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Intermodal markets

Overview

After equities markets close Thursday, CSX will release its fourth-quarter financial results. CSX is considered a bellwether of the transports sector because it's the first major company to report earnings. Thursday we'll get a glimpse into railroad pricing and capacity strategies going forward into 2020. Perhaps more importantly, on Friday morning we'll see how markets react.

After years of precision scheduled railroading (PSR), at some point the railroads will run out of ways to meaningfully improve operating leverage and the public markets will start to care about volumes and revenue again. If and when that happens — and the other rails will be watching to see how CSX trades on Friday — we will eventually see volatility return to intermodal spot markets as rails reach for volume.

So far, though, the railroads have no reason to change strategies: Class I stocks outperformed the market last year, even in what turned out to be an exceptional year for the S&P 500.

Beyond that, we're looking for an upside surprise in global trade and U.S. consumer spending to move the needle on volumes. Inventories-to-sales ratios are near the top of their recent historical range. If wages and spending move up unexpectedly as retailers run their inventories down, demand for intermodal transportation will surge. Outside of those scenarios, we expect intermodal markets to follow trucking markets in what is typically freight's seasonal trough.

Spot rates per mile

Chicago to Linden, NJ	$1.88
Los Angeles to Dallas	$1.55
Linden, NJ, to Chicago	$1.16
Los Angeles to Chicago	$1.17
Chicago to Los Angeles	$0.93

53-foot container volume seven-day MA (weekly change)

Los Angeles to Chicago	995.43 (+38.47%)
Chicago to Los Angeles	755.00 (+28.28%)
Chicago to Elizabeth, NJ	562.86 (+17.23%)
Elizabeth, NJ, to Chicago	395.14 (+35.85%)
Los Angeles to Dallas	389.29 (+36.89%)

Outbound intermodal tender rejections

Savannah, GA	0.00%
Joliet, IL	1.30%
Chicago	0.85%
Memphis, TN	0.57%
Los Angeles	1.97%

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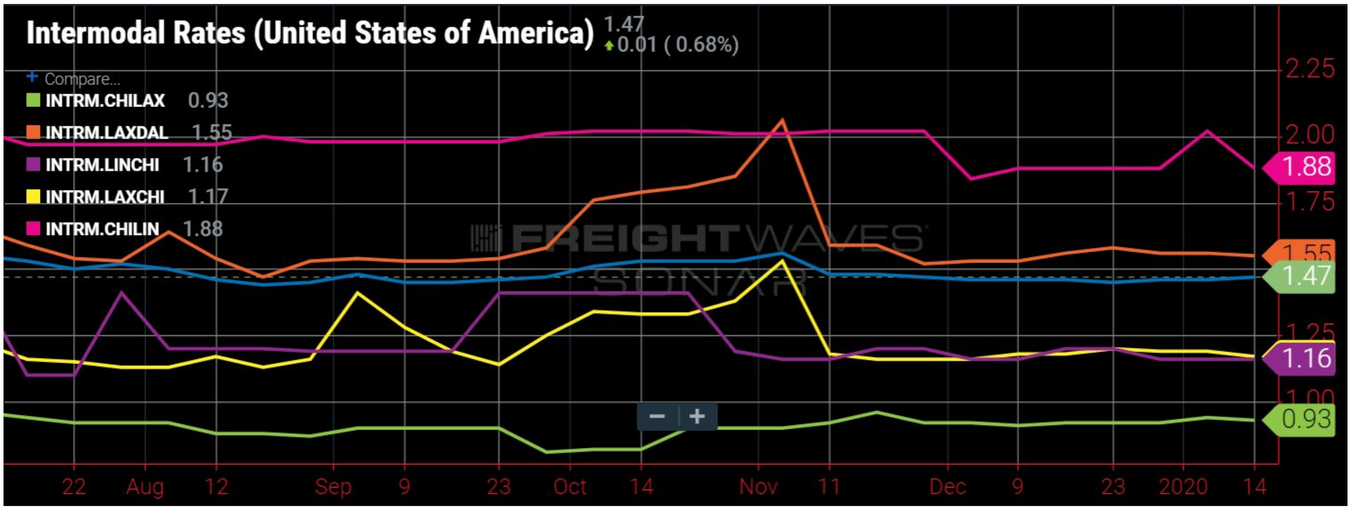
Intermodal spot rates



