

ECONOMIC VIEWPOINT

Is the U.S. Auto Market at Risk?

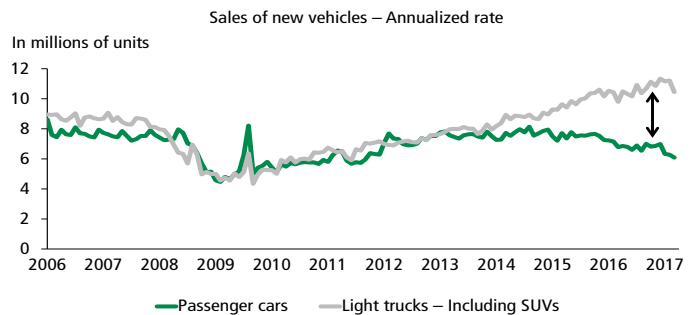
Auto sales have risen steadily in recent years, but have lost steam in the last few months. This plateauing appears to indicate that sales have reached their cyclical peak. Tighter credit conditions in this market are further complicating the situation. Declining auto sales could lead to slower growth by real U.S. consumption and Canadian exports tied to this sector.

A Solid Upward Cycle

After taking a nosedive during the 2008–2009 economic crisis, new vehicle sales saw strong growth during the recovery. Between 2010 and 2015, average annual growth reached 9%. The annual change was more stable in 2016 with a gain of only 0.6%. However, sales remained quite high (graph 1) and last December, they reached their highest level since 2005. Between their 2009 low and this peak, new vehicle sales more than doubled. Meanwhile, auto consumption in constant dollars rose by 79.7%. By comparison, total real consumption of goods and services increased 18.9% over the same period.

GRAPH 2

In recent years, the large car segment has performed the best

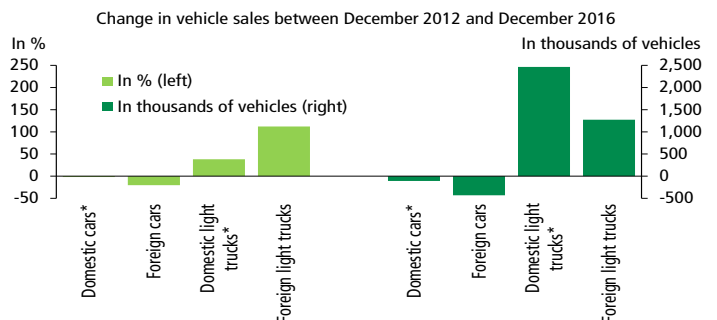


Sources: Datastream and Desjardins, Economic Studies

a boost to North American manufacturers, which account for a larger share of this market segment (graph 3). However, foreign light trucks also saw solid growth despite being subject to more protectionist measures.

GRAPH 3

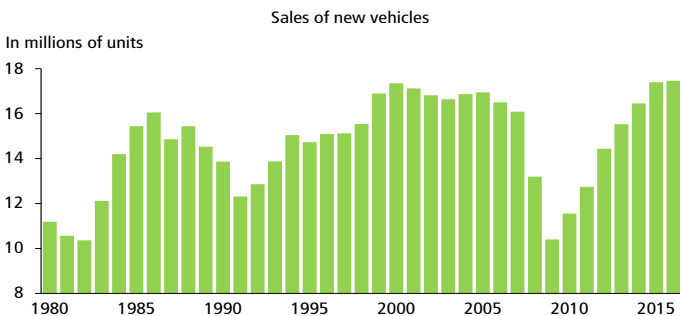
In terms of volume, light trucks manufactured in North America benefited the most from increased sales



*Includes imports from Canada and Mexico.
Sources: Datastream and Desjardins, Economic Studies

GRAPH 1

Strong sales for new vehicles throughout 2016



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

A Fascination with Light Trucks

The upward trend in auto sales didn't play out in the same way for all market segments. Gains were particularly high for light trucks. This segment, which includes vans, mini-vans, SUVs and pick-up trucks, has experienced strong growth since the financial crisis, while auto sales (in the strict sense) have stagnated or even decreased (graph 2). This fascination with light trucks provided

