2008 Mid-Year Tie Demand Forecast

By Fred M. Norrell

It should come as no surprise that a forecast of tie demand written in July 2008 takes its lead from an economic climate fraught with uncertainty.

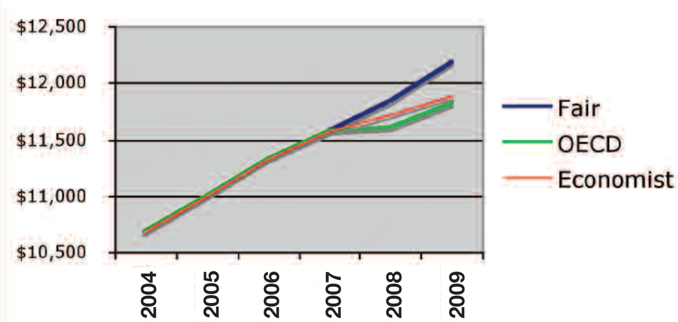
The current unsettled picture can be partially understood by reviewing the past few years of economic activity. For several years, U.S. consumers have spent freely and in the process driven solid economic growth. But now that consumer confidence is shaken and spending has slowed to a crawl, the U.S. economy is assaulted by a host of other problems—a storm of woes in financial markets such as plunging home prices, a bear market in equities, a sick construction sector, high energy prices, higher food prices, rising unemployment, and threat of a recession, to name a few.

Yet the shift in spending was probably inevitable as household debt had reached risky levels. In this context, recent mortgage problems can be seen as something of a catalyst, rather than a fundamental cause of the slowdown. However the causes are explained, jobs are being lost and income is being eroded. This complicates the process of resolving debt and implies a lengthy adjustment period before consumers are able to move forward and expand purchases.

In recent weeks, most economic forecasts have been dramatically revised. In general, the presumed recession is not expected to be deep, but recovery is predicted to be slow.

Graph 1 below compares Yale University's Fair model forecast (released on April 30), the average of various forecasts published in *The Economist* magazine (July 5), and a forecast from the Organization for Economic Co-operation and Development (June 25).

Graph 1 - Economic Forecasts
Real GDP in billions of 2000 dollars



The Fair forecast proceeds as if there is no slow-down, and is shown only as a reference. In contrast, the forecast from *The Economist* decelerates from 2.2 percent real GDP growth in 2007 to 1.4 percent in 2008, then 1.3 percent in 2009. All three years represent sub-par growth, compared to an average 2.7 percent during the past three years. A more serious downturn is predicted by OECD with 0.3 percent in 2008, which likely contains some quarters of negative growth…in other words, a recession. This is followed by a moderate (1.9 percent) gain in 2009. Rather than take a position as to which forecast is more realistic, this article presents both and demonstrates the potential impacts on crosstie market purchases arising from the two scenarios.

Just how the economy interacts with or drives the RTA crosstie forecast has been described in several articles published in *Crossties* magazine, so an abbreviated sketch is presented here. Two groups of tie purchasers are dealt with: Class 1 railroads and the "small market," which is composed of all others. The main determinant of Class 1 purchases is freight…the ton-miles moved. This, in turn, is largely determined by the volume of commerce…measured by real U.S. Gross Domestic Product (GDP). According to the RTA model, small market tie purchases are driven largely by U.S. production of nondurable goods, which, in turn, is driven in part by U.S. GDP. Other variables are included in the RTA models but play lesser roles. These have also been described in previous forecast articles in this journal.

Two forecast scenarios are presented. The first was produced by the Organisation for Economic Co-operation and Development (OECD) and is titled "Recession." This outlook appears to involve a recession in 2008 and a mild recovery in 2009. Notice the forecast has been extended to the year 2010. This was accomplished by assuming values for the economic drivers in that last year.

Notice the stagnant economic performance in 2008. This

Table 1: Recession Scenario
New Wood Crossties (in thousands)

Year approx.	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	Pct
2005	3.1%	15,029	3,776	18,805	4.5%
2006	2.9%	15,937	4,709	20,647	9.8%
2007	2.2%	15,285	5,109	20,394	-1.2%
2008	0.3%	15,163	4,725	19,888	-2.5%
2009	1.9%	15,270	4,685	19,955	0.3%
2010	1.9%	15,204	4,795	19,999	0.2%

leads to a reduction in crosstie purchases. The small market is also subject to the economic weakness as well as the expiration of temporary (2005 through 2007) investment tax credits for short line railroads. Extremely slow growth of purchases in the last two years of the forecast reflects a prolonged economic recovery.

The second forecast scenario takes its starting point from a poll of economic forecasters, the results of which are published in *The Economist* magazine. This forecast appears to suggest the economy avoids a recession this year and next: the "No Recession" scenario.

Despite the name, this scenario suffers from similar slow economic growth; thus, crosstie purchases also decline, though more modestly. As in the first scenario, short line special tax credits cease in 2007.

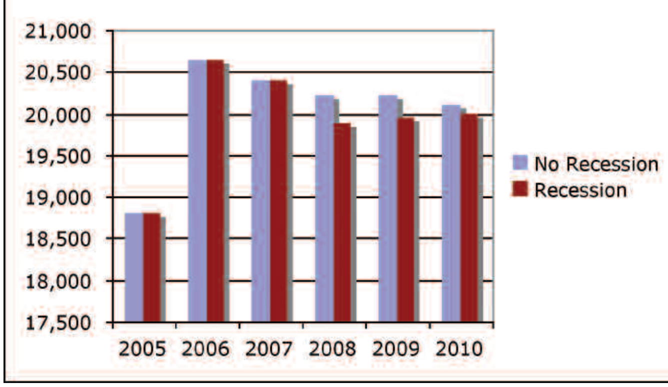
As fresh financial market information is digested, and as new economic data are considered, it appears difficult to dismiss the likelihood of recession. By all accounts, consumer balance sheets (assets and debt) are a mess. And, if history is any guide, these problems take time to sort out. This suggests that even though real GDP has yet to decline (as of the first quarter of 2008) weak future performance may be difficult to avoid. Add to this a variety of restrictions in the credit market and it is hard to imagine how other economic segments will not be restrained.

