Auto Market Update

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A semi-annual review of the North American auto industry **May 8, 2018**

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North American Sales: Light Trucks Doing the Heavy Lifting

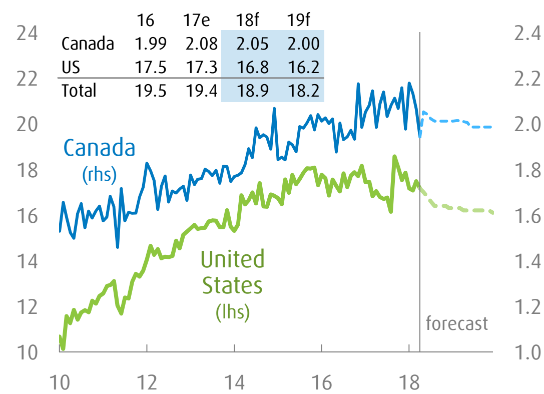
The gentle deceleration of North American sales volumes from their cyclical peak continues. Through April, sales were up 0.2% in the US and 0.4% in Canada, though the year-over-year comparisons will be more challenging as the calendar progresses. With unemployment rates in both regions hovering near multi-decade lows, sales should remain robust, though they will face increased headwinds as interest rates grind higher. Our forecasts for the US and Canadian markets are little-changed from our last update, with combined sales expected to slide to just under 19 million units in 2018 before downshifting towards the 18 million unit mark in 2019 – healthy volumes by any metric.

Looking through the noise, **US sales** have been on a steady downward drift since early-2016, with volatility around that trend due to weather disturbances or vehicle incentive programs. The simple explanation for the deceleration is market saturation. The vehicle ownership rate is near all-time highs at roughly one vehicle per driver and, barring an unprecedented increase in scrappage rates, sales should run at a rate commensurate with replacement demand for the remainder of the cycle. Naturally, interest rates will have a role in determining the pace of the deceleration. Our forecast for five additional hikes in both countries through the end of 2019 would see financial conditions tighten, though not to a degree that would cause significant market disruptions. US sales are expected to remain above 16.5 million units in 2018 before gliding towards 16 million units in 2019, a healthy pace amid more manageable inventory levels.

The **Canadian buying cycle** has enjoyed a longer half-life thanks to less market saturation, in part due to higher population growth, while home price gains over the past several years have provided an additional catalyst by boosting household net worth. Sales powered ahead to a record 2.08 million units in 2017, contrasting with the gradual drop-off in US activity over the same timeframe. However, the Canadian credit cycle appears to be reaching its limit, with credit growth gradually beginning to decelerate amid elevated consumer debt levels and rising interest rates. This trend appears to be feeding into the auto segment, with sales slipping somewhat as long-term loans become increasingly difficult to access and the popular tactic of rolling over negative equity becomes more costly. Leasing has acted as a safety valve, assuming the sales baton (at over 30% of sales and rising) as dealers look for alternative options to meet buyers' monthly payment targets, though there are limits to this strategy. A better-than-expected start to the year has nudged our 2018 forecast above 2 million units, though a gradual tapering in sales is still expected to take place through this year and into 2019.

Chart 1
Light Vehicle Sales

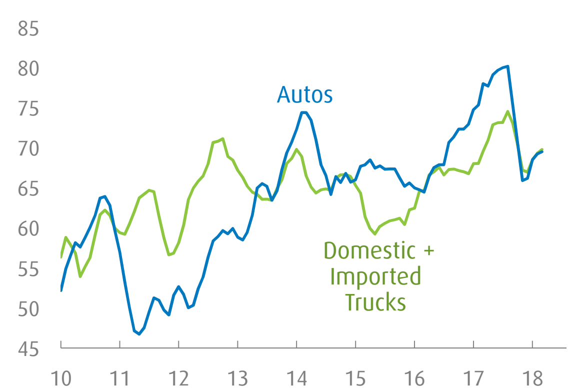
(mlns of units : s.a.a.r.)