(Chart: FreightWaves SONAR)

Intermodal spot rates are continuing to walk along the x-axis, as they have done for much of the history of this report. The national average intermodal spot rate increased by 0.7%. The biggest weekly change came from the Chicago-Linden lane as rates fell 6.9%. Other lanes that saw price changes were Los Angeles-Chicago (-1.7%), Chicago-Los Angeles (-1.1%) and Los Angeles-Dallas (-0.6%).

Rates are behaving as anticipated by remaining roughly flat as we begin the year. The firm intermodal spot market, with prices set by a highly consolidated railroad industry, comes at a stark contrast to trucking rates, which have already dropped significantly. Sticky intermodal pricing comes as no surprise because the railroads have remained clear on their messaging that rates will stay flat to slightly up this year.

Beginning with CSX Thursday, railroads will report Q4 earnings over the next few weeks, which will give us a better view into how the rails think about the profitability of their intermodal franchises and guidance going forward. Not only will there be important questions asked about pricing strategy and capacity going forward, but we will also see how the markets digest the news.

In a client note Wednesday morning, Deutsche Bank analyst Amit Mehrotra wrote, “To be sure, we still expect a difficult guide from CSX on Thursday (yoy OR contraction likely) … though shares should reflect real-time trends in volume (and export coal … which appears to have stabilized with potential for recovery).”

Railroad stocks posted strong returns in 2019 even as intermodal volumes saw steep declines y/y. In fact, railroads have outperformed the S&P 500 16 of the past 17 years.

Freight demand

U.S. Class I intermodal volumes were down 9.1% y/y in Week 2, worse than the four-week average of -8.6%. We are still in a tough comps environment, but that will likely ease going forward. Note that as we approach the moveable Chinese New Year holiday, which is preceded by a volume surge and followed by a volume drop, year-over-year comparisons will get noisy.

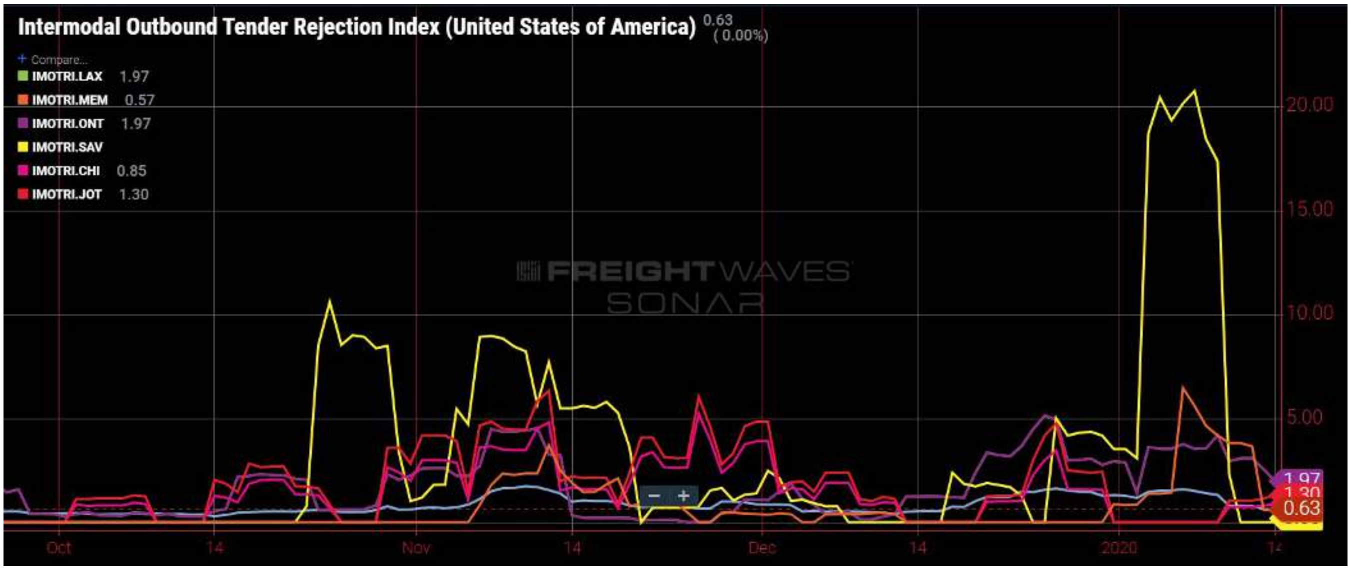
Union Pacific continues to underperform its Class I peers on a volume basis, which has been the case for an extended period of time. One positive for Union Pacific is that one of its major hubs, Los Angeles, is seeing a drastic increase in volumes over the past week and up slightly y/y, which should help UNP intermodal volumes going forward.