For the next several quarters the business environment will likely present challenges to RTA members. Some of these challenges lurk on the supply side and are discussed in a companion article. §

Table 2: No Recession Scenario
New Wood Crossties (in thousands)

Year approx.	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	Pct
2005	3.1%	15,029	3,776	18,805	4.5%
2006	2.9%	15,937	4,709	20,647	9.8%
2007	2.2%	15,285	5,109	20,394	-1.2%
2008	1.4%	15,356	4,862	20,218	-0.9%
2009	1.3%	15,500	4,705	20,205	-0.1%
2010	1.9%	15,309	4,795	20,105	-0.5%

Graph 2 - Crosstie Purchases (thousands)



Mid-Year Issues Facing RTA Members

By Jim Gauntt

A look at the current mid-year forecasts that have been developed for tie demand reveals one striking feature. Even if the U.S. economy suffers a mild recession this year, tie demand remains quite healthy.

If one takes an average of the two scenarios for 2008-2010, the difference between mild recession vs. no recession is only 229,000 ties annually. And, both scenarios present demand hovering around the 20 million tie mark—only about half a million ties below the industry's best year in the last two decades.

Thus, either way, for most producers the good news would appear to be that demand remains healthy in spite of turbulent economic times.

So what are the concerns for RTA members at this juncture? While there may be many small concerns, there are two significant issues that would seem be on the horizon—if they are not already here. The first concern is not as apparent as the second and has to do with data reporting for the industry.

As the mid-year forecast was being developed, it became obvious to RTA's economist that 2007 data reporting showed irregularities as compared to previous years. November 2007 purchases were markedly higher than previous November purchases. And then December purchases fell off the table and hit lows equal to some of the industry's worst years.

Adding the two months of data together and averaging them, the purchases compare relatively well with previous November-December combined and averaged purchase totals.

So what's the big deal? As it turns out, the way data are typically used in the forecasting model, accurate and timely reporting of production and inventory from RTA members is absolutely critical, especially at the end of the year. Without going into significant detail on this point, it is sufficient to say that if December numbers are misreported, it requires some significant statistical manipulation of the data to normalize it in a way that one can have confidence with the results.

This point should not be lost on RTA reporting members throughout the year as well. Timely and accurate data reporting is a must if the industry is going to have quality forecast outputs. And, given the number of people who say they rely on RTA for this information, this is possibly one of the most important issues facing RTA members.

As an example, at the writing of this in late July, RTA still is awaiting production numbers for June from several reporters.

This concern, however, is outweighed this August with one other issue that has reared its head—production. Reports are coming in from the field that would indicate that the industry may not meet new wood tie production requirements for the current level of demand.

While this does not seem to be the case in every region, between board road and mat timbers, lack of demand for hardwood lumber, weather affecting logging, and other pressures on the hardwood sawmill, it now appears that 2008 will not see enough new wood tie production to fill every order. And, the inventory-to-sales ratio indeed is dropping to levels not seen since 2002 at 0.70 (May 2008 last data available).

Thus, the overriding concern for some is not only production but also the health of the hardwood sawmill community.

Furthermore, what does that signal for next year? If treating plants aren't able to build inventory, then how much capacity will be diverted to Boultonizing come next spring? Since Boultounizing takes longer in the cylinder than treating air-dry ties, will that put a cap on treated tie production next year?

On the other hand, reports are filtering in about railroads accepting species that they may not have allowed in the past. Poplar and pine ties are rumored to be on the increase for low-density track applications. So, maybe this will meet some of the demand.

Thus, there are two primary questions:

First, is the worst case scenario only a mild recession? If so, then tie demand suffers only a little. If not, all bets are off until it is better known how deep a recession the economies of the world fall into.

Second, will the tie industry be able to respond in 2008 if tie demand continues to remain healthy? In spite of previous tough economic times, the industry has risen to the occasion many times in the past and thus it might be natural to think that it will do so again in 2008. Yet, there are quite a few members who report that this time the problem has reached greater depth. Thus, more fingers are crossed this year, as it relates to anticipated production, as the U.S. and world economies continue to struggle and sawmills bear the brunt of the weakness. §

New Wood Crossties (in thousands)

Year	Total Purchases	Class 1 Purchases	Small Market Purchases
HISTORICAL SUMMARY			
1992	15,652	12,679	2,974
1993	16,073	12,887	3,186
1994	16,557	12,371	4,186
1995	16,772	12,129	4,642
1996	16,953	12,632	4,321
1997	17,238	13,150	4,088
1998	17,082	13,021	4,060
1999	15,729	12,072	3,657
2000	14,805	11,706	3,099
2001	15,127	11,805	3,322
2002	17,135	13,498	3,637
2003	16,473	13,578	2,895
2004	18,001	14,307	3,695
2005	18,805	15,029	3,776
2006	20,647	15,937	4,709
2007	20,394	15,285	5,109
FORECAST SUMMARY (Recession Scenario)			
2008	19,888	15,163	4,725
2009	19,955	15,270	4,685
2010	19,999	15,204	4,795