Sources: BMO Economics, Haver Analytics

Chart 2
Days' Supply for Vehicle Industries

(days : s.a. : 3-mnth m.a.)



Sources: BMO Economics, Haver Analytics

Truck Sales: Built More Tough

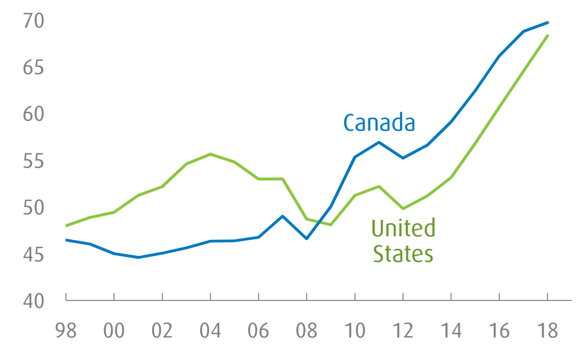
After years of volume erosion, the shoe has finally dropped on passenger cars; several OEMs are now planning to slash or outright abandon the segment in North America. The figures have been ugly; car sales are down 13.7% YTD in the US and 12.4% YTD in Canada, with the trend worsening over the past several months. This is not to be confused with broader motor vehicle market weakness; indeed total sales are roughly flat in both regions.

From an OEM or a dealer's standpoint, the shift in consumer preferences is generally positive. Light trucks command higher sticker prices and provide fatter margins, the main reason why North America remains the most profitable region for many OEMs despite, in some cases, lower sales volumes than Europe or China. The question that arises is: haven't we seen this story before? Indeed, many clients have been asking about the sustainability of the current rally given the eerie similarities it shares with the ill-fated SUV boom of the mid-2000s, particularly now that fuel prices are on the rise (*Chart 3*). However, we would dare to argue that "this time is different".

First and foremost, the great shift in vehicle sales composition we've observed since about 2013 is more nuanced than the one experienced in the mid-2000s. At that time, the choice between vehicles was more binary – either a large or mid-sized sedan or a larger sports utility vehicle (with no disrespect to the minivan). The shift in the current cycle is rendered more complex by the penetration of cross-over utility vehicles (CUV) in most segments. CUVs built on compact car platforms are the most recent example of the extent to which the segment has overlapped cars in the model line-up. In nearly every case, a CUV sharing a car's platform has drawn sales away from the latter, in some cases diminishing volumes to unsustainable levels. No wonder then that some automakers are simply folding their car portfolios and going with the winner.

Chart 3
Light Truck Sales

(% of market share)



2018 data as of Apr. 2018
Sources: BMO Economics, Wards Auto, Desrosiers

Table 1
Fuel Economy Index[1]

United States (mpg)

Segment Group	2013	2018
Small Car	29.6	32.3
Middle Car	27.6	31.7
Large Car	20.2	21.7
Luxury Car	24.0	31.1
Total Car	**27.6**	**31.4**
Cross Utility	22.4	25.3
Sport Utility	17.6	18.5
Van	19.7	20.9
Pickup	16.7	18.6
Total Light Truck	**20.2**	**22.8**
Total Light Vehicle	**24.2**	**25.7**

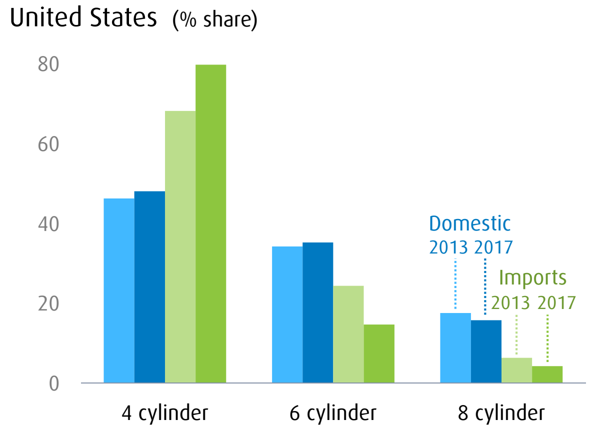
Sources: BMO Economics, WardsAuto Intelligence