(Chart: FreightWaves SONAR)

Chinese and U.S. officials signed the Phase One trade deal early Wednesday afternoon. While the deal is incomplete and limited in scope, it's a positive for global trade and containerized shipping volumes. East Coast ports continue their above-trend growth, outpacing volumes on the West Coast; Savannah has been a primary beneficiary, along with Houston.

The Port of Los Angeles has struggled over the past year, which we believe has to do with production moving from China to other South Asian countries. But a pause in the trade war, along with lower tariff rates on some Chinese goods, could trigger a 2020 recovery in Los Angeles/Long Beach volume growth.

Intermodal capacity



(Chart: FreightWaves SONAR)

Intermodal capacity has continued to loosen through the first half of January. Intermodal tender rejections (IMOTRI.x) have been cut in half in the past week, falling below 1% of contracted loads being rejected by IMCs. The largest Midwest intermodal markets, Joliet and Chicago, saw capacity tighten almost imperceptibly as rejections in both markets rose above 0% this week.

Capacity in Savannah has corrected itself this week with tender rejections falling to 0%, where it spent most of the back half of 2019.

Intermodal capacity is much less volatile than trucking capacity because the networks are fixed, the transportation providers are fewer in number, the schedules are more regularized and there is no driver availability issue. To the extent that incremental volume growth in intermodal can be the result of spillover from trucking, depressed trucking rates and loose trucking capacity have led to extremely loose intermodal capacity.

Class I railroads are opting to transload more 40-foot container freight to 53-foot containers to keep capacity stable and not have to lower rates to chase freight. We expect capacity to remain loose through the first half of the year as trucking markets continue to rebound as the rails don't chase volumes at the expense of price.

(Chart: FreightWaves SONAR)

Weekly intermodal train speeds are an average speed in miles per hour that trains travel across the Class I railroads. Overall Class I train speeds have been steadily increasing for the past two months. Train speeds are a measure of service that the railroads provide to their customers. The faster the trains are moving across the rail networks, the better the service provided to their customers.

We note that lower volumes and the removal of assets from the rails have made it easier for railroad networks to achieve fluidity and increase velocity; it's unclear to us how well these service levels will hold up in a high-volume environment.

All of the Class I rails — with the exception of BNSF — are in the process of implementing their versions of PSR. BNSF has yet to come out and say that it is implementing PSR, but it has continued to increase its weekly train speeds.

As Norfolk Southern begins its implementation of the third phase of TOP21, its version of PSR, it will be focused on the intermodal segment of the business. Look for NS's service metrics to improve further, meaning that trains should be longer, move at higher speeds and spend less time sitting in terminals.