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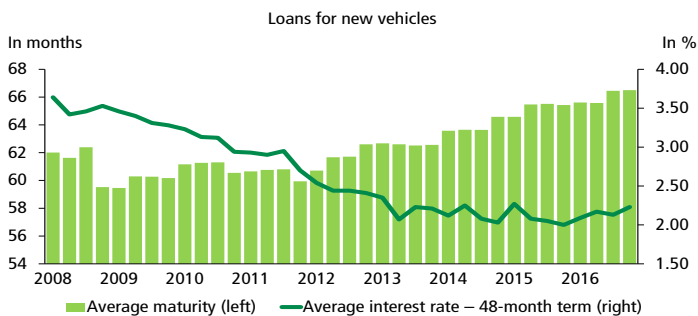
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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Favourable Factors

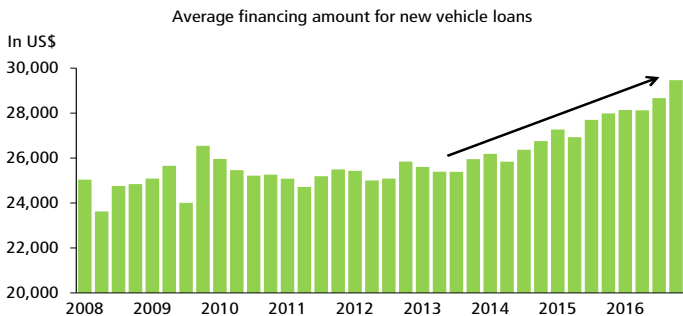
A number of elements contributed to the positive performance of the auto sector and light trucks in particular. Certain macro-economic factors clearly spurred consumption as a whole, such as job creation and greater consumer confidence. Easier credit conditions also played a role, resulting in lower average interest rates and longer terms for car loans (graph 4). These factors enabled consumers to borrow more and opt for more expensive vehicles (graph 5), particularly in the light truck segment.

GRAPH 4
Easier credit conditions helped boost auto sales



Sources: Federal Reserve Bank of St. Louis, Federal Reserve Board and Desjardins, Economic Studies

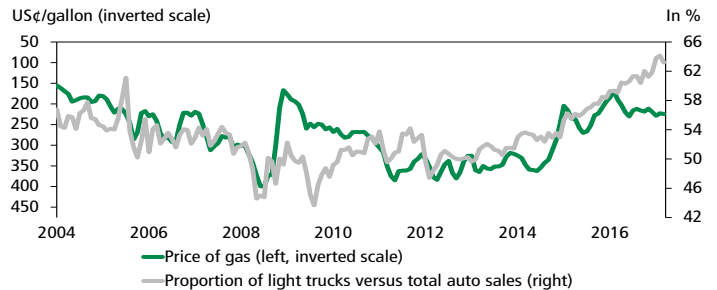
GRAPH 5
The attraction to more expensive vehicles is reflected in total car loans



Sources: Federal Reserve Bank of St. Louis and Desjardins, Economic Studies

Low gas prices also encouraged consumers to buy heavier vehicles with relatively higher fuel consumption. While gas mileage has improved over the years for both cars and light trucks, there is still an average gap of 40% between the two categories. Declining gas prices since 2014 has boosted the popularity of light trucks (graph 6) over cars that are less expensive to drive.

GRAPH 6
Low gas prices favoured purchases of larger vehicles

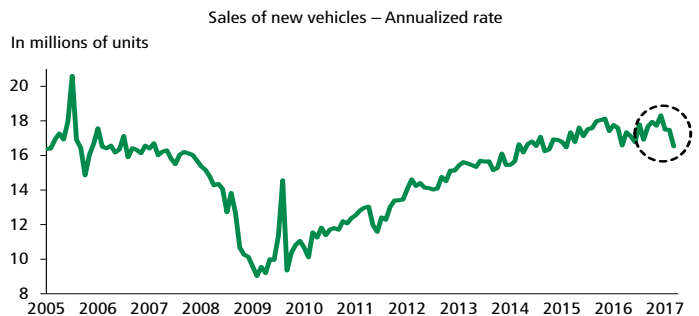


Sources: Energy Information Administration, Bureau of Economic Analysis and Desjardins, Economic Studies

The Start of a Downward Trend?