Now, all else being equal, a car will burn less fuel than a light truck, raising the important question of fuel consumption. But, surprisingly, average fuel economy, even when adjusted for sales, has actually improved. Wards US Fuel Economy index has steadily increased over the past five years despite the share of light trucks soaring 16ppts to nearly 70% of sales. That counterintuitive result speaks to the huge advances made in engine technology by the OEMs in five short years (*Table 1*). To wit, the average CUV in 2018 has around the same fuel efficiency as the average sedan had in 2013! From a consumer standpoint, that means that even if fuel prices were to continue to increase, their average spend at the pump is likely no more than it was for their previous smaller car. This is quite a different situation than what was

[1] The Wards Intelligence Fuel Economy Index expresses estimated average fuel economy in miles per gallon per light vehicle sold. The index is based on reported sales, EPA MPG ratings and Wards Intelligence's surveys of engine installation rates, and is intended for comparative analysis over time. Large pickups and vans over 8500 lbs GVW are exempt from CAFE standards and are excluded from the index.

observed in the 2000s, mostly thanks to leaps in transmission and engine technology that have managed to squeeze more power out of smaller displacement engines (*Chart 4*). From an environmentalist's standpoint, things look ever better. Average annual fuel consumption of the entire fleet, including new vehicles and existing vehicles in operation, has declined 10% since 2007. One could be forgiven for thinking hybrids and electric vehicles (EV) were mostly responsible for this downward trend in consumption, given the amount of press on the issue. In reality, both segments account for a growing but still small portion of the market (1.9% for Hybrids, 0.6% for EVs in the US), hardly enough to move the needle on fuel consumption statistics just yet.

Chart 4
Engine Installations by Cylinder Count



Sources: BMO Economics, Wards Auto

Looking ahead, we would argue that increased electrification of the fleet will only tilt the balance further in favour of light trucks. There are many narratives as to why passenger car EV sales for most OEMs have disappointed, but we would argue that consumers simply did not find the typical compact or subcompact EV attractive or practical for their everyday needs. Battery technology has improved rapidly, making full electrification of larger, heavier, CUVs and SUVs feasible, painting a rosier outlook for EV sales. For those with range anxiety, advances in hybrid systems are being applied to a broader range of light trucks and even sports cars. This should hopefully remove some of the stigma associated with the technology which, in fairness, was marketed in a staid manner towards the environmentally conscious buyer. In retrospect, this may have been somewhat of a miscalculation as hybrid technology can offer incredible performance gains; put to great use by no less than the world's best Formula 1 teams. All of this is to say that over the next couple of years, light truck buyers will have an alternative option that will consume dramatically less fuel than even today's most fuel efficient vehicles, at a price point that is more likely to meet their budget.

There are of course some important considerations. First, we are not witnessing the death of the sedan or compact car; there will always be a consumer segment that prefers cars. Rather, what we are seeing now is an efficient consolidation of the segment with OEMs who have experienced the most success poised to gain a larger market share. Second, the higher average transaction price of a light truck is an important factor to consider in the context of the current credit cycle. With interest rates on the rise as the business cycle ages, it will become more difficult for buyers to finance the purchase of a larger, fully-loaded light truck. However, this has been mitigated by a greater selection of light trucks at different price points, another stark difference from the 2000s. If volumes were to take a tumble in the event of an economic slowdown, we would predict sales to shift to the used-vehicle market rather than a dramatic shift in the composition of new vehicle sales.

Bottom Line: The consumer-led shift to light trucks is here to stay, with technology and engineering being the key factors differentiating the current cycle from past experience.