations that have had a difficult time weathering the recent financial storms and may be slow to respond to the demand for increased production that is certain to come."

RTA also believes production may lag behind demand in 2010. At best, given the current state of the industry, the reluctance of timber owners to part with their assets at current pricing and recent wet weather in many tie procurement regions, log availability looks to be the first constraint in the system.

Once things do begin to loosen up and logs begin to flow, then the question remains: How many sawmills will be operating and in a position to answer the call for more ties? Based on this uncertainty, RTA has built into its 2010 plans a potential shortfall of anywhere from 700,000 to 1 million ties based on projected demand.

Thus, the optimism facing even a middle-of-the-road approach to forecasting tie demand is offset to a degree by lingering concerns for the supply base. Under these circumstances it looks like 2010 may be one of the most daunting years the industry has faced in quite a while. Though a struggle may ensue for raw material, the very bright side of the equation is that railroading appears the place to be now and in the future. §