Auto Market Update

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A semi-annual review of the North American auto industry **May 6, 2019**

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Revving below the Redline

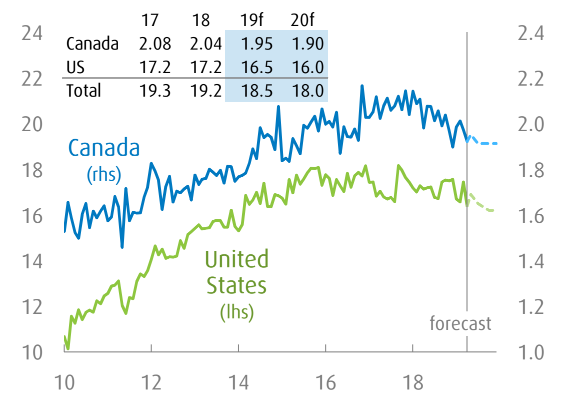
You can only redline for so long before overheating; given past experiences, the controlled deceleration being displayed in the North American market should be seen as a relatively positive outcome. **Sales are poised to slip below a 19 million unit pace for the first time in four years, but should remain quite healthy on a cyclical basis (Chart 1)**.

In the U.S., the sugar-high from the Tax Cuts and Jobs Act is wearing off, steering sales out of the passing lane after a late cycle surge late last year. **Volumes are expected to fall more closely in line with the multi-year downward glide observed since 2016's cyclical peak**. **In Canada, the market has turned, with sales cooling after running red-hot for the past two years**. The overarching factor is the broad deceleration in consumer credit growth, which is spilling into the auto segment. On this front the about-face by both the Federal Reserve and the Bank of Canada on policy tightening reinforces our view that sales will downshift smoothly, rather than hit the hand brake.

Naturally, lower sales volumes entail fiercer competition. Dealerships with stronger inventory mixes and superior customer service stand to benefit, while others may experience a more difficult transition. From a macro perspective, lower production and sales volumes in North America will continue to act as a drag on growth.

Chart 1
Light Vehicle Sales

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



Sources: BMO Economics, Haver Analytics

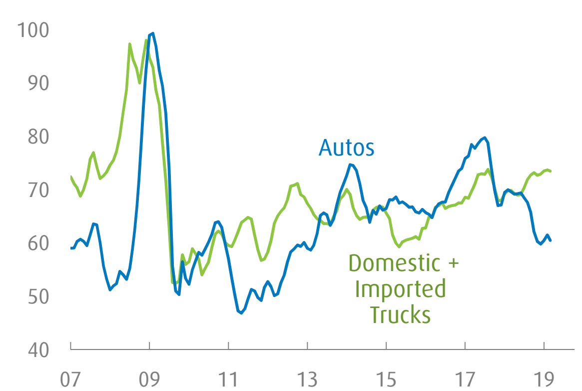
U.S: Tenacious D

U.S. vehicle demand remains robust, with a tight labour market squeezing the maximum potential of a sales landscape marked by late-cycle conditions. **Though sales are down 2.2% year-to-date, they are still cruising above a 16.5 million unit pace (despite the government shutdown and poor winter weather in Q1), a fairly hearty figure this late into the cycle**. Equally as important, the composition of sales is becoming richer, with the consumer rotation towards higher-priced light trucks and luxury vehicles continuing its course.

Manufacturers have been proactive in responding to softening market conditions, cancelling unpopular models and nimbly adjusting production. This has helped contain dealership inventories and limit the need for incentive spending, both of which will help dealerships' bottom line (Chart 2).

Chart 2
Days' Supply for Vehicle Industries

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



Sources: BMO Economics, Haver Analytics

Ultimately, market saturation is the main culprit for the downtrend in sales. The vehicle ownership rate is hovering near the peak reached in the past cycle (at more than one vehicle per person of driving age) and the market churn is simply too slow to accommodate a sales rate well above 16 million units. The aggravating factor is population growth, tracking at a measly 0.6%, the slowest clip since the Second World War. Absent a change in immigration trends, demographics will be a heavy headwind in the long-term.

Canada: Credit where credit's due

The Canadian market has cooled off its boil in an almost synchronized fashion with the housing market. After nearly 30 years, credit growth is re-aligning with income growth at last. Although a cocktail of tightening policy rates and the Alberta oil shock provided a strong jolt of turbulence in the winter months, sales now appear to be headed towards a soft landing.

Debt remains the key headwind for the market, with Canadians dedicating 14.8% of their income towards servicing obligations, roughly equal to the record set ahead of the financial crisis (though policy rates are 275bps lower than they were in Q4 2007). This stands in sharp contrast to the U.S. market, where the comparable ratio is near record lows. As such, the recent pause by North American central banks represents a more important development for the Canadian space.

However, **even amid softening credit growth, the overall sales landscape in Canada remains quite strong**. Job growth has exceeded expectations despite economic disruptions, keeping the unemployment rate near all-time lows. Similar to the U.S., benign labour market trends are the crucial element underpinning market performance. While demographics present a headwind to the U.S. market, **generationally strong population growth of 1.6% is the key tailwind that will keep Canadian sales churning well above previous cyclical levels.**

Overall, sales look to advance **above a 1.9 million pace this year, which combined with positive compositional shifts, should represent a fairly healthy climate for dealerships**, particularly when considering that the number of franchises remained fairly steady through the sales boom.

