OBSERVATION

TD Economics

January 17, 2012

U.S. AUTO SALES COMING BACK TO LIFE… SLOWLY BUT SURELY

Highlights

