
OBSERVATION

TD Economics



March 1, 2013

CANADIAN AUTO SALES TO STAY STRONG, BUT FURTHER UPSIDE LIMITED

Highlights

- Canadian auto sales hit a 10-year high in 2012, falling just short of the record set in 2002.
- Several supportive factors remain in place to keep auto sales at robust levels, including the need to replace vehicles, high affordability, the introduction of new models, and high used car prices.
- However, the upside for sales is likely limited. Little pent-up demand, lackluster employment growth, a softening in the housing market and high consumer indebtedness is expected to constrain demand over the next two years.
- Overall, we expect sales in Canada to be fairly flat in 2013 and 2014.

2012 was a great year for auto sales in Canada. Not only did new vehicle sales return to pre-recession levels, but they hit a 10-year high of 1.677 million units, falling just short of the record set in 2002. Last year's performance turned out to be better than most had anticipated, leading to increased optimism for the sector going forward. In fact, if the momentum continues, they could close in on the record high this year. However, while we expect 2013 to be another good year for auto sales, we suspect that a repeat performance of the 5.7% growth seen last year is unlikely. Rather a modest 1% increase in sales this year is the more probable outcome, followed by a slight decline in 2014.

2012 in review

Early in the year, sales were propped up by the return of supply of Japanese-brand vehicles which had been limited due to the earthquake and tsunami. Indeed, after seeing their share of the market slide in 2011, Toyota and Honda came back strong last year, with each automaker gaining just over a percentage point of the market – largely at the expense of GM and Ford. As a result, while Chrysler managed to hang onto its gains from the previous year, the Detroit-3 automakers as a group saw their share of the market slide back below 45%. Still, Ford, Chrysler and GM remained the top selling automakers in Canada.

Later in the year, the introduction of a slew of new and redesigned vehicles for the 2013 model year helped to boost traffic in new car showrooms, resulting in higher sales. But, perhaps one of the biggest factors supporting sales over the course of the year was extremely favourable credit conditions. Not only have borrowing rates remained quite affordable, but lenders have been offering attractive financing options such as longer loan terms. In fact, in 2012, 58% of new vehicle loans were for a term of 72 months or longer. That is up from just under 40% in 2010 and only 15% in 2007. Growth in chartered bank loans to purchase private passenger vehicles was up 11% y/y in the third quarter of 2012 (latest available data), which is above the average 4% pace seen in 2000-2007.

	Y/Y chg	Market Share	
	%	%	↑ / ↓
Ford	0.0	16.5	0.9
Chrysler	5.5	14.5	0.0
GM	-6.6	13.5	1.8
Toyota	18.8	10.6	1.2
Hyundai	5.4	8.1	0.1
Honda	22.0	7.9	1.1
Kia	19.5	4.6	0.5
Nissan	-4.5	4.4	0.5

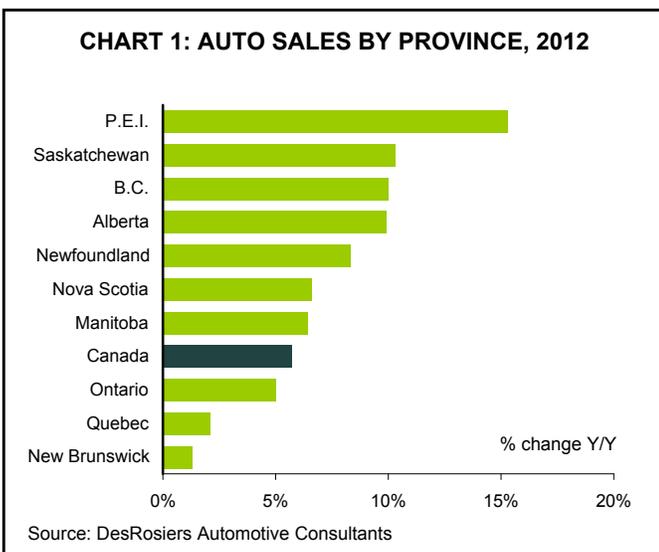
Source: DesRosiers Automotive Reports, Ward's Automotive

up, with average fuel prices during the last two years higher than at any other point in history. This trend was due partly to the strength in sales seen in the West, where light trucks are extremely popular – accounting for over 70% of sales in Alberta and Saskatchewan – as well as the fact that housing starts were particularly strong, rising 10% last year, which gave demand for pick-up trucks a boost.

As well, there appeared to be a shift in preferences among Canadian drivers towards luxury vehicles, with large luxury SUV's and compact luxury SUV's experiencing the fastest pace of growth last year, up 34% and 25%, respectively. The luxury/large/sport segment combined was up by 10% in 2012, outpacing all other sub-segments. Considering the higher sticker prices of vehicles in this category, the trend is likely due in part to the attractive financing options available for consumers. Indeed, if lenders are willing to extend the loan term, consumers are able to afford a more expensive vehicle (luxury, larger or both), with the same monthly payment that they would have under a shorter loan term for a less expensive vehicle. So long as the right incentives are in place, this trend should continue.

