Auto Market Update

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A semi-annual review of the North American auto industry **December 7, 2018**

Alex Koustas, Senior Economist • alexandros.koustas@bmo.com • 416-359-4624

Solid sales outlook amid increasing headwinds

Even with a modest cooling this year, the auto cycle is showing some late cycle verve, surpassing industry estimates with a tenacious second-half performance. In the U.S., generationally-low unemployment, towering consumer confidence, and a fiscal dividend from the Tax Cuts and Jobs Act have provided a late-cycle lift to sales. Meantime, Canadian sales have slowed after storming out of the gate to begin the year, as the broader credit cycle has ratcheted downward. Despite the recent divergence in trends, sales in both markets are historically strong, particularly given the stage of the economic cycle, albeit they are gradually drifting lower. U.S.-Canada sales are set to top 19 million units for the third straight year, a mark never reached in previous cycles. Looking toward 2019 (*Chart 1*), sales activity should remain relatively solid in both markets, but rising interest rates will present an increasingly important headwind.

U.S. Surpassing expectations...for now

U.S. sales were aligning with expectations up until recently, gently ebbing to a sub-17 million seasonally adjusted annual rate as automakers tightened the reins on incentives and as the cycle matured. However, a late-year resurgence to a mid-17 million pace has nudged up final estimates for 2018. Unlike the fall of 2017, when Hurricanes Irma and Harvey took a combined 600,000 vehicles off the road and boosted sales, this bump appears to be based more on fundamentals. To wit, Hurricane Florence affected an estimated 40,000-60,000 vehicles; which, while being sales-positive, is not enough to fully explain the near-17.5 million unit pace of the past three months.

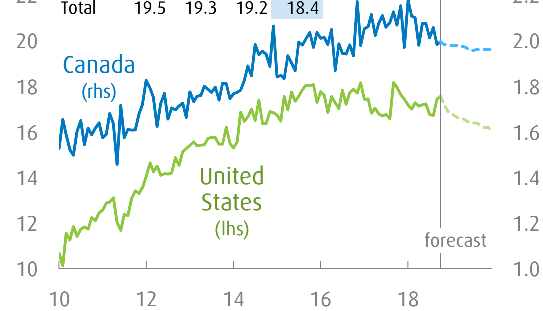
There is no shortage of factors supporting sales: consumer confidence has trended near cyclical highs; unemployment is at its lowest level since the late 1960s; and wage growth, while controlled, is slowly churning upwards. Add in the one-time boost of savings from the Tax Cuts and Jobs Act, a buoyant (albeit softening) housing market and, until recently, a ten-year rise in equities, and conditions couldn't be more supportive from a demand-side perspective. Indeed, a deluge of fiscal spending has powered U.S. growth to an estimated 2.9% in 2018 and will sustain a glide to an above-potential 2.5% in 2019, further compressing the unemployment rate toward generational lows.

But, there's **one big roadblock: market saturation**. The vehicle ownership rate has once again reached its pre-recession peak at over one vehicle per person of driving age. Absent a dramatic increase in the scrappage rate or a sudden boom in population growth, the

Chart 1
Light Vehicle Sales

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

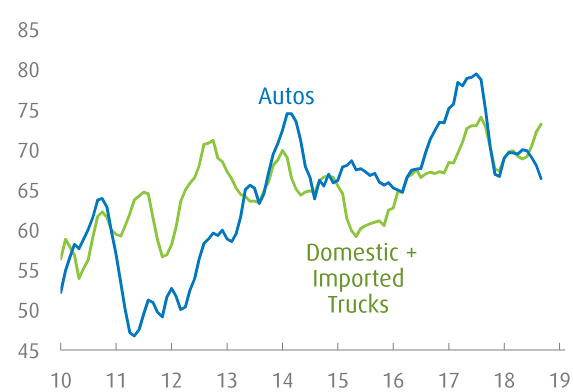
	16	17	18e	19f
Canada	1.99	2.07	2.05	1.97
US	17.5	17.2	17.1	16.4
Total	19.5	19.3	19.2	18.4



