Round & Round

Update On Tie Market Projections

By Fred Norrell

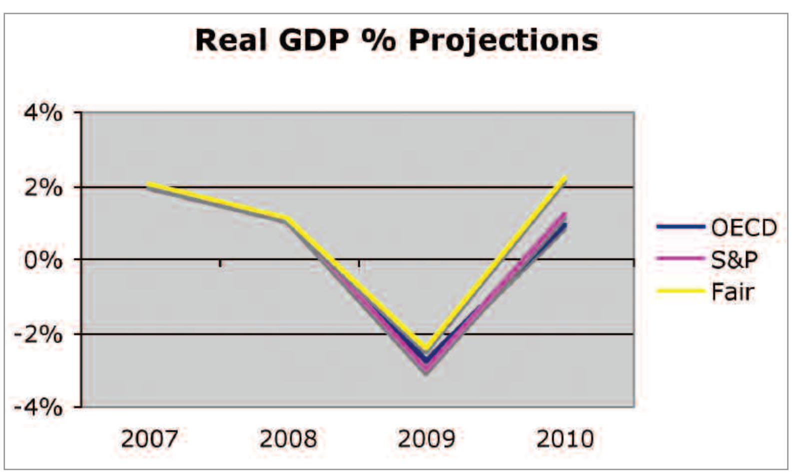
"Round and round it goes, where it stops nobody knows…" This may typify the feelings of many business people who are anxiously watching what appears to be an economic roulette wheel. To some degree it also reflects the uncertainty involved in making economic forecasts and related business plans.

In the January/February 2009 issue of this journal, RTA presented two projections of the U.S. economy and resultant crosstie purchases. The first projection described a one-year recession in 2009; the second involved a two-year recession that stretched into 2010. Both scenarios were carved out of past recession data and were presented in the light of "what if it gets this bad?"

Seven months later, U.S. economic predictions appear to be favoring a one-year recession. Presented below are the views of the Organisation of Economic Co-operation and Development (OECD), Standard & Poor's (S&P), and the Fair econometric forecasting project at Yale University (Fair). Although the outlooks differ enough to merit comparison, they tend toward a one-year recession, as the graph below illustrates. This is likely due to policy response: planned increases in federal government spending, easy money (in some parts of the banking and financial system), and continuing efforts to unclog credit pipelines. Lending credibility to this outlook is the resilience of consumer spending, which increased at a rate of 1.4 percent in the first quarter of 2009.

Not to understate the gravity of the situation, it must be admitted that all other spending (business, government and foreign transactions) contracted steeply, and GDP fell at an annual rate of 5.5 percent. Industrial production peaked in December 2007, and has declined by 15 percent since. Employment peaked in November 2007, and has fallen by about 4.7 percent since. By June, the unemployment rate shot up to 9.5 percent. In the first 27 weeks of 2009, North American Class 1 carloads of freight were down by 19 percent from the year earlier; short line freight was reported to be down by 27 percent.

The reduced burden on roadways should ease the need for tie replacements, although Class 1's declare their commitment to long-term performance goals, including maintenance. Short lines may have a more difficult time of it, as recent reductions in freight revenues quickly make their way into reduced capital expenditures. In the crosstie forecasts that follow, one can see a more immediate retrenching in the "small market," composed mostly of short line railroads.



OECD regularly publishes economic projections for a large number of countries and for the world economy. Their March release is represented in the GDP graph to the left and in Table 1 above. Historical and forecast economic data are fed into the RTA econometric model, which produces a forecast of wood crosstie purchases. Note the severe impact on tie purchases: a 13 percent decline from 2008 to 2010. To put this in perspective, recall that purchases fell 19 percent from 1996 to 2000.

Tables include revised historical data that reflect the conclusion that small market tie purchases have been overestimated in recent years. Small market forecasts reflect this change.

S&P published in July "The Outlook," involving a steep recession in 2009 but a recovery visible the following year. In Table 2, note that tie purchases continue to decline in 2010. This is due to some time lags identified in RTA's market research. Readers might recall the 1991 recession in which GDP fell 0.2 percent; tie purchases managed to grow that year but declined by 4.9 percent in 1992. According to RTA's model, Class 1 freight rises and falls with GDP, but the current year's tie replacements depend on freight movements in the current and previous year. In this scenario GDP and freight fall in 2009, then rise in 2010. However, freight from the two years ended 2010 is lower than freight from

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

Year approx.	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	Pct
2005	2.9%	15,029	3,639	18,668	4.2%
2006	2.8%	15,937	4,668	20,606	10.4%
2007	2.0%	15,285	4,961	20,246	-1.7%
2008	1.1%	16,186	4,091	20,277	0.2%
2009	-2.8%	14,988	3,494	18,482	-8.9%
2010	0.9%	14,259	3,342	17,601	-4.8%

Table 2: S&P Scenario
New Wood Crossties (in thousands)

Year approx.	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	Pct
2005	2.9%	15,029	3,639	18,668	4.2%
2006	2.8%	15,937	4,668	20,606	10.4%
2007	2.0%	15,285	4,961	20,246	-1.7%
2008	1.1%	16,186	4,091	20,277	0.2%
2009	-3.0%	14,952	3,465	18,418	-9.2%
2010	1.2%	14,249	3,364	17,613	-4.4%

the two years ended 2009. Tie replacement and purchases thus decline in 2010.

The third and last scenario, with GDP projections provided by the Fair project at Yale University, represents a less severe downturn in 2009 and recovery in 2010. In Table 3, note the impact on tie purchases is moderated but still represents a 10 percent decline from 2008.

The graph at right summarizes the three scenarios.

Taking all these scenarios together, tie purchases are projected to decline by 10 to 13 percent during the two-year period examined…roughly 2 million to 2.7 million ties. Recent tie purchases data looked positive until May 2009, when a sharp decline revealed a 19 percent drop from May 2008. Assuming similar drops for the remainder of the year, 2009 would boast purchases of 18.9 million ties. While this is higher than any of the three forecast scenarios above, it may be a precursor of additional weakness that could present itself as the year goes on.

This begs the question: what next? Will subsequent years bring a market rebound? Most sources caution that economic recovery will not be as brisk as with past U.S. recessions. This is partly due to balance sheet problems…the amount of debt relative to assets, and relative to income streams that can be used to pay down that debt. This problem characterizes consumers, government, and a large portion of the business sector. Worse, it characterizes many countries besides the U.S. All of which suggests adjustments to more conservative business plans for railroads and their suppliers. §

Table 3: Fair Scenario
New Wood Crossties (in thousands)

Year approx.	Real GDP	Class 1 Purchases	Small Market Purchases	Total Purchases	Pct
2005	2.9%	15,029	3,639	18,668	4.2%
2006	2.8%	15,937	4,668	20,606	10.4%
2007	2.0%	15,285	4,961	20,246	-1.7%
2008	1.1%	16,186	4,091	20,277	0.2%
2009	-2.4%	15,056	3,549	18,605	-8.2%
2010	2.2%	14,605	3,564	18,169	-2.3%