Let the good times roll

Toby Kolstad

Regarding the current state of rail-car leasing, some folks in my hometown of New Orleans would say *"Laissez le bon temps roulette,"* or "Let the good times roll." Demand for both new and used rail cars is strong, and supplies are almost adequate, putting a high floor under the market-based lease rates for used cars. Interest rates remain low, but new-car prices have risen enough to increase new-car lease rates to the point of meeting equipment owners' investment requirements.

Will the good times continue, or is change in the wind? First, a little perspective: Conditions are never static in a free-market environment. Rail-car demand and supply is a constantly changing balance; the prices and interest rates that affect these factors are never fixed. That said, let's look into the short-term crystal ball.

DEMAND STILL STRONG

Rail-car demand is driven by railroad efficiency and traffic. Railroads posted impressive traffic gains in 2004; carloads were up almost 3 percent and intermodal loads, more than 9 percent. And the expectations for 2005 — and perhaps even 2006 — are very positive. Rail Theory Forecasts (RTF) projects carloads will increase about 2 percent in 2005; intermodal traffic, about 6 percent.

Meanwhile, railroad efficiency — as measured in loads per car, per year — has declined as traffic has increased, which has introduced an artificial rail-car demand. In summary, car demand will remain strong during 2005 and into 2006.

Car supply is determined by the number of cars being delivered and retired. Because the price of scrap metal increased from less than $100 to more than $200 per ton, many more older cars have been retired during the past year than in the recent past. Some either were underutilized or stored as rusting hulks and not replaced; some were replaced by new and larger cars, but in fewer numbers.

> **When interest rates rise, lease rates for new cars will, too — around $70 per month (average) for every 1 percent increase in long-term interest rates.**

Until recently, the delivery rate for most new-car types did not cause supply to outpace demand; lease rates rose as prices, driven by the cost of steel, increased.

A STEELY PROBLEM

However, during 2004's first three quarters, the new-car order rate exceeded those from the boom (or pre-bust) years of 1997 and 1998. But just as the cast-parts shortage put some pricing discipline back into car prices and lease rates in 2003, steel prices might put the brakes on the runaway demand for new equipment.

In December 2003, the average price of steel used in rail-car construction was about $300 per ton. By late 2004, the market price had risen to more than $800 per ton, adding almost $8,000 to the cost of an average rail car (and about $60 per car per month to the average lease rate). And there are more increases to come as supply contracts negotiated during this period will affect material prices in 2005.

CAR PRICES TO FALL

Car prices and lease rates could dampen buyers' — and their bankers' — enthusiasm for new cars until they believe prices will stay high or they actually fall. Our research indicates that the latter is a more likely event: Steel prices will begin to fall this year; rail-car prices, too, will begin to come down later this year or in early 2006. Lease rates also may fall, unless the long-anticipated increase in interest rates finally materializes.

During the past year, economists repeatedly have predicted that the twin deficits in the budget and national account would drive up interest rates — which, as of early 2005, hadn't happened. One day they will, perhaps this year; and when they do, lease rates for new cars also will rise — about $70 per month for an average car for every 1 percent increase in long-term (i.e., 10-year) interest rates.

In summary, the rail-car leasing market's looking really good right now and, depending on how events unfold, it'll continue to look good for a while longer.

High car prices and looming interest rate increases are clouds on the horizon that we'll probably have to contend with next year. In the meantime, enjoy the sunshine. PR

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