Youth Drivers: Mind the Hype

An inordinate amount of ink has been splashed on the "worrying" driving and buying trends of Millennials and Generation-Z. Generally, the gist is that urbanization, "uberfication" and "mindfulness" have dramatically altered the American auto market. But, are we really entering a post-car world? Have Millennials reached a level of mindfulness that has slammed the door shut on the auto industry as we know it?

Evidence suggests that this is not the case; rather, our old friend the invisible hand seems to be playing a much larger role. The much publicized drop in the percentage of young drivers has much more to do with structural shifts in the domestic economy and the re-alignment of incentives it has entailed, as well as more immediate cyclical factors, than any of the more marketable narratives being floated around.

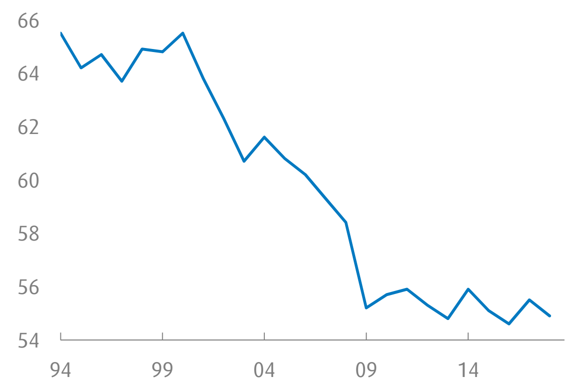
On a structural basis, it is little wonder that the share of the student-aged population with a driver's licence has decreased; far fewer are employed on a full-time basis. The U.S. labor force participation rate of 16-24 year olds has nosedived from 65% in the 1990s to 55% in 2017 (*Chart 3*). This follows the broader trend of the domestic economy's re-orientation towards incentivizing skills-based trades and higher education. Or, put differently, a greater share of the youth population is concentrating on furthering their education or training rather than pursuing full-time employment during or immediately after high school (*Chart 4*).

In this context, the existential crisis caused by the 2013 study from the University of Michigan[1] that first socialized the decline in young drivers seems somewhat overblown, and it becomes even more questionable when examining the details. The researchers asked respondents "What is the main reason you do not currently have a driver's licence"; the overwhelming response (37.9%) amongst those aged 18 to 19 was that they were "too busy or didn't have enough time to get a driver's licence". This figure dropped significantly in older millennial brackets (20-29), strongly suggesting that students were rationally prioritizing studying (an immediate incentive if one wishes to or is attending college) over the driver's exam (which has become more difficult to pass, more costly and less accessible, while providing less immediate incentive if one doesn't need to drive to work) rather than eschewing the prospect of vehicle ownership entirely. **There also appears to be a bit of age-ism at play in the popular analysis, as the same study shows a boom of licenced drivers aged 70 and older, with the licenced share skyrocketing from 55% in 1983 to 76% in 2014**! A similar trend can be found through the 55+ age groups, a key reason why the new vehicle market has kept churning despite shifting trends in younger segments.

Cyclical economic factors have also played an important role. Over the 2011-2013 period of the study, the unemployment rate for 16-19 year olds averaged well over 20% (after hitting an eye-watering peak of 27% in 2009), by far the worst job market on record for this age segment, negating any imperative to pursue a licence (if one could even afford to). College-aged students and graduates didn't fare much better, facing the worst job market in a generation while being saddled with record levels of student debt. As these factors subsided, **the driver's licence uptake in the 19-24 year old bracket has improved, helping to bring the share of the licenced driving-age population in line with recent historic norms** (*Chart 5*).

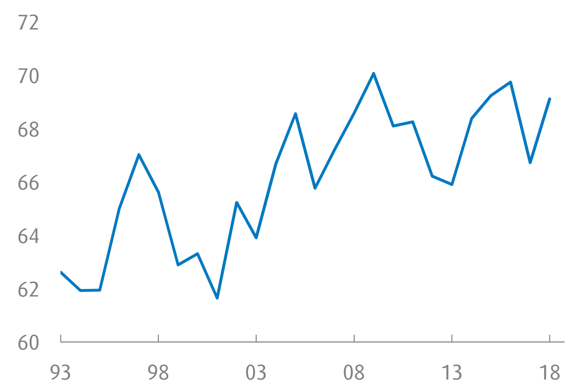
With respect to demographics**, it may surprise some that the share of the urban population has actually remained flat over the past sixteen years**. A Pew Research Center study of U.S. Census data[2] found that suburban communities were the ones to enjoy the largest

Chart 3
Participation Rate—Ages 16 to 24
United States (% of population)



