Is This Recovery?

By Fred Norrell, RTA Economist

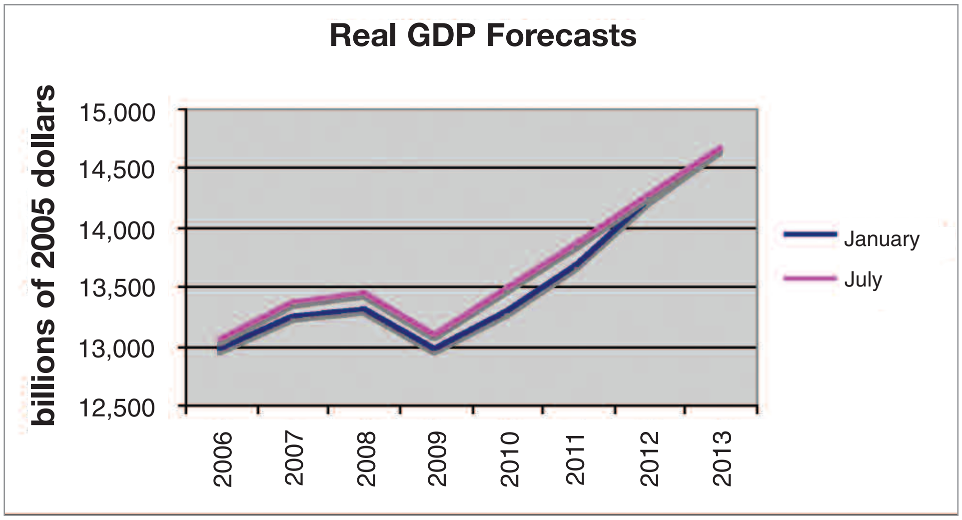
There has been fair warning the recovery would be slow by historical standards. Still, one has to wonder: will the rest of the recovery proceed so weakly?

Since the Railway Tie Association's (RTA) last crosstie forecast in January, things have changed in three general areas: the economic environment, the railroad/tie market, and in RTA's forecast mechanics.

The Economy

The Standard & Poor's (S&P) forecast of January portrayed the end of recession. The latest (June) S&P forecast acknowledges the awkward position of a number of governments that have extended themselves in efforts to stabilize financial markets and avert recession but assumes no full-blown international crisis. In addition, as some of the Bush-era tax cuts expire, taxes are set to increase, giving rise to a further drag on the economy.

Despite these dark clouds, S&P's forecast of real U.S. Gross Domestic Product (GDP) has not suffered a setback, as the graph below shows. This is due in part to a higher beginning point (0.8 percent higher in 2009) but also to strong expected growth in the current year, which can be traced to a more optimistic outlook for consumer spending. The projected growth rates are displayed in the Real GDP Forecasts table below.



The Railroad & Tie Markets

This year has seen the continuing effects of a withdrawal of enhanced investment tax credits for regional and short line railroads; small market tie purchases have consequently taken a hit—down 26 percent in 2008 and a further 4.5 percent decline in 2009.

Forecast Summary
New Wood Crossties (in thousands)

Year approx.	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	Pct
2006	2.4%	15,937	4,848	20,785	11.1%
2007	2.4%	15,285	5,396	20,681	-0.5%
2008	0.6%	16,761	4,003	20,763	0.4%
2009	-2.7%	16,216	3,821	20,038	-3.5%
2010	3.1%	15,305	3,690	18,995	-5.2%
2011	2.7%	15,569	3,917	19,486	2.6%
2012	3.0%	17,087	4,326	21,413	9.9%
2013	2.8%	17,392	4,468	21,860	2.1%

Class 1's started the current year with a determination to sustain investment in infrastructure. This had held firm in 2009 within the United States but weakened a bit in Canada. However, current capital expenditure plans are incorporating positive train control costs, and these are taking priority.

Furthermore, Class 1 freight declined by almost 14 percent in 2009 and has recovered only partially, increasing 8 percent year to date by week 24. The RailConnect Index of short line freight indicates a drop of 25 percent in 2009, followed by a year-to-date increase of about 8 percent. Purchases from RTA members were 20.9 million ties in 2008 but fell to 19.6 million in 2009. Year-to-date June 2010, purchases are 14 percent down from the same time last year.