The steady growth of auto sales (in the broad sense) is now showing signs of losing momentum (graph 7). After the recent peak in December 2016, auto sales have posted decreases for three consecutive months, a first since winter 2015. With a total drop of 9.7%, this setback is far from negligible and annualized sales for March 2017 were at their lowest level since February 2015. In the first quarter of 2017, light truck sales showed a bit more resilience (-7.8%) than passenger car sales (-12.9%).

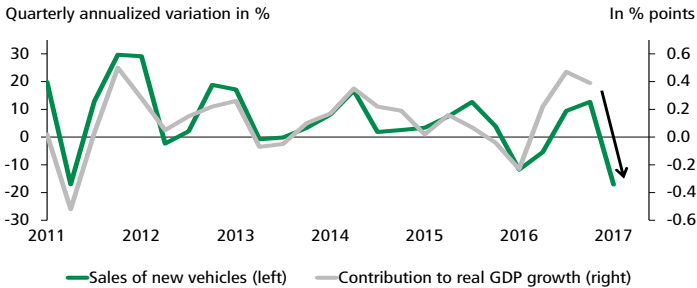
GRAPH 7
Auto sales appear to have plateaued in the United States



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

Declining new vehicle sales is one factor behind the anticipated slowing of real consumption growth in the first quarter of 2017. In terms of annualized quarterly change, auto sales fell 17.1%. Such a significant contraction can only have a negative impact on real GDP growth (graph 8 on page 3).

GRAPH 8
Consumer spending in the auto sector will likely have a negative impact on real GDP growth

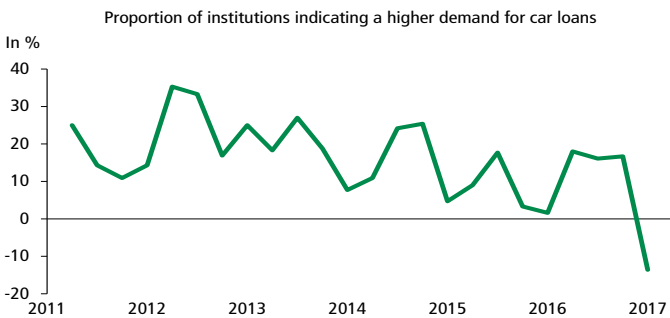


Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

Tightened Credit Conditions

The decrease in auto sales since late 2016 has lowered the demand for loans. The net percentage of financial institutions that saw an increase in the number of loans fell into negative territory for the first time since this data became available (in 2011) (graph 9 on page 3).

GRAPH 9
Financial institutions have observed a lower demand for car loans

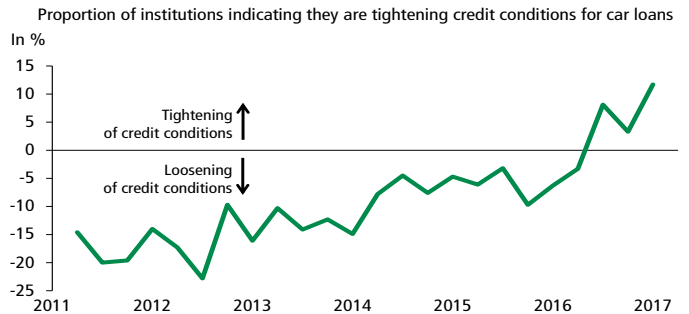


Sources: Federal Reserve Board and Desjardins, Economic Studies

The drop in demand for cars and loans may be due in part to stricter credit conditions. Since mid-2016, a growing number of financial institutions have tightened their credit conditions (graph 10); this could be the result of a rise in late payments on car loans. Ratio increases remain relatively low, but the number of late payments has never returned to the healthier levels seen before the financial crisis (graph 11).