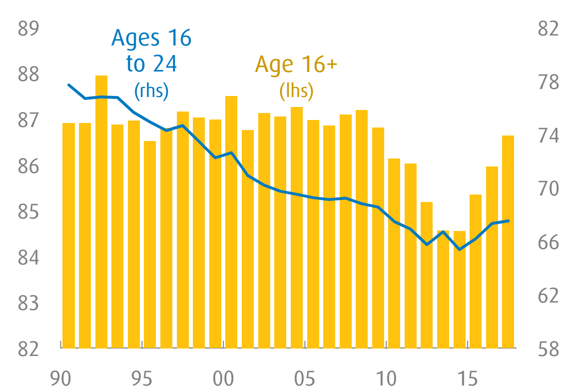
Sources: BMO Economics, Haver Analytics

Chart 4
High School Graduates Enrolled in College
United States (percent)



Sources: BMO Economics, Haver Analytics

Chart 5
Share of Population with a Driver's License
United States (percent)



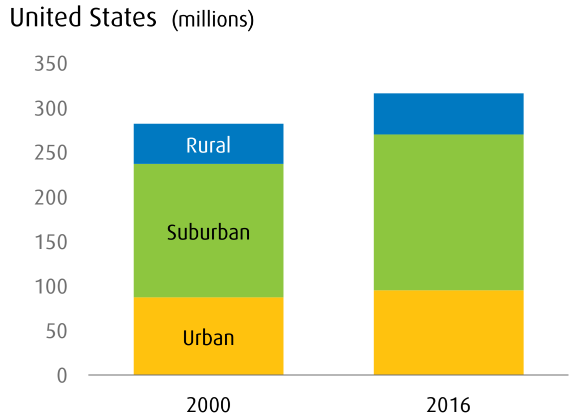
Sources: BMO Economics, Haver Analytics

[1] Schoettle, B., & Sivak, M. (2013, August). The Reasons for the Recent Decline in Young Driver Licensing in the U.S. Retrieved from https://deepblue.lib.umich.edu/bitstream/handle/2027.42/99124/102951.pdf

[2] Parker, K., Horowitz, J. M., & Brown, A. (2018, May). Demographic and economic trends in urban, suburban and rural communities. Retrieved from https://www.pewsocialtrends.org/2018/05/22/demographic-and-economic-trends-in-urban-suburban-and-rural-communities/

population flows, growing 16% from 2000 to 2016, and seeing their share of the population rise from 53% to 55% (*Chart 6*). **While the urban population is indeed rising (+13% over the same period), its importance in the scheme of the domestic auto market has not changed materially, negating the notion that urbanization is depressing sales**. It is true that suburban commuters have become more conscientious, as evidenced by an increase in transit ridership, but this has mostly served to ebb the growth rate of vehicle miles traveled. Indeed, a car is still a necessity for many to get to a transit station or to run daily errands.

Chart 6
Population



Sources: BMO Economics, Haver Analytics

Ride-sharing presents another interesting issue. First, an important caveat: at the time of the initial University of Michigan study, ride-sharing platforms were not nearly as prevalent as they are today, so their effects during the sample period were likely limited. Insofar as the current situation is concerned, **research has shown that ride sharing has become a substitute to public transit use, rather than a replacement for vehicle ownership**. A study conducted by UC Davis[3] found that 90% of ride-sharing users have not been influenced to change their vehicle ownership decision, a finding backed by trip data which showed that the majority of rides were to restaurants, bars, parties or cafes. Furthermore, the study found that the majority of these trips would have alternatively been made by transit, cycling or walking, suggesting that ride-sharing is actually adding to congestion. A more recent survey conducted by the Pew Research Center[4] found that while adoption of ride sharing services has more than doubled in the past five years (to 36% of the population), over two thirds of users utilize the service less than once per month. In fact, only 4% of the U.S. adult population use ride-sharing apps on a weekly basis, largely unchanged from the last poll conducted in 2015. Therefore, **ride-sharing doesn't yet appear to be a significant factor in the vehicle market**, though advances in autonomous driving could drive structural change in the next decade.

Bottom Line: Structural and cyclical economic factors have changed the behaviour of young drivers, but a sea-change in vehicle ownership trends is unlikely in the near-term. Simply put, Millennials and Generation-Z are pushing the pursuit of a licence and the purchase of a vehicle later in life based the employment opportunities available. On the other hand, older drivers are driving for longer, keeping the aggregate driving population roughly in line with historical norms. This helps to explain the steady upward creep in luxury sales and general shift in composition towards the higher-end being witnessed across all brands. **More broadly, the focus on shifting trends between demographics isn't what's most important; rather the fact that U.S. population growth is at its lowest level in modern history presents a far greater issue for industry prospects in the medium term**.

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[3] Clewlow, R. R., & Mishra, G. S. (2017, October). Disruptive Transportation: The Adoption, Utilization, and Impacts of Ride-Hailing in the United States. Retrieved from https://steps.ucdavis.edu/new-research-ride-hailing-impacts-travel-behavior/

[4] Jiang, J. (2019, January). More Americans are using ride-hailing apps. Retrieved from https://www.pewresearch.org/fact-tank/2019/01/04/more-americans-are-using-ride-hailing-apps