SPECIAL REPORT
TD Economics

May 23, 2017

U.S. AUTO SALES HAVE PEAKED, BUT REMAIN ELEVATED

Highlights

- Auto sales kicked off the year on a soft note, falling 1.5% during the first four months versus year-ago levels. While they remain at healthy levels, signs that underlying strength in demand is fading have emerged.
- Going forward, automakers will be faced with a number of challenges, including lack of pent-up demand, competition from the used vehicle market and some tightening in credit conditions.
- However, any decline in sales is likely to be gradual, due to a number of factors including ongoing support from a strong economy and still-attractive financing conditions. Hence, sales should remain close to the 17 million unit mark over the next two years.

After hitting a new record in 2016, U.S. auto sales kicked off this year on a soft note, down 1.5% during the first four months versus year-ago levels. Even with a slowdown, sales are averaging over 17 million units – a healthy pace by any standard. That said, higher incentive spending and rising inventories suggest that underlying strength in demand is fading.

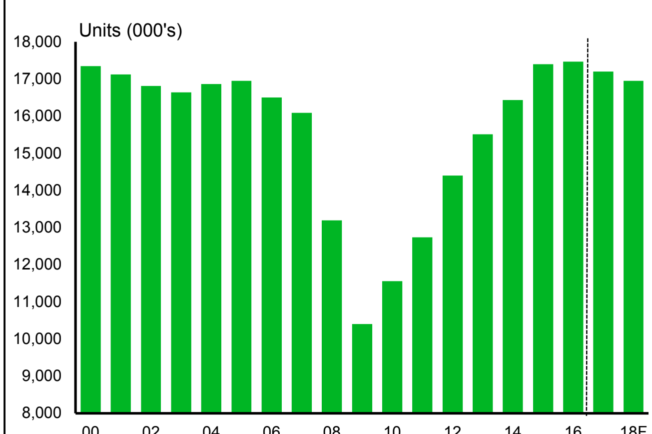
A slower pace of sales does not come as a surprise. In our report last year, we noted that automakers would be faced with a number of headwinds in 2017 that would make it difficult to record further sales growth. Indeed, longer buying cycles and new lifestyle trends suggest that current sales are likely still above their longer term trend rate. What's more, the pent-up demand during and after the financial crisis that was instrumental in taking sales to record levels has largely been sated. Meanwhile, the return of leasing a few years ago means that competition from the used vehicle market is set to intensify. These are the key challenges facing automakers in the near term.

Conditions are ripe for sales to edge lower, but only at a gradual pace due to ongoing support from solid job and wage growth, still-attractive financing conditions and the emergence of new technologies available in new models. All told, we expect auto sales to come in at around 17.2 million units this year before slipping below the 17 million unit mark in 2018.

Underlying strength in demand fading

Consumers have tapped the brakes on auto sales before only to be proven to be temporary. But, recent evidence offers a sense of more permanency to the slowdown underway this time around. Indeed, sales may been even lower if not for higher incentive spending, which averaged $3900 in the first quarter. This translates to over 10% of average transaction prices – the highest level since the recession in 2009 and above the 8.4% spent in 2012 and 2013, which is considered to be a healthy level. Despite higher incentives, inventories have been building, sitting above the 4 million unit mark for a fourth straight month in April – a trend that has only happened once before, back in 2004. At 76 days supply, inventories were well above the 70 days supply seen a year earlier.

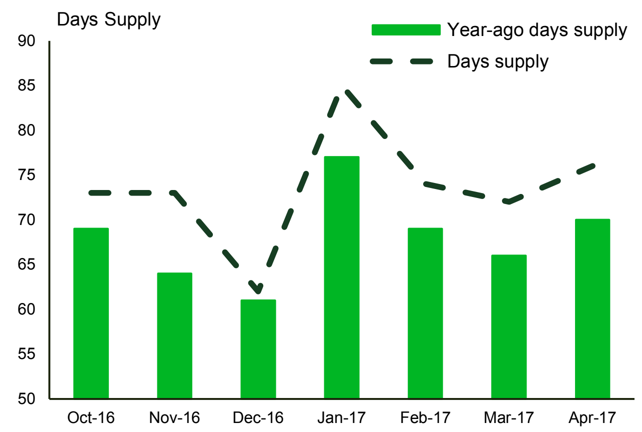
CHART 1: U.S. AUTO SALES



Source: WardsAuto.com; Forecast by TD Economics as at May 2017.