Sources: BMO Economics, Haver Analytics

Chart 2
Days' Supply for Vehicle Industries

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



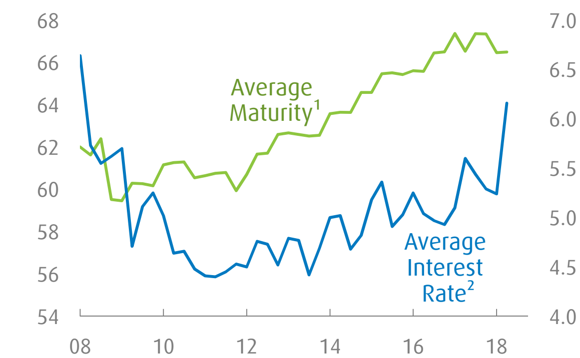
Sources: BMO Economics, Haver Analytics

market will struggle to maintain a 17-million unit selling rate, let alone the current pace.

Resistance will also come in the form of rising interest rates. After years of mostly shrugging off rate hikes, financing costs have responded forcefully in recent months, bolstered by an upturn in longer-term yields (*Chart 3*). The increase has been so acute that the average loan term, which had been rising steadily through the cycle, has started to decline as marginal buyers are squeezed out at the most extended terms. This headwind will only strengthen with the Fed forecast to raise rates three more times by the end of 2019, alongside an expected upward ratcheting of long-term yields.

Chart 3
New Car Loans

United States

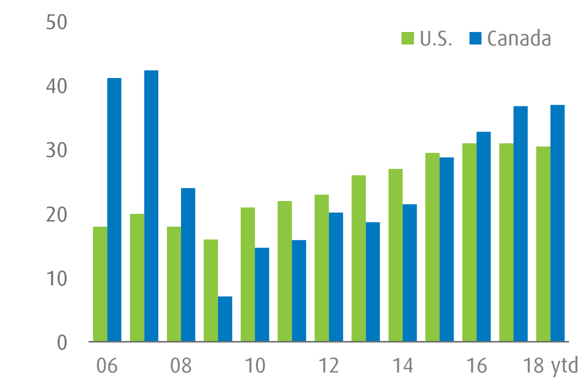


[1] (lhs : months) [2] (rhs : percent)
Sources: BMO Economics, Haver Analytics, Federal Reserve Board

To this end, **leasing has provided a welcome safety valve**, with activity now trending well above pre-recession levels (*Chart 4*). The average monthly lease payment was roughly $130 lower than an equivalent loan payment in 2017 according to a report by Deloitte, offering considerable capacity to target cash flow conscious buyers. Helping to support activity is the shift in the sales mix towards light trucks. Heavier vehicles have much more favourable residual values, a key support of the leasing market, while advances in technology have also aided in this regard by optimizing the allocation of off-lease vehicles to dealerships. These factors will take some of the sting out of rising rates and are a key support for our U.S. sales forecast landing near the 16.5 million unit mark in 2019.

Chart 4
Vehicle Leasing

(% of vehicle sales)