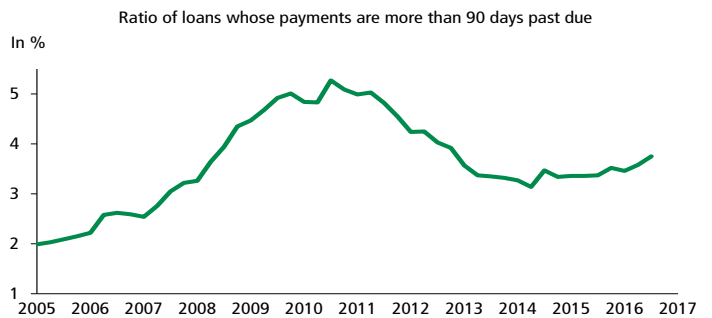
Outstanding car loans rose considerably in the U.S. economy, increasing from less than US\$700B in 2010 to over US\$1,100B at the end of 2016. There is also a greater number of these loans on the financial markets via securitization. The total value of securitized car loans surpassed its pre-financial crisis peak, even after being adjusted for inflation (graph 12). However, it is important to remember that even if problems in the car loan market escalate, the impact will never be as severe as what we

GRAPH 10
Financial institutions are tightening credit conditions for car loans



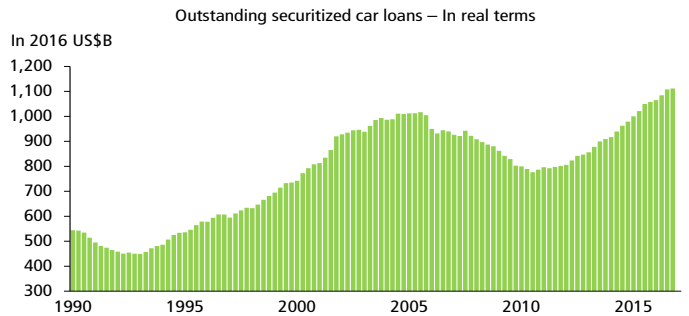
Sources: Federal Reserve Board and Desjardins, Economic Studies

GRAPH 11
The delinquent loan ratio for the auto market is on the rise again



Sources: Federal Reserve Bank of New York and Desjardins, Economic Studies

GRAPH 12
More auto loans are on the bond market



Sources: Federal Reserve Board and Desjardins, Economic Studies

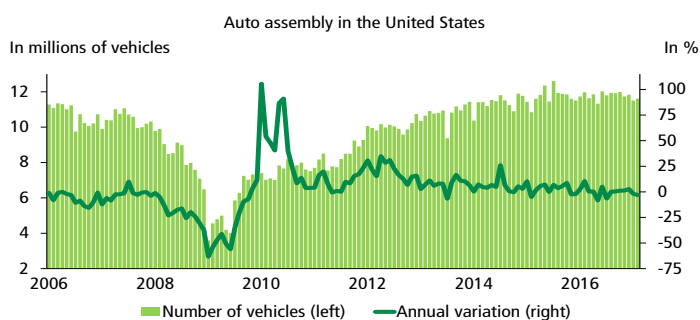
witnessed with mortgages during the crisis. The total amount of car loans represents 5.9% of the U.S. GDP, whereas mortgages soared to over 73% in 2009. Furthermore, the trend for loans does not indicate a significant deterioration in the credit quality of buyers. In 2015 and 2016, 21.9% of loans granted fell into the subprime category, whereas the average since 2004 is 23.3%.

Nevertheless, a further deterioration of credit conditions in the auto market could have certain negative effects.

Consequences on North American Production

After plummeting due to the financial crisis and the unique problems facing auto makers, the number of vehicles assembled in the United States experienced a strong recovery between 2010 and 2014, returning to the levels seen during the previous cycle. However, this upward trend has flatlined and the annual change in production was rather neutral in 2015 and 2016 (graph 13).

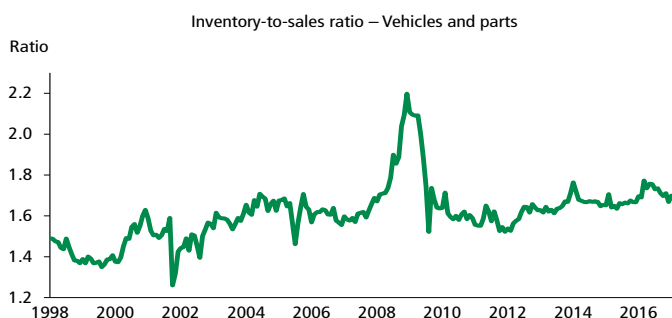
GRAPH 13
Auto assembly stabilized in the United States



Sources: Federal Reserve Board and Desjardins, Economic Studies

As a result of this stabilization, the inventory-to-sales ratios haven't moved much. From late 2011 to winter 2016, there was a slight upward trend, but a dip has been observed over the past year (graph 14). However, there doesn't appear to be much room to manoeuvre. In fact, according to some indicators, the inventory-to-sales ratio for passenger cars produced in North America is more worrisome (graph 15).

