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.

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 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 1**
Strong sales for new vehicles throughout 2016

**GRAPH 2**
In recent years, the large car segment has performed the best

**GRAPH 3**
In terms of volume, light trucks manufactured in North America benefited the most from increased sales

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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.

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.

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%).

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).
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).

Outstanding car loans rose considerably in the U.S. economy, increasing from less than US$700B in 2010 to over US$1,110B 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 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 flattened and the annual change in production was rather neutral in 2015 and 2016 (graph 13).

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).

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 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).

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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