Sources: BMO Economics, Haver Analytics, DesRosiers

Canada: Downshifting a gear or two

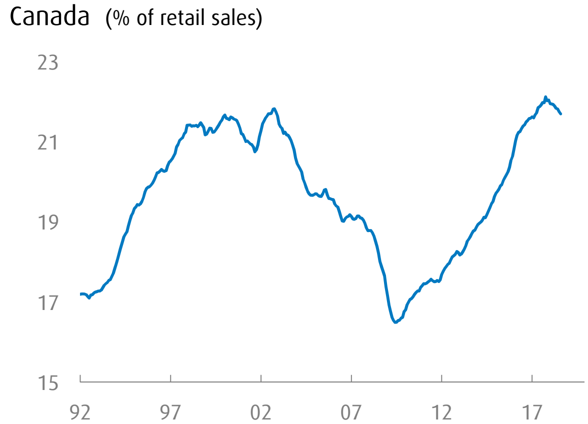
After years of defying lofty expectations, it appears as if the Canadian market has finally peaked. Sales jolted off the line in the first quarter, hinting that they may once again upend expectations. But, credit markets felt a summer chill as the Bank of Canada raised rates and strengthened its conviction to normalize policy. The auto market hasn't been immune from the broader deceleration in credit; sales have fallen on a year-over-year basis for nine straight months, the longest stretch for this cycle, with November's 9.4% y/y sales decline offering a sure sign that the market is coming off the boil.

Notwithstanding the recent deceleration, total vehicle sales are still expected to surpass 2 million units in 2018 for only the second time on record. Similarly, an environment of low unemployment and improved business and consumer confidence following a provisional agreement for a revised NAFTA, re-dubbed the U.S.-Mexico-Canada Agreement (USMCA), as well as an improved capital cost allowance framework, should limit the slowdown in sales in 2019. Indeed, the new agreement will be a welcome relief for auto dealers as the U.S. administration was using the threat of a 25% import tariff on vehicles as a cudgel to push for more favourable terms, a measure that would have caused significant price distortions and severely affected sales across the continent. **In light of these developments, we highlight three key medium-term factors that will help keep sales punching above 1.9 million units, a mark unreached in the previous cycle**.

First, demographic growth in Canada is supportive of sustained volume strength; the driving-age population is growing at a rate of 1.3% compared to 0.9% in the U.S. The nexus of a growing buyer base and downwardly-drifting unemployment rate will provide a rock-solid backdrop for activity.

Second, the Canadian space has relatively low saturation (stronger demographics), with the vehicle ownership rate still in the low 80% range. In this sense, the market isn't running up against an upper bound like in the U.S., but it bears mentioning that a fair portion of current non-owners would be more likely to participate in the used-vehicle market.

Chart 5
Auto Sales: Share of Total Retail



Sources: BMO Economics, Haver Analytics, Statistics Canada

Third, this cycle has been marked by a major shift in Canadians' overall spending preferences. Sales at new-car dealerships have accounted for roughly 22% of total retail sales in 2018 (*Chart 5*), the highest level since the late 90s. Manufacturers deserve a lot of credit for this change in attitude, as a richer complement of light trucks (which now account for 70% of vehicle sales!), more attractive safety and infotainment features, technological advances and improved fuel economy have enticed buyers to spend more on a vehicle in preference to other discretionary purchases.

The big factor weighing against these supports is the credit market. Thus far, consumers have been quite responsive to rising rates, as evidenced by the broader deceleration in aggregate credit growth over the past few months and, despite its recent dovish turn, we still expect the Bank to tighten policy further in 2019. Even though rates would still remain historically low, additional hikes would surely lift the household debt service ratio toward previous cyclical highs (a sharp contrast to the U.S. market where it is near record lows), leaving less spare cash on hand for loan or lease payments. Compounding the issue is that the leasing market, which has provided a partial offset to tightening credit conditions, may be approaching its limit. In the past five years, leasing has boomed from 20% of vehicle sales to close to 40%, a mark that has proven difficult to sustain in previous cycles. In short, interest rates will continue to pack a punch in 2019.

Bottom Line

While auto sales in both Canada and the U.S. are expected to step down from their highly-revved pace of the past few years, they should nevertheless remain solid, supported by strong consumer fundamentals and solid competition among auto makers. Most badges have been successful in their efforts to woo buyers by offering superior quality, design and technology as opposed to the pure price discounting prevalent in previous cycles. This has been reflected in increased average transaction prices and a broad shift towards higher-margin light trucks and luxury vehicles. Product placement and model design will be crucial elements to keep revenues on track as sales decelerate from cyclical highs, with a dealership focus on service plans and management of off-lease used vehicle sales.