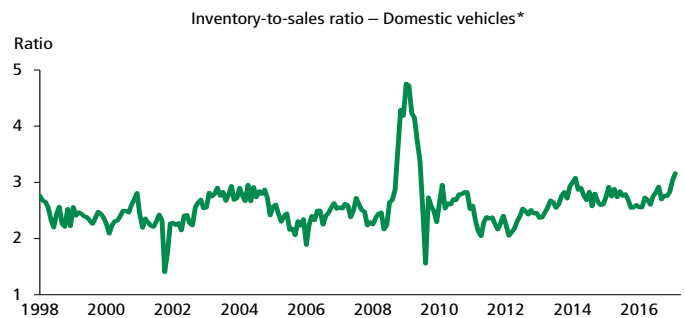
GRAPH 14
Inventory tied to the auto sector is relatively high, but nothing dramatic



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

If stagnating sales are not accompanied by a production adjustment, they could lead to increased inventory. This could push down prices for new cars, which haven't seen much movement in the last few years as it is. This phenomenon has

GRAPH 15
Inventory of domestic passenger cars is on the rise



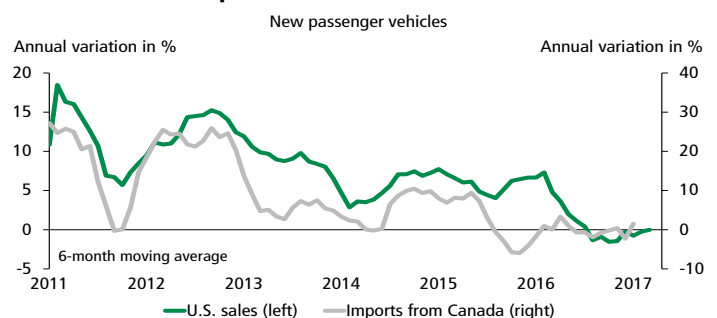
* Includes imports from Canada and Mexico.

Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

likely already been observed as a number of retailers have offered substantial discounts in recent months in reaction to lower sales. Discounts recently climbed to over 10% of the manufacturer's suggested retail price, a first since the recession. However, despite this incentive, sales have dropped instead of rebounding. Furthermore, a decrease in used vehicle prices (nearly 5% in annual change) has been observed for some time, putting additional pressure on new vehicle sales and prices.

In short, there is reason to fear that the auto market will no longer offer the same growth potential as in previous years. The conditions that were once in its favour, such as easier credit and steadily declining gas prices, now appear to be things of the past. Without a new boost in sales, U.S. auto production will not be able to pick up. The same is true for production in the rest of North America, including Canada, where a similar slowdown was observed in 2016 for the passenger car segment (graph 16).

GRAPH 16
Stagnating auto sales in the United States will have a negative effect on Canadian production



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

However, other factors could breathe new life into the U.S. auto sector. Consumer confidence is high in the United States; a situation that could spur consumption more quickly. If the Trump administration and U.S. Congress move ahead with substantial tax cuts, the spike in disposable income could help

consumers purchase vehicles. The gradual recovery of gas prices could also be a boon to the fuel-efficient vehicle segment. In addition, the cars currently on the road are older (11.6 years old on average in 2016). This could lead to consumers replacing their vehicles. There is also the potential for a new generation of electric cars that are more affordable for the middle class.

Lastly, the protectionist tendencies of the new administration in Washington could prove destabilizing for the auto market. Though aimed at favouring local manufacturers, protectionist policies would be a double-edged sword that could hurt consumers through higher prices, fewer choices or lower quality. The complexities of the value chain in the automobile production sector could also complicate the situation for domestic manufacturers.

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