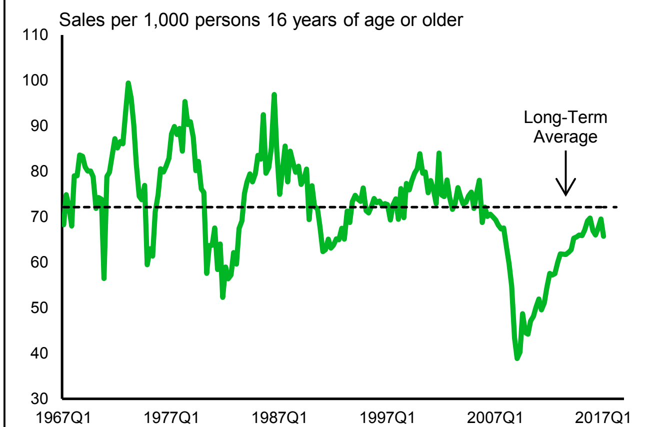
Dina Ignjatovic, Economist 416-982-2555

CHART 2: U.S. AUTO INVENTORIES



Source: WardsAuto, TD Economics.

CHART 4: SALES PER DRIVING AGE POPULATION



Source: BEA, BLS, TD Economics.

What's more, the inventory-to-sales ratio has reached the highest level since 1989, excluding the 2008-09 recession. The longer inventories remain elevated, so too will incentive spending, squeezing automakers' margins and increasing the likelihood of lower residual values.

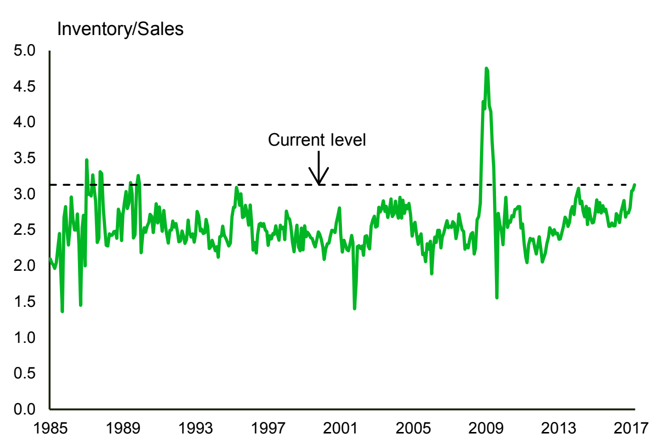
A few producers have already scaled back production in recent months to help rein in inventories and bring production more in line with demand. Some have indicated that production schedules may need to be adjusted this year if inventories continue to rise. This signals that automakers do not want to fall back into the practice of having to continually raise incentives in order to sell vehicles. But, ongoing inventory control across all automakers will be crucial for them to steer clear of those bad habits.

Some speed bumps on the road ahead

Going forward, the selling environment is likely to be more challenging than in recent years. Pent-up demand that accumulated in the years following the credit crisis has largely petered out. Since sinking to the lowest level on record in 2009, sales per driving age population has climbed back toward its long run average. And, over the last 12 quarters, that ratio has levelled off, suggesting that the current range may be the new norm going forward. This is especially true as vehicles are now made to last longer and drivers are holding onto them for longer. As such, further growth in sales from already elevated levels will be hard to come by.

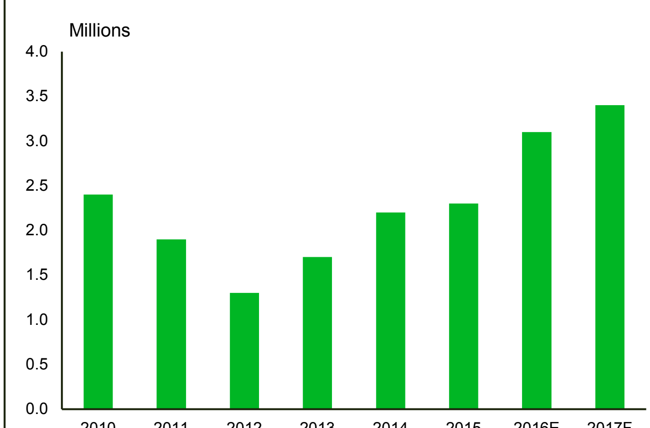
What's more, a rising number of late-model used vehicles has provided consumers with more choice. Indeed, 58% of used sales were 3-years old or newer in 2016, up from 54% a year earlier and 45% in 2012. This trend is expected to continue as an influx of off-lease vehicles is expected to increase the supply of pre-owned vehicles hitting the market

CHART 3: INVENTORY-TO-SALES RATIO



Source: BEA, Haver Analytics, TD Economics.

