OBSERVATION
TD Economics

October 27, 2014

CANADIAN AUTO SALES TO DOWNSHIFT FROM FIFTH TO FOURTH GEAR

Highlights

- Following last year's record performance, Canadian auto sales have been remarkably robust so far in 2014 and are on track to finish this year above 1.8 milllion units, which would be a first for the auto industry in Canada.
- Looking ahead, auto sales are likely to downshift a notch. A stabilization in vehicle ownership rates, limited pent-up demand, and a gradual rise in interest rates will put the brakes on higher sales. However, long loan terms, stronger economic growth and rising incomes should ensure a soft landing, helping to keep auto sales at relatively lofty levels.
- Overall, we expect auto sales to edge down by 0.5% in 2015 and slip by 1.7% in 2016. After strong performances in recent years, Ontario and B.C. will flatten out next year and decline in 2016. Alberta and Nova Scotia are the only provinces expected to record gains over the forecast horizon, in line with solid economic growth.

After hitting a record of 1.74 million units sold last year, only the second time Canadian auto sales have exceeded 1.7 million units, expectations for 2014 were generally more subdued. Most forecasters were expecting a slight rise of 0-2%, if not a mild decline. Quite the contrary, Canadian auto sales have been remarkably robust so far in 2014, with light vehicle sales up 5.5% through September. What's more, sales have hit a monthly record in each of the last six months, topping a seasonally adjusted annualized rate of 2 million units for the first time ever in September (see Chart 2). If the current pace is maintained, sales are set to end 2014 above 1.8 million units, which would be another first for the auto industry in Canada.

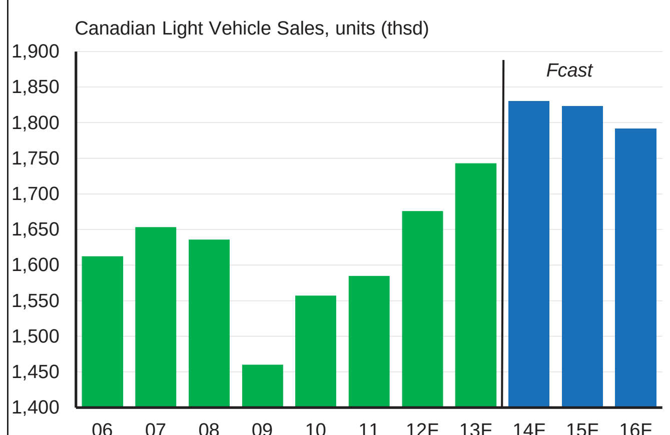
While light vehicle sales may have slightly more room to run, there are several reasons to believe that the years of strong gains may be coming to an end. A stabilization in vehicle ownership rates, limited pent-up demand, and a gradual rise in interest rates will put the brakes on higher sales. That said, long loan terms, stronger economic growth and rising incomes should ensure a soft landing, helping to keep auto sales at relatively lofty levels.

Long-term trend suggests limited upside potential

Looking at the long-term trend in sales can give some indication of where auto sales are heading. Over any period of time, auto sales can exceed or undershoot this trend due to a number of factors. However, sales tend to revert back to trend over time.

Based on the average level of sales relative to driving-age population (16+) since 1990, auto sales in Canada have been

CHART 1. CANADIAN AUTO SALES TO REMAIN FLAT NEXT YEAR BEFORE SLOWING IN 2016



Source: WardsAuto.com; Forecast by TD Economics as of October 2014.

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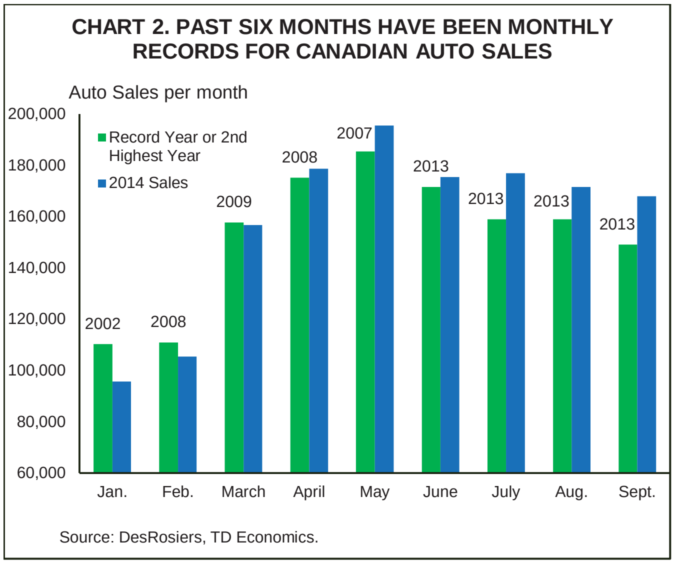
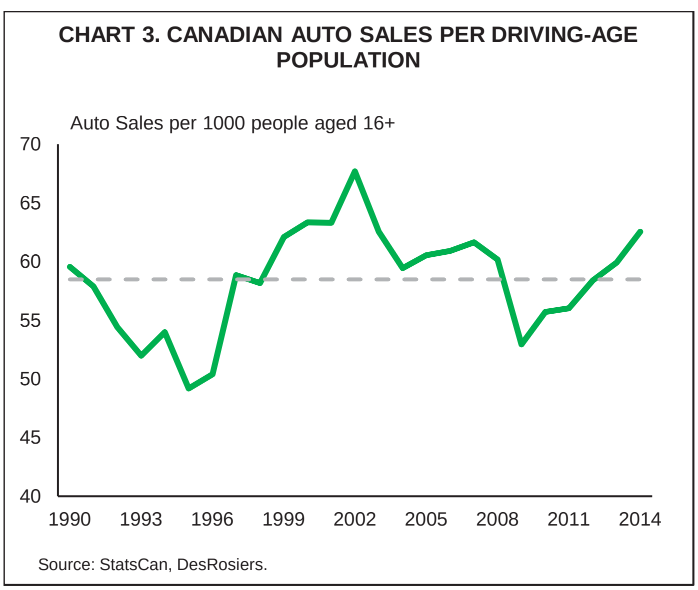


overshooting their trend level since 2012 (see Chart 3). That said, vehicle ownership rates have been on the rise, supporting higher auto sales. In 1994, there were roughly 68 vehicles for every 100 individuals aged 16 and over. By 2013, this number had reached 78 vehicles. Ownership rates differ across the country, with the Prairie provinces leading the way. In fact, the Prairie provinces in 2012 had nearly the same ownership levels currently seen in the U.S. at 95 vehicles per 100 individuals (16+). In contrast, at 68 vehicles, Ontario has the lowest ownership level in Canada. Interestingly, Ontario is the only province where ownership levels have remained fairly stable, diverging from the rising trend that has been a common theme throughout the rest of the country over the past two decades. That said, vehicle ownership rates appear to have hit a plateau. From 2009 to 2013, the ownership rate has remained within a narrow range of 77.4-77.9 vehicles nationally. Even at the provincial level, there appears to have been a general stabilization across the country. There are a number of factors that influence the level of vehicle ownership, including income per capita, geographical factors, population density, as well as personal or cultural preferences. While the steadying in ownership rates over the past few years may have been recession induced, that fact that it has yet to resume its uptrend five years after the economy has recovered and at a time when sales have been skyrocketing, suggests that it may hover in this range going forward. There have been some studies that show that licensing rates among young drivers is falling. If this is indeed the case and the trend persists, there is actually some downside risk to future ownership rates.

Pent-up demand has likely petered out

Pent-up demand has often been cited as the key driver of auto sales growth. That has certainly been the case in the U.S., where sales are only now returning to their pre-crisis levels, even with a population that has grown by almost 18 million individuals since 2008. In contrast, sales in Canada only briefly dipped during the 2008-2010 recessionary years and have strongly rebounded since then (see Chart 4). Based on the size of the dip in auto sales experienced during the downturn, pent-up demand was likely a key contributor to higher auto sales over the 2010-2013 period, but on a national level, it has largely petered out.

On a regional basis, the only provinces exhibiting a significant degree of pent-up demand are Ontario and British Colombia, and to a lesser extent, Nova Scotia. Ontario and B.C. experienced the largest downturn in sales relative to



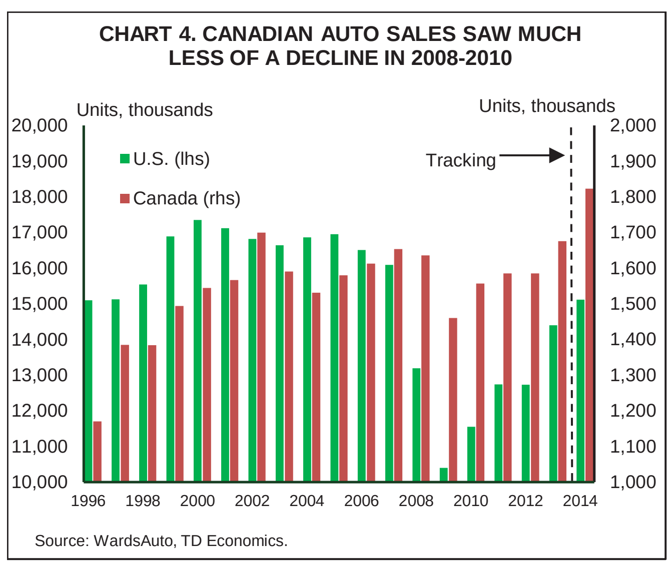


TABLE 1. AVERAGE AGE OF LIGHT VEHICLES		
Year	U.S.	Canada
2012	11.4	9.3
2011	10.8	9.3
2010	10.6	8.5
2009	10.3	8.5
2008	10	8.4
2007	9.8	8.4
2006	9.7	8.4
Chg since 2006	1.7	0.9

Source: WardsAuto (U.S.), DesRosiers (Canada).

driving-age population following the financial crisis, and sales were also slow to return to trend thereafter. This explains why these two provinces are topping the leaderboard this year, with auto sales through September up 10.9% Y/Y in Ontario and 5.8% Y/Y in B.C.. Given that Ontario is the largest auto market, representing 37% of Canadian sales in 2013, this year's outperformance is bolstering the sales total nationwide.

Another indicator that helps assess the extent to which consumers have been delaying the purchase of a new automobile is the average age of vehicles on the road. In Canada, the average age of vehicles has increased by 0.9 years since 2006 – only about half of that seen south of the border. Given the relatively small increase in the average age, combined with the fact that vehicles today are more durable than in the past, there is likely very little pent-up demand in Canada, and it is unlikely to be a key source of strength for auto sales going forward.

Higher affordability to prop up sales in the near term

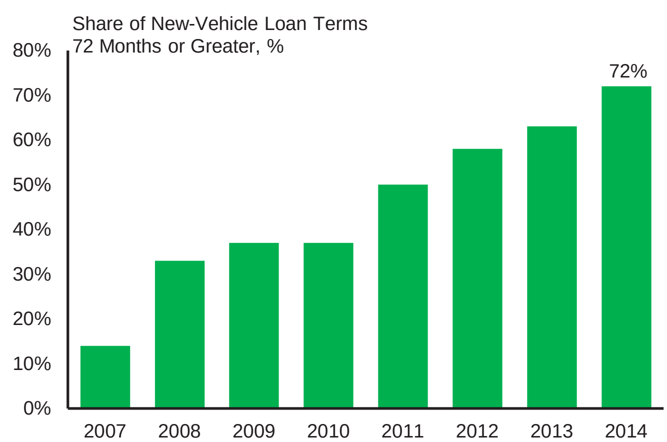
Several other factors have helped underpin the rise in auto sales in recent years. Soaring home prices have led to greater household wealth, which consumers have then used to increase spending, including on vehicles. It shouldn't come as a surprise that some of the provinces seeing the greatest rises in home prices this year (including Ontario, British Colombia and Alberta) are also seeing increased vehicle purchases. Similarly, while job growth has generally been weak in Canada so far in 2014, some of the provinces experiencing the largest employment gains (same ones) have also seen a greater rise in auto sales.

Another factor that has been encouraging consumers to visit showrooms is the fact that there are so many new or redesigned vehicles that have been introduced. Plus, with all the new technology that is now available in new vehicles, some consumers are eager to try it out.

Above all, increased affordability has perhaps provided the greatest lift to auto sales. Interest rates have essentially been at rock bottom levels since early 2009, credit is available, and loan terms have increasingly become longer. Indeed, while many expected consumer loan rates to begin rising this year, they actually edged lower, providing more incentives for consumers to purchase a vehicle. Moreover, only 14% of new vehicle loans in 2007 were for 72 months or more. By 2014, this ratio had jumped to 72%, with the average loan term sitting at 69 months. These longer loan terms greatly improve affordability by lowering monthly payments. It also allows consumers to buy a more expensive vehicle or add options, as evidenced by the fact that the average price paid for a new vehicle has been on a general uptrend since 2009, following declines in the 2007-08 period.

It is clear that consumers are showing a preference for these longer loan terms over leases. In the years preceding the financial crisis, loans and leases each represented over 40% of the retail market for new vehicles sold, with the remainder – less than 15% of vehicles – being purchased with cash. As the availability of leasing became much more limited following the crisis, consumers shifted away from leasing and increasingly resorted to loans in order to finance new vehicle purchases. Even as the availability of leasing has returned, consumers have maintained their greater use of loans. In 2013, 69% of vehicles were purchased with loans, a level that remains roughly 20 percentage points higher

CHART 5. VEHICLE LOAN TERMS HAVE GOTTEN LONGER AND LONGER



Source: JD Power and Associates

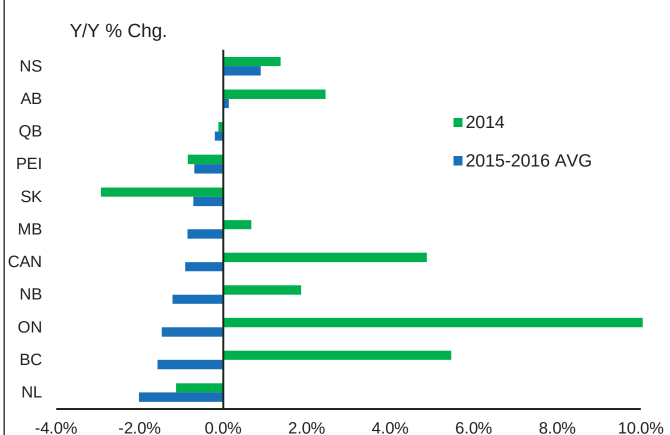
than the pre-crisis share. Meanwhile, the share of vehicles leased remains at less than half of the levels seen prior to the recession. This is likely due in part to the fact that monthly payments spread over more years can be comparable to that of a lease – and without the restrictions that come with a lease, such as a limit to the number of kilometers driven.

While the increased use of longer loan terms is supportive for auto sales given the improved affordability, there is a risk that it will lead to longer purchasing cycles, as many consumers will not purchase a new vehicle before the old one is paid off. For example, consumers who finance a vehicle for 72 months are not likely to be in the market for a new automobile after four years, as they would have been had they leased the vehicle or financed it for a shorter term. For those consumers who would like to upgrade before the financing term expires, they would have to pay off the remaining balance which could be a large chunk of money depending on where in the cycle they are. Hence, if these longer loan terms persist, it could lead to a period of lower sales down the road.

Where to from here?

Looking ahead, most of the factors that have underpinned the strong performance in Canadian auto sales are unlikely to provide the same amount of strength going forward. A stabilization in vehicle ownership rates and limited pent-up demand will cease being a tailwind for auto sales. Meanwhile, more headwinds are appearing. Interest rates are expected to begin increasing next year, which will bite into discretionary spending and may lead vehicle affordability to slip somewhat. The impact of higher rates will be more acutely felt considering the elevated level of household debt across the country. Home price growth is expected to moderate over the next year and decline slightly in 2016, limiting growth in household wealth.

CHART 6. PROVINCIAL AUTO SALES



Source: DesRosiers Automotive Consultants, TD Economics

TABLE 2. PAYMENT TYPE FOR NEW RETAIL SALES MARKET

Year	Cash	Lease	Loan
2001	14.1%	27.0%	58.9%
2002	15.4%	28.7%	55.9%
2003	9.6%	35.9%	54.5%
2004	11.9%	39.5%	48.6%
2005	11.0%	45.0%	44.0%
2006	12.1%	41.2%	46.7%
2007	12.6%	42.4%	45.0%
2008	15.5%	24.0%	60.5%
2009	16.5%	7.1%	76.4%
2010	17.1%	14.7%	68.2%
2011	16.2%	15.9%	67.9%
2012	13.0%	20.2%	66.8%
2013	12.5%	18.7%	68.8%

Source: DesRosiers.

That being said, the rise in interest rates is likely to be very gradual, and given longer loan terms, affordability will generally remain favorable in the near term. As well, the outlook for a moderate pickup in economic growth in Canada is likely to translate into somewhat better job creation, as well as mildly higher incomes, two factors that are typically supportive of auto sales. As a result, Canadian auto sales should be able to hover around current lofty levels, but the years of strong annual sales gains are likely in the rear view mirror.

Overall, we expect auto sales to edge down by 0.5% in 2015 and slip by 1.7% in 2016. Performances across the country will be mixed. While the outsized gains recorded this year will likely expend a significant amount of the pent-up demand in Ontario and B.C., there will likely be enough outstanding to ensure that auto sales remain at a relatively lofty level at least for 2015, before mildly declining in 2016. These are also two provinces that are expected to see a cooling off in their housing markets over the next few years. Nova Scotia and Alberta (even taking into account lower crude oil prices) are the only provinces where auto sales are expected to continue rising throughout the forecast horizon – albeit quite modestly – which is in line with solid economic growth prospects for both those provinces.

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