RTA's Forecasting Model Changes

The models are built from historical data and their relationships, so the 2009 tie purchases data were used to update equations—a routine change.

Further, some equations were modified by replacing diesel fuel price with crude oil (West Texas intermediate) price; since these two prices are highly correlated, the change should not be exaggerated. The switch between these two variables was needed because S&P does not release a forecast of diesel prices, but they do project oil prices.

The equation for non-durable manufacturing (driven by real GDP) was changed from a linear to a linear/log form, which better accommodates the fact that non-durables are growing slower than GDP.

Finally, the two equations for Class 1 tie purchases and small market tie purchases were modified in terms of time-lag structure.

The Forecast

The main theme is that given policy conditions of the recent past, a growing economy will drive higher railroad freight volumes, which in turn will drive higher levels of crosstie purchases. This is clear from the projected Class 1 purchases, but short line and regional railroads will take more time to recover. The Forecast

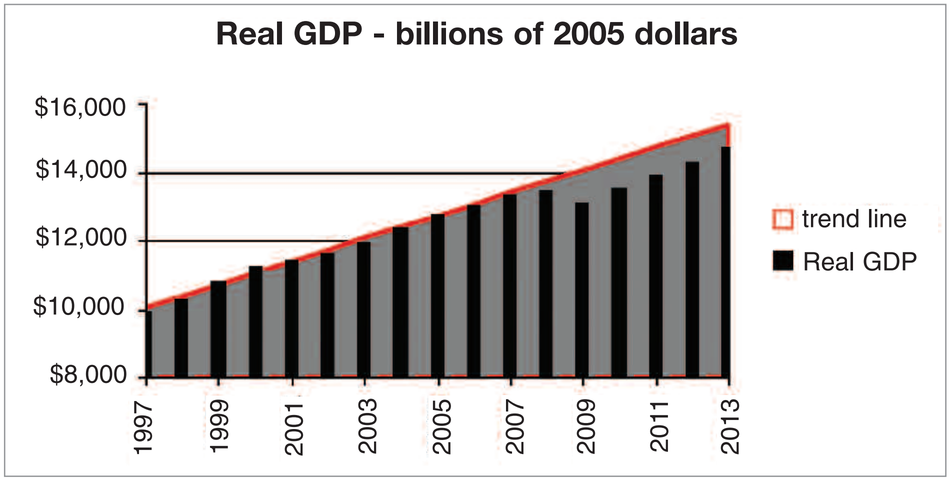
Summary table presents these results.

Crosstie purchases follow the normal pattern, recovering some time after real GDP returns to positive growth. This may very well lead some market observers to question whether this is indeed recovery. RTA's forecast says yes, it is recovery, but not as soon or pronounced as our members would wish.

As the recovery gains traction, crosstie purchases are projected to grow beyond recent experience, topping 21 million in 2012 and after. Given current market conditions, this may be difficult to imagine, and certainly deserves a closer look.

Starting with the economy, the Real GDP graph illustrates real GDP levels (bars) compared with a trend line (red) that tracks data from 1997 to 2007. (The recession began in December 2007.) One sees the recession's impact in 2008 and especially 2009. One also sees the magnitudes predicted by S&P: growing, but not closing the gap (the gap is about 4 percent below trend.)

Nevertheless, note GDP in 2011 is higher than any previous year. Again, the main theme of RTA's forecast model is economic growth feeds railroad freight growth, which in turn stimulates the need to purchase crossties for replacement and expansion.



Of course, events may not unfold as RTA's model predicts. One natural characteristic of forecasts is that venturing further into the future brings with it increased uncertainty. As one considers possibilities in 2012 and beyond, keep this in mind.

Along the path of the next few years lies the obstacle presented by Positive Train Control (PTC) and the massive investment required for its implementation. Clearly, railroad budgets will be thrown some challenges, yet RTA's forecasting model currently has no way to address this issue.

As a consequence, the crosstie predictions above assume no impact from PTC; this must be factored in to arrive at a reasoned outlook. Such is one purpose of the companion article on page 8. §