CHART 5: OFF-LEASE VEHICLES



Source: J.D. Power, WardsAuto, TD Economics.

by around 5% this year. This, in combination with lower prices for new cars thanks to incentives, will put downward pressure on used vehicle prices from their record levels. In turn, the new vehicle market will absorb the knock-on effects of intensified competitive pressures. Automakers will have to work hard to maintain strong residual values, without relying too heavily on incentives. With lease penetration on the rise – reaching 31% of total new car sales in 2016 – pressure from the used vehicle market is unlikely to relent over the coming years.

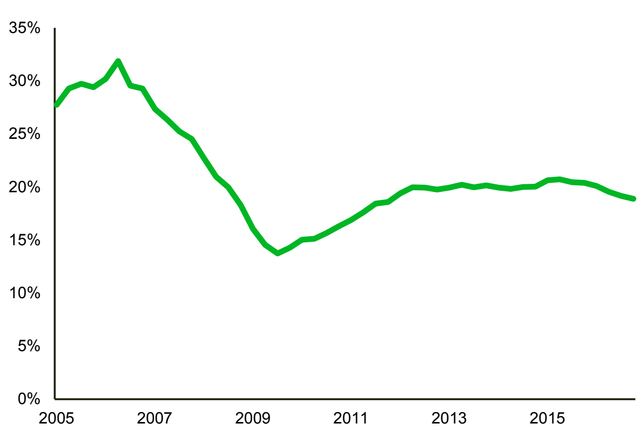
Credit conditions may be tightening, but still big appetite for auto loans

A tightening in credit conditions could also pose a challenge considering that about 85% of new vehicle sales require a loan. An uptick in subprime delinquency rates has triggered concerns surrounding the health of the auto financing market. As a result, some lenders – particularly banks – have signaled a tightening in lending conditions with higher interest rates or down payment requirements.

Loan originations to subprime borrowers peaked at the end of 2015 and have stabilized at a slightly lower level over the last couple quarters. Meanwhile, originations for higher quality borrowers have continued to rise. As such, subprime originations as a share of total auto loans never returned to its pre-crisis peak and have actually been falling since mid-2015. This could be a sign that lenders are shifting toward more high quality loans.

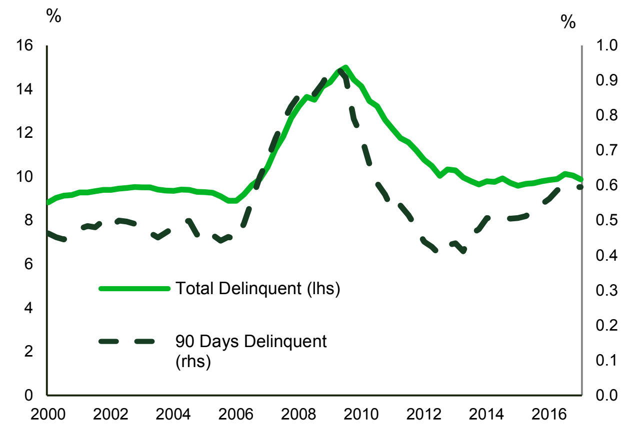
Overall, the state of the auto financing market is not too worrisome at this point. Subprime delinquency rates for other types of loans such as credit cards and lines of credit have also been on the rise and are higher than that of autos. Moreover, past experience shows that consumers tend to prioritize their auto payments ahead of other financial obligations. And, while subprime delinquency rates have risen, they remain quite low; around 0.6% of borrowers were seriously delinquent (90 days past due) in the last quarter of 2016, with that rate having leveled off over the last three quarters. The total delinquency rate among these high risk borrowers was under 10%, which is roughly in line with pre-recession norms.

