SPECIAL REPORT

TD Economics

May 12, 2016

CANADIAN AUTO SALES TO REMAIN LOFTY, PRODUCTION OUTLOOK UNCERTAIN

Highlights

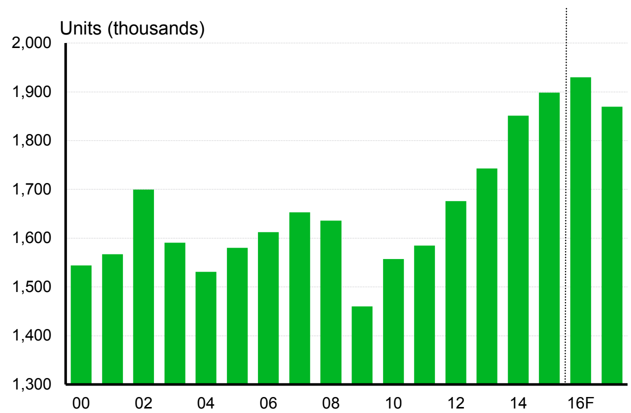
- Canadian auto sales have had a remarkable run, setting a new record in each of the last three years. Momentum has continued into 2016, putting sales on track for yet another spectacular performance this year. However, economic and industry-specific indicators suggest that the turning point is near, with sales expected to begin edging down in 2017. Still, over the medium term, auto sales will likely remain above historical averages.
- The impressive sales numbers have not been matched on the production side, with auto assembly manufacturing trending down. While a small bounce back in assembly production is expected this year, the outlook for next year and beyond remains highly uncertain, as it depends largely on the outcome of labour negotiations that will take place later this year.
- Auto parts manufacturing has been picking up some of the slack and opportunities for further growth are expected to rise alongside the technological advancement that is taking place within the industry. This is true for both traditional parts makers, as well as engineering and communication firms, as vehicles become more automated and connected.

Canadian auto sales have had a spectacular run, blasting through expectations and setting a new record in each of the last three years. Last year's sales tally of nearly 1.9 million units was particularly impressive given the struggles within the broader national economy. However, economic activity picked up heading into 2016 and auto sales followed suit – the sales tally for the first four months of the year was up by a whopping 9% versus year-ago levels. As such, the industry is on track to hit yet another record high this year.

While sales are running strong, the headline number masks diverging performances across regions. Indeed, oil-driven Alberta and Saskatchewan have recorded sizable declines in recent months, while gains elsewhere have more than offset this weakness.

Going forward, although some supporting factors will be present across the country, the regional divergence in auto sales is set to continue alongside varying rates of economic activity in each province. However, with the top performing economies in Central Canada and B.C. accounting for nearly three quarters of all new vehicles sold in Canada, the gains will continue to outweigh the losses. Given that auto sales are cyclical by nature and prone to ebbs and flows, sales will not rise forever. But, predicting the turning point is challenging – particularly following last year's gravity defying performance. Our outlook for underlying economic and industry-specific conditions suggest that auto sales will continue to rise this year, reaching 1.92 million units, before pulling back to 1.87 million units in 2017. While further

CHART 1: CANADIAN AUTO SALES



Source: DesRosiers; Forecast by TD Economics as at May 2016.

Dina Ignjatovic, Economist 416-982-2555

declines are likely to follow post-2017, demographic trends should keep auto sales elevated relative to historical norms over the medium term.

Within the Canadian auto industry, the robust sales performance has not been matched by the production side as assembly output has followed a downward path. Auto production is expected to bounce back modestly this year following last year's 5% decline; however, the future of auto assembly production in Canada beyond 2016 remains highly uncertain. Labour negotiations set to begin later this year will be crucial to automakers' decision-making process, and the outlook for Canadian auto production should become clearer once a deal with the union has been made.

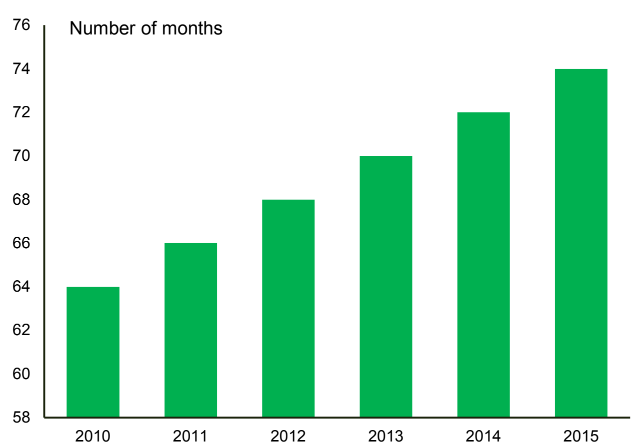
Notwithstanding, the technological development that has taken place in the auto sector in recent years has provided new opportunities for parts makers, as automakers have increasingly been looking to them for new innovative products in order to remain competitive in the rapidly changing environment. Given its highly skilled workforce and engineering and technological hubs, Canadian firms – both within and outside the automotive space – are well-positioned to take advantage of the future demands of the industry, and have the potential to increase the auto sector's footprint in the economy.

Affordability propping up auto sales

Auto sales have been one of the bright spots in an economy that is slowly adjusting to the low oil price environment. Indeed, with economic conditions not particularly favourable for auto sales over the last year, Canadians have managed to keep the record-breaking streak going. Attractive financing conditions have likely been a key driver underpinning the robust sales figures, with interest rates at rock bottom levels and loan terms being extended. In fact, the average loan term in Canada has risen steadily since 2010 and is now sitting at 74 months (Chart 2). Longer loan terms, combined with low interest rates, are making monthly payments quite reasonable for consumers. In fact, while leasing has also roared back to life since the recession, offering consumers an even more affordable option, financing the purchase of a vehicle is by far the preferred option, accounting for about two thirds of new vehicle sales (Chart 3).

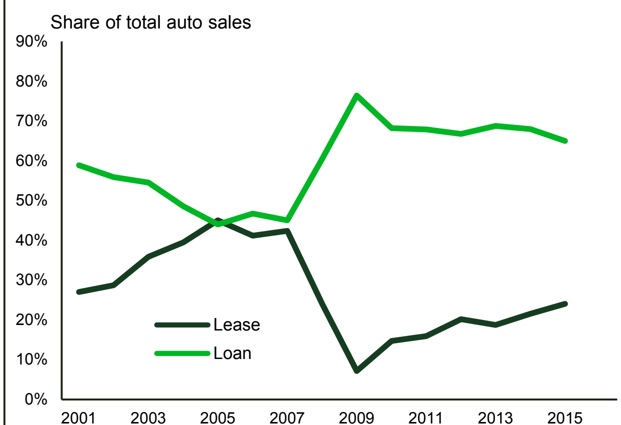
These financing terms have also enabled consumers to purchase more expensive vehicles. Average transaction prices have been trending up in recent years but not entirely due to higher price tags. The shift toward light trucks and luxury vehicles means that consumers are opting for more expensive vehicles on average, which ultimately leads to an increase in the average price paid (Chart 4). Longer loan

CHART 2: AVERAGE AUTO LOAN TERMS



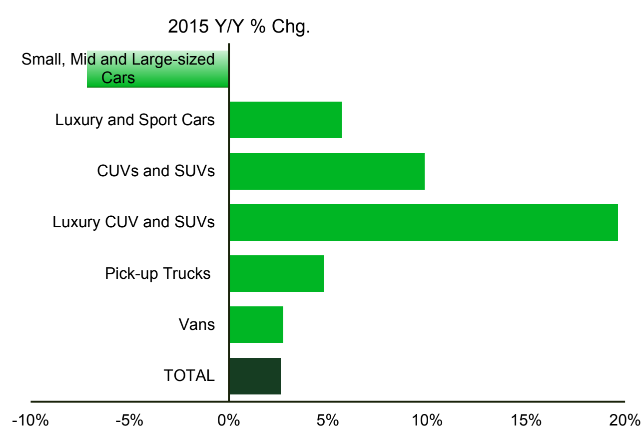
Source: FCAC

CHART 3: LEASING VS FINANCING



Source: DesRosiers.

CHART 4: AUTO SALES BY SEGMENT



Source: Wards Auto, TD Economics

terms and the low cost of borrowing allow them to do so without increasing the financial burden relative to what they would pay for a more inexpensive vehicle with more conventional financing terms.

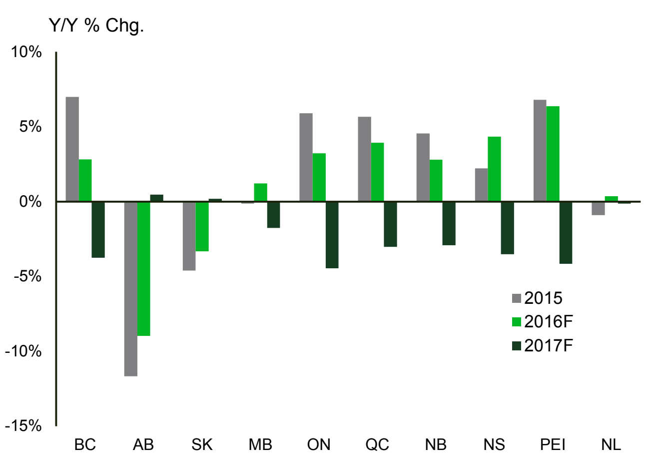
Going forward, financing conditions are likely to remain favourable for some time. The Bank of Canada is unlikely to move off the sidelines for the foreseeable future, keeping the overnight rate at 0.50% through the end of next year. Together with leasing availability and extended loan term options, the affordability of a new vehicle is likely to remain quite high.

Economic support varies by region

While affordability will certainly be supportive, economic conditions must also be considered when forecasting auto sales. Indeed, auto sales are typically an indication of the overall health of an economy. Looking beyond the headline figure, this certainly appears to be the case throughout most of Canada, as sales in oil-hit Alberta, Saskatchewan and Newfoundland and Labrador were down last year, while sales in top-performing Ontario, B.C. and Quebec recorded sizable gains. The trend has continued into this year, with one exception: sales in Newfoundland and Labrador are up handsomely, while the economy is in what is likely to be its third year of recession.

Looking ahead, varying economic performances across provinces is expected to continue, with the oil-producing provinces continuing to struggle, while an uptick in manufacturing and exports support stronger growth in B.C. and Central Canada. This will have implications for auto sales in each region, as some of the key drivers of sales, including employment, incomes and housing activity will be moving in different directions. Further strength in auto sales in Ontario and Quebec will drive the overall market higher, as they account for the bulk of national sales. Alberta, which has been the third largest market for auto sales, is likely to be surpassed by B.C. this year, as sales in the two provinces move in opposite directions (Chart 5).

CHART 5: PROVINCIAL AUTO SALES FORECAST



Source: DesRosiers, TD Economics

CHART 6: AUTO SALES PER DRIVING AGE POPULATION

Source: DesRosiers, Haver Analytics, TD Economics.

Sales to lose steam in 2017

The favourable economic backdrop throughout most of the country should help to propel sales higher this year. However, momentum in this notoriously cyclical market is poised to fade over the medium term. The run up in sales seen over the last six years has led to an increase in the ratio of sales per driving age population, which has now exceeded the long-run average for the last three years. Still, even with this run, the ratio is has not reached the peak seen in 2002 (Chart 6). While overshooting can happen – particularly following a period of below trend sales – the ratio does tend to revert back to the trend over time. There are a few notable factors that are likely to aid in this reversion in the coming years.

First is the lack of pent-up demand. While the sales-to-population ratio has not reached the peak seen in 2002, it was the second highest level on record last year, and is set to rise further this year if sales continue to move higher as we expect. Moreover, on a regional basis, sales in all provinces are either at or above the trend relative to the population. Alberta is the only region that may have some pent-up demand next year, following two years of sharp declines.

Moreover, the average age of vehicles on the road in Canada has risen over the past ten years, but at about half the pace seen in the United States. With durability of vehicles having improved, the slow rise suggests that Canadian consumers have not been holding back on new vehicle purchases, further substantiating the view that there isn't much pent-up demand for autos. Without pent-up demand, sales can only rise so far.

Another factor that will bring the sales per driving age population ratio back toward the trend is the high level of household indebtedness. After holding relatively steady in 2012-13, the debt-to-income ratio in Canada has resumed its upward trek, with Canadian consumers holding more debt than ever before. Eventually, consumers will need to slow down the rate at which they are racking up debt – regardless of affordability – which does not bode well for big ticket items such as autos.

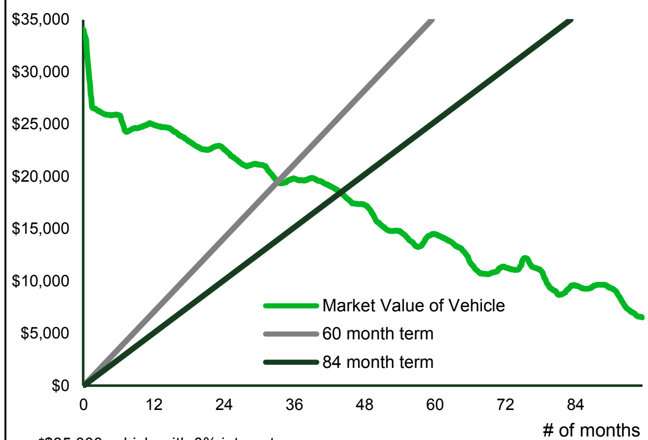
Somewhat related is the fact that growth in longer loan terms mean that consumers are in a negative equity position for a longer period of time (Chart 7). It also means that consumers are tied to their vehicles for longer, potentially stretching out the buying cycle. Several consumers may opt to trade in their vehicle before the term is up, rolling the remaining balance into a new vehicle, essentially paying for a vehicle they no longer own. This is risky for consumers who continue to trade in vehicles before any positive equity is accumulated, as they could find themselves perpetually underwater. Moreover, the larger the amount of negative equity, the harder and more costly it will be to obtain financing. For consumers that are already highly indebted, this may not even be an option.

While certainly providing a boost to auto sales in recent years, extended loan terms may not be sustainable over the long term. Rolling over a loan with negative equity increases the risk level for lenders, limiting the number of times a consumer can do it. For auto sales, this means that the buying cycle will ultimately need to be stretched out. This, however, will likely become more of an issue over the medium-to-longer term.

As well, housing market activity – which has been another bright spot for the Canadian economy in recent years – tends to have a notable influence on auto sales. In particular, rising home prices increase the wealth of homeowners, and higher housing starts typically lead to higher auto sales. Housing activity, particularly in the sizzling markets of Toronto and Vancouver, appears to be close to a peak and likely to cool down over the next few years, which should weigh on auto sales in these key regions.

Lastly, the used vehicle market will increasingly provide some competition for new vehicles sales. The uptick in leasing that has occurred since 2012 means that the influx of off-lease vehicles will be on the rise over the next couple of years. Hence, after years of tight supply and consequently, higher prices, the inventory of younger, used vehicles is set to grow, weighing on prices and providing consumers with a suitable alternative to a new vehicle. Indeed, much of the new technology that has attracted consumers into showrooms in recent years is now available in pre-owned vehicles, which along with more supply and lower prices, should steal some sales from the new vehicle market.

CHART 7: TIME IN NEGATIVE EQUITY POSITION



*$35,000 vehicle with 0% interest.
Source: J.D. Power, 2013.

All these factors combined suggest that momentum is likely to lose pace. While the strong start to the year suggests that auto sales are on track for another record performance above 1.9 million units this year, sales will likely begin to edge down next year. That said, favorable financing terms and economic conditions throughout most of the country should ensure a soft landing, with sales expected to remain at a lofty 1.87 million units.

This forecast is based on our outlook for other key economic indicators. If the underlying drivers of auto sales in the Canadian economy perform better than we expect, the turning point for sales could be pushed out further. However, eventually, the market will run out of gas and return closer to trend levels.

That said, these trend levels will be higher than in the past. Given the growth in the driving age population, sales of about 1.78 million units will be required to keep the sales-to-population ratio close to trend over the medium term. So while over and undershooting this level will certainly happen, we suspect that auto sales are likely to average somewhere in the 1.75-1.80 million unit range over the medium term. In absolute terms, this is much higher than the 1.6 million unit average recorded over the 2004-08 period when the ratio was hovering close to trend levels.

Future of Canadian assembly production uncertain

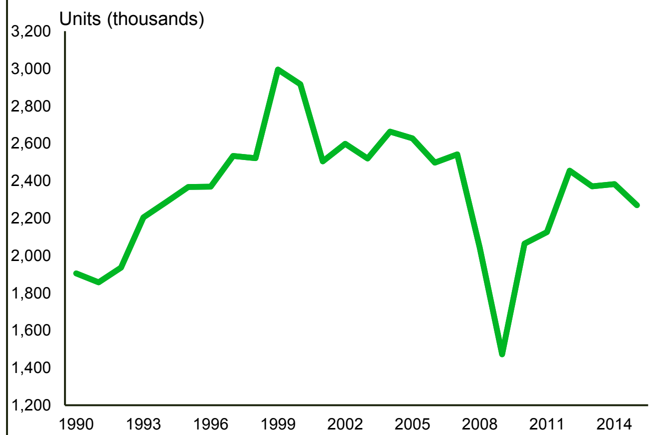
While auto sales have been supporting the domestic economy, auto assembly production has been weighing on it. Despite bouncing off the recession-induced lows in 2008-09, production in Canada has not risen back to pre-recession levels – and at this point, it is unlikely to do so (Chart 8). Since 1999, when production in Canada peaked, the bulk of new North American investment in the sector has gone to the U.S. and Mexico, where 24 new assembly plants have opened, compared to just one in Canada. This trend looks set to continue, unless Canada can find a way to compete with the incentives and cost structure in the rest of the continent.

Last year, assembly production was down by 5%, due in large part to a temporary, but lengthy shutdown of the FCA plant in Windsor as it was retooled for a new model. With the plant up and running again – and sales in Canada and the U.S. on track to reach a new record high this year – total Canadian production should bounce back modestly this year, although the rebound will be tempered by declines elsewhere – most notably GM's Oshawa plant which is ceasing production of some of models that are built there.

Beyond 2016, the outlook for Canadian assembly production is quite murky. While there have been some investments made in recent years – including at FCA's Windsor plant, Ford's Oakville plant, and GM's Ingersoll plant – the fate of some Canadian plants remains uncertain. Negotiations between the Detroit Three and the labour union are set to begin later this year and will play a key role in determining the outcome. Indeed, the union is tempering wage expectations, as its top priority is to secure investment in existing plants. GM and FCA have stated that they will not make any investment decisions until after negotiations have concluded. This could have serious implications for GM's Oshawa plant which has no new allocations announced past this year (GM's other Oshawa plant is slated to close in 2017), and FCA's Brampton plant which is in need of significant upgrades and has nothing allocated post-2019. These two plants accounted for nearly a fifth of total Canadian production in 2015, which underscores their importance to Canada's assembly sector. Negotiations will also cover Ford's engine plant in Windsor which has no new product mandates after 2017. Investment in these facilities will be the focus of the negotiations for the union representatives, while a competitive cost structure will be at the forefront for the automakers.

On that front, the recent depreciation in the Canadian dollar – and expectations for it to remain around current levels

CHART 8: CANADIAN LIGHT VEHICLE PRODUCTION



Source: DesRosiers.

for the foreseeable future – will certainly help. Indeed, the recent deal between the Detroit Three automakers and the union in the U.S. is estimated to bring all-in hourly labour costs up to US$60 for GM and Ford (previously US$55 and US$57 respectively), and up to US$56 for FCA workers (previously US$47) by the end of the 4-year term. Average hourly labour costs in Canada are estimated to be C$60-62, translating into a very competitive US$48-50 with the loonie at 80 US cents. That said, automakers will not make decisions based on currency alone, and Canada is undeniably facing tough competition from some U.S. states and Mexico – particularly when it comes to government incentives.

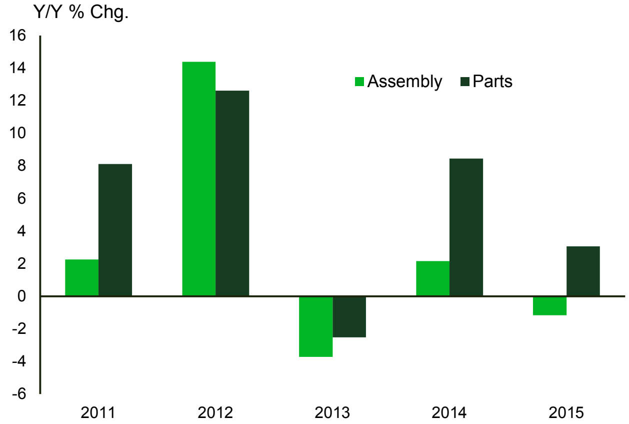
The good news is that sales in both Canada and the U.S. are expected to remain at lofty levels over the medium term, underpinning robust demand for autos. Some Canadian plants will certainly benefit from this strong demand; others will have to wait to see how the labour negotiations and subsequent decisions of automakers play out.

Parts manufacturing providing some offset

While assembly production has taken a hit in Canada, auto parts manufacturing has picked up some of the slack, with output rising by about 3% last year (Chart 9). Parts makers have benefited from the robust sales performance as well as the slew of new models being introduced over the last year that have required new and innovative products. Going forward, while Canada's assembly production sector will continue to compete with other low cost regions, parts makers will be presented with a plethora of opportunities to grow.

Indeed, the massive degree of technological advancement that has taken place over the last decade – with respect

CHART 9: AUTO PARTS VS ASSEMBLY MANUFACTURING



Source: Haver Analytics / Statistics Canada.

to lowering emissions, increasing safety, and expanding connectivity and automation – has increased demand for new innovative products, and automakers are increasingly looking to suppliers to develop these products.

No doubt suppliers will be faced with pressures to compete for business in other regions around the world – and set up manufacturing facilities close to assembly plants. But there is still a great deal of work that can be done in Canada.

In fact, with electronics becoming a more integral part of each new generation of vehicles, the auto sector is not just about manufacturing anymore. A great deal of design and engineering will be required to keep up with the rapid technological advancements. This will provide considerable opportunities for vehicle development – not just for traditional automakers and suppliers, but for firms with no direct automotive experience as well, including those involved in hardware and software engineering and communications. Given its highly skilled workforce and expanding high-tech industry, Canada is well positioned to take advantage of the shifting vehicle landscape. Hence, despite headwinds facing Canadian auto assembly manufacturers, there is still ample scope for domestic firms to compete in the global industry and increase its automotive footprint at home.

Bottom Line

The strong start to the year suggests auto sales in Canada will continue its winning streak this year, topping 1.9 million units. While there could still be more upside in store, we suspect that underlying economic and industry-specific conditions, will take some steam out of the market in 2017, driving sales back toward trend levels. These trend levels, however, in absolute terms are expected to be above the averages seen prior to the recession, with sales in the 1.75-1.80 million unit range considered to be in line with demographics.

The same cannot yet be said for auto manufacturing in Canada, which has been struggling to return to pre-recession levels. The outlook for assembly production depends largely on the outcome of the labour negotiations that will take place later this year. However, the rapid pace of technological advancement taking place within the industry presents ample opportunity for auto suppliers, as well as engineering and communications firms, which can help the industry maintain a solid presence in the Canadian economy.

Dina Ignjatovic, Economist
416-982-2555