Tariffs, Easing Business Inventory Growth: Possible Links To Future Tie Demand

By Petr Ledvina

In the January/February edition of *Crossties*, the Railway Tie Association (RTA) indicated there would be an updated forecast for tie demand in this issue. However, not all the data for 2018 is available yet, so we have updated the model with the existing data. One of the model-recalibrated components was Class 1 Railroad freight.

This part of the model predicts basically flat freight growth for 2019. However, as with any model, this update cannot account for unexpected recent or future events, such as the flooding that occurred in the Midwest and any impacts to tie demand this may have created.

Last year was relatively good for the railroads, with revenue ton-miles up by 3 percent. Part of the increase in freight was due to companies that were front-loading inventory before the tariff on Chinese goods took effect late in September. In addition, another increase was scheduled for January, which would have raised the total border tax on Chinese goods to 25 percent. However, this increase has not yet taken effect as the U.S. and Chinese governments started trade negotiations in December 2018.

Since then, there have been several meetings and, according to the Trump administration, good progress has been made. Regardless of the trade talk outcome, companies will eventually stop building inventories to avoid constraints on cash flow.

Another concern for businesses is weaker retail sales. In 2018, retail sales growth slowed from 2017 levels. The month-to-month average growth was 0.5 percent in 2017, but only 0.1 percent in 2018. In particular, December was quite a bad month. Figure 1 shows the last five years.

Without the December data point, sales grew 0.3 percent per month on average. Was it the government shutdown, the stock market plunge, or early holiday shopping in October, when sales jumped by 1 percent from the previous month? Most likely it was a combination of all these factors that caused consumers to hold back. This year's retail sales were up nicely in January by 0.7 percent but then fell in February by 0.2 percent (FRED).

As a result of these factors, the inventory-to-sales ratio for merchant wholesalers, businesses and retailers has been on the rise. Values reported in January were 1.34, 1.39 and 1.47, respectively. All three measures are getting close to their recent peak in early 2016, the highest since the recession. For example, the wholesalers' ISR was 1.38 in February 2016. (Figure 2 shows the last five years for all three segments. Additional analysis can be found in the Business Trends section of this issue.)

Consequently, the end of inventory build-up will put some drag on Class 1 freight. However, the economy is still relatively strong, and it is predicted to grow by 2.2 percent (S&P forecast). This will provide support for freight this year, and we expect

Figure 1

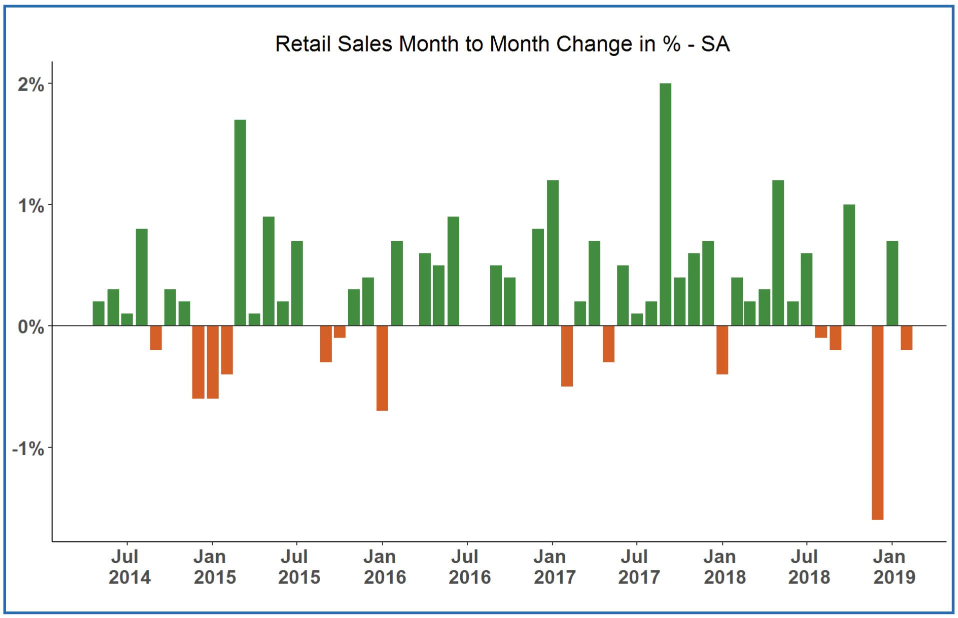
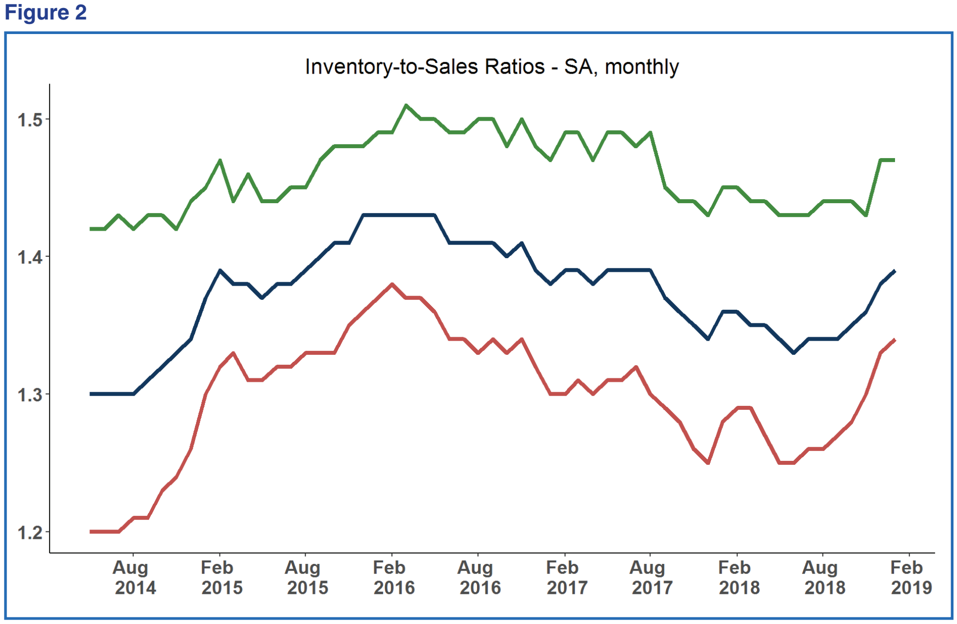


Figure 2



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Class 1 freight to be basically unchanged from 2018.

The 2.2 percent GDP growth was revised down from the 2.4 percent growth, which was an input into the tie demand model in January. Hence, our partially revised model predicts lower demand. Needless to say, the predicted number for 2019 is still higher than actual purchases in 2018. The updated forecast is presented in Tables 1, 2 and 3.

What any model cannot account for are extraordinary events such as flooding. During the March flooding in the Midwest, it was not only individual lives that were drastically disrupted. At least two major railroads reported damage to infrastructure. These affected railroads saw a significant decrease in freight from the end of February to the end of March (Reports for Association of American Railroads on individual railroads' websites), possibly as a consequence of rerouting trains and holding some cargo at origination points or en route. This disaster will require the railroads to repair the affected tracks and may have spurred nominally higher demand for ties. As a result, March and April purchases may be higher than monthly norms.

While that may be one reason for higher demand, it may not be the only reason. There remains a possibility that the U.S. economy's strength and pent-up unfilled demand from the past two to three quarters could be playing a role. If this is the case, the upside scenario could be reached. If not, and trade issues are not resolved, thus slowing the economy, a move toward the downside could be in play. ■

TABLE 1: BASE CASE SCENARIO

NEW WOOD CROSSTIES (IN THOUSANDS)					
YEAR	REAL GDP	CLASS 1 PURCHASES	SMALL MARKET PURCHASES	TOTAL PURCHASES	PCT
2016	1.5%	16,531	7,788	24,319	-0.30%
2017	2.3%	15,929	7,400	23,329	-4.10%
2018	2.9%	15,271	7,428	22,699	-2.70%
2019	2.2%	15,382	7,377	22,759	0.30%
2020	1.7%	15,513	7,478	22,991	1.00%

TABLE 2: UPSIDE SCENARIO

NEW WOOD CROSSTIES (IN THOUSANDS)					
YEAR	REAL GDP	CLASS 1 PURCHASES	SMALL MARKET PURCHASES	TOTAL PURCHASES	PCT
2016	1.5%	16,531	7,788	24,319	-0.3%
2017	2.3%	15,929	7,400	23,329	-4.1%
2018	2.9%	15,271	7,428	22,699	-2.7%
2019	2.5%	15,607	7,377	22,983	1.3%
2020	2.1%	16,114	7,418	23,532	2.4%

TABLE 3: DOWNSIDE SCENARIO

NEW WOOD CROSSTIES (IN THOUSANDS)					
YEAR	REAL GDP	CLASS 1 PURCHASES	SMALL MARKET PURCHASES	TOTAL PURCHASES	PCT
2016	1.5%	16,531	7,788	24,319	-0.3%
2017	2.3%	15,929	7,400	23,329	-4.1%
2018	2.9%	15,271	7,428	22,699	-2.7%
2019	1.7%	14,845	7,012	21,857	-3.7%
2020	1.2%	14,657	7,113	21,770	-0.4%

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