CHART 6: SUBPRIME ORIGINATIONS AS A SHARE OF TOTAL



Source: Equifax, TD Economics.

CHART 7: SUBPRIME DELINQUENCY RATES



Source: Equifax, TD Economics.

Meanwhile, there still appears to be a great deal of appetite among lenders for auto loans, with any tightening more concentrated in the subprime segment, which represents less than a fifth of the overall market. Moreover, growth in issuance of auto asset backed securities has decelerated somewhat this year, but is on track to remain in line with levels seen in recent years. Hence, although credit conditions may have tightened in recent months, it has yet to have a material impact in the auto lending space.

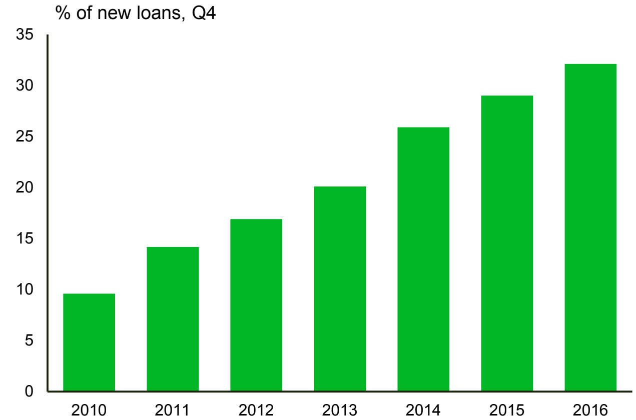
Slower but still healthy

While demand may be softening, there will be a number of supportive factors to keep sales historically high. Following a disappointing first quarter, the U.S. economy is expected to bounce back, with growth averaging roughly 2.5% over the remainder of this year, and 2.1% in 2018. Employment and income growth is also expected to remain strong, with the jobless rate at a very low 4.4% and projected to trend lower through 2018, and real disposable income to grow at a solid pace of about 2.5%. Meanwhile, consumer confidence has surged in recent months, reaching the highest level seen since December 2000. And housing starts, which are a key driver of auto sales, are expected to continue growing over the forecast horizon, supporting overall demand for new vehicle sales.

CHART 8: INTEREST RATE ON 48-MONTH NEW CAR LOAN

Source: Federal Reserve, TD Economics.

CHART 9: LOAN TERMS



Source: Experian Automotive, TD Economics.

Affordability will also remain favorable for buyers. While the Federal Reserve has shifted into tightening mode – with two additional rate hikes expected this year – interest rates still remain low by historical standards. Indeed, at 4.5%, the commercial bank rate for a 48-month new car loan is well-below the 8% rate seen prior to the financial crisis and roughly in line with that seen in 2013-14. While interest rates are expected to continue creeping up, any increase will be gradual leaving them at affordable levels. What's more, loan terms have continued to stretch out, with 32% of new vehicle loans 72 months or longer in the fourth quarter of last year – well above the 26% share in 2014 and 10% share in 2010. Longer terms could help to offset the increase in interest rates, leaving overall financing conditions attractive for new car buyers. This will be supportive for sales in the near term, but could limit auto sales down the road as it could lengthen the time between purchases.

Aside from affordability, there are a few other factors that should help entice consumers to visit showrooms. Despite the record level of sales in recent years, the average age of the vehicle fleet on the road is now sitting at 11.6 years. While vehicles are lasting longer, some of the older ones will eventually need to be replaced, supporting demand for sales. Moreover, a number of new and redesigned models are entering the market this year, along with new technologies that continue to enhance the driving experience and prompt drivers to upgrade their vehicle. This is one aspect that will keep some consumers in the market for a new vehicle rather than purchasing a pre-owned one.

Bottom line

After an impressive few years, U.S. auto sales are likely to shift into a lower gear. Pent-up demand is now largely satisfied and there are already signs that demand for new vehicles is beginning to fade. While sales are expected to fall short of last year's record 17.5 million unit pace this year, there are several factors that will help to keep them propped up in the near term, chief among them continued gains in employment and wage growth, and still-attractive financing terms. All told, we expect auto sales to average 17.2 million units this year, before slowing to just under the 17 million unit mark in 2018.