Canadian auto sales to remain healthy...

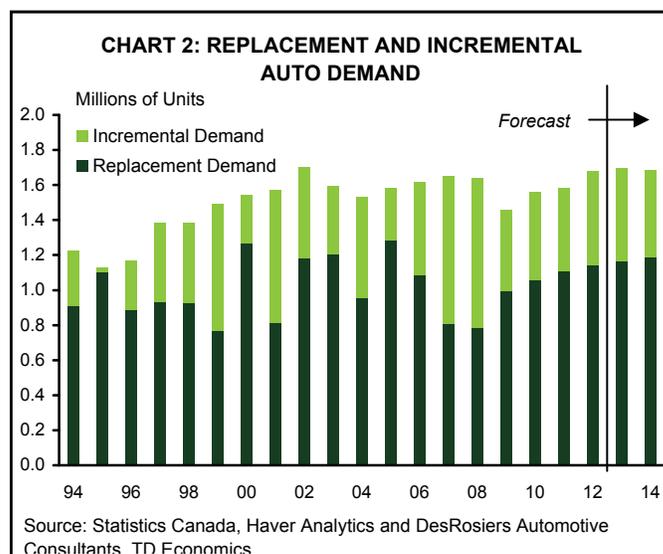
Looking ahead, auto sales in Canada are likely to remain quite healthy, supported by a few key factors. There is always an element of replacement demand in the market. On average, consumers in Canada drive a newly purchased vehicle for 8-9 years. And the portion of vehicles on Canadian roads that are aged 8 and up is just over 50%. As such, replacement demand will be a key driver of auto sales going forward, accounting for roughly two thirds of total sales – a

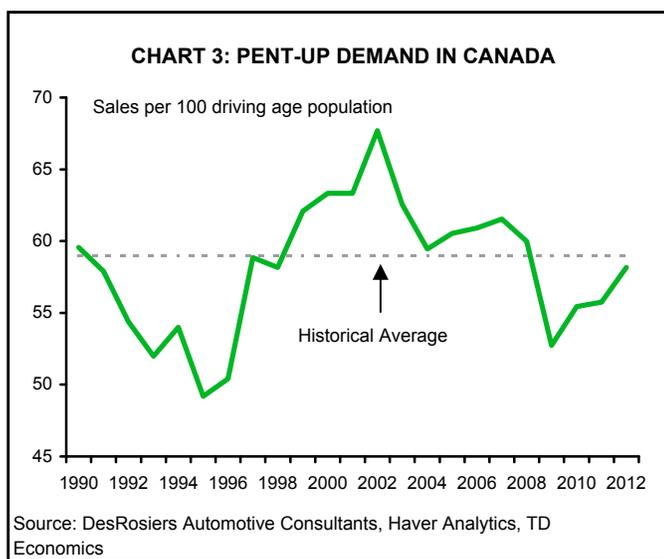


The West puts the pedal to the metal

While all provinces recorded an increase in sales last year, growth was uneven across the country. The resource rich provinces of the West were particularly strong, with B.C., Alberta and Saskatchewan all recording a gain of 10%. It was Prince Edward Island, however, that topped the leaderboard with a 15% increase in sales for the year. Meanwhile, New Brunswick, Quebec and Ontario lagged behind the national average. (See Chart 1) Looking at the level of sales, Saskatchewan and Manitoba hit a record high in 2012, while Ontario and Quebec – which together account for over 60% of total sales in the country – were still sitting about 9% and 5% below their all-time peaks, respectively.

For the third straight year, sales of light trucks outpaced sales of passenger cars, accounting for nearly 55% of total sales. Interestingly, this preference for larger vehicles has taken place at a time when gas prices have been trending





rate that is in line with historical averages. The rest will be made up of incremental demand, consisting of population growth (of the driving age population in particular), which is expected to grow at a decelerating rate over the next two years, as well as ownership rates, which we expect to remain flat. Hence, incremental demand will provide modest support for auto sales.

Moreover, affordability is likely to remain high. Prices are still sitting below pre-recession levels (in real terms), and interest rates are not expected to rise before the second half of 2014. Add to that the longer loan terms, and consumers will continue to enjoy attractively priced new vehicles over the next 18-24 months.

As well, the significant number of new and redesigned models that are hitting the market for the 2013 model year that helped prop up sales during the second half of 2012 should also be supportive for new vehicle sales this year.

Lastly, while used vehicles typically provide some competition for the new vehicle industry, used car prices are quite elevated and likely to remain on the high side this year thanks to tight supplies. Given these higher prices on pre-owned vehicles and attractive financing options for new vehicles, consumers that would typically be in the market for a used vehicle, may find themselves considering a new one.

...but the upside is limited

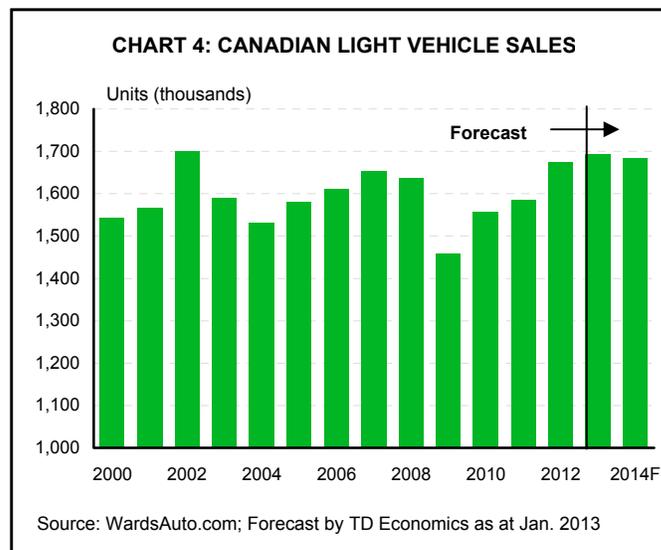
While auto sales are expected to remain quite robust, growth in sales will be limited. Given the strength in sales seen of late, and the fact that sales are sitting just under their previous peak, the market is probably quite sated. In fact, the sales per driving age population ratio suggests that there isn't

a whole lot of pent-up demand in the market. (See Chart 3)

Moreover, economic indicators do not appear to be overly supportive of higher sales levels over the next few years. Employment was surprisingly strong during the second half of 2012 given the soft overall pace of economic growth, and there will likely be some payback during the first half of this year. Overall, job creation is expected to average only 10,000-15,000 positions per month this year – well below the pace of job creation seen in the years leading up to the recession. Meanwhile, after a red-hot performance following the recession, the new home market in Canada – which typically correlates well with auto sales – is likely to cool somewhat over the next few years. Homebuilding activity is expected to fall by 10-15% from 2012 levels, while sales and prices are expected to follow a flat-to-declining trend through 2015. As such, sales of commercial vehicles – consisting of large pick-up trucks and large vans – which reached a record high in 2012 following two years of robust growth, may slow over the next couple of years.

Furthermore, the rising popularity of auto sharing programs is also likely to have a negative impact on auto sales. For consumers who do not need access to a vehicle daily or even weekly, auto sharing is an attractive option. While these companies need to purchase new vehicles to lend out, adding to sales, it could result in lower ownership rates, which would weigh on sales overall.

Perhaps the biggest factor that will restrain growth in auto sales over the next few years is the elevated level of consumer debt in Canada. The overall debt-to-income ratio is at a record high of 163%, and consumers have slowly begun to heed the warnings from the Bank of Canada and



the Department of Finance. While auto sales have held up quite well in spite of a more cautious consumer in recent months, scope for further gains in the sector is likely limited. Moreover, once interest rates begin to rise in the latter part of 2014, financing or leasing a vehicle will become less attractive. Likewise, should lenders decide to reduce the loan terms available, this could also constrain auto demand.

Much of the strength in sales over the past couple of years has stemmed from the West thanks to strong growth in the oil patch. However, with Canadian oil producers receiving a heavily discounted price for oil, growth in these economies is not going to be as strong as it has been. In fact, while they are expected to outperform the national average, economic growth in these regions is likely to slow over the next couple of years. What's more, the strength seen in the West has led the region to accumulate debt at a faster pace relative to income than other regions in the country, suggesting that credit growth among western consumers is likely to slow. As a result, the stellar performance seen in

auto sales in these provinces lately may begin to fade. Central Canada may pick up some of the slack given the recent underperformance in these markets, but Ontarians are also heavily indebted, suggesting that big-ticket purchases may not top the shopping list in the near term.

Bottom line

Overall, we expect Canadian auto sales to remain healthy, however further upside is limited. While there will be some supportive factors helping to lift auto sales, including the need to replace vehicles, high used car prices and the introduction of new models, there are many that will hamper demand. Lackluster employment growth, a cooling in the housing market, and, perhaps above all, elevated debt levels, will likely constrain growth in new vehicle sales over the next two years. We expect auto sales in Canada to increase only slightly this year, reaching 1.695 million units – the second highest level on record. Next year, however, we suspect that sales will edge down to 1.685 million units.

Dina Ignjatovic, Economist
416-982-2555

This report is provided by TD Economics. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of TD Bank Group and the members of TD Economics are not spokespersons for TD Bank Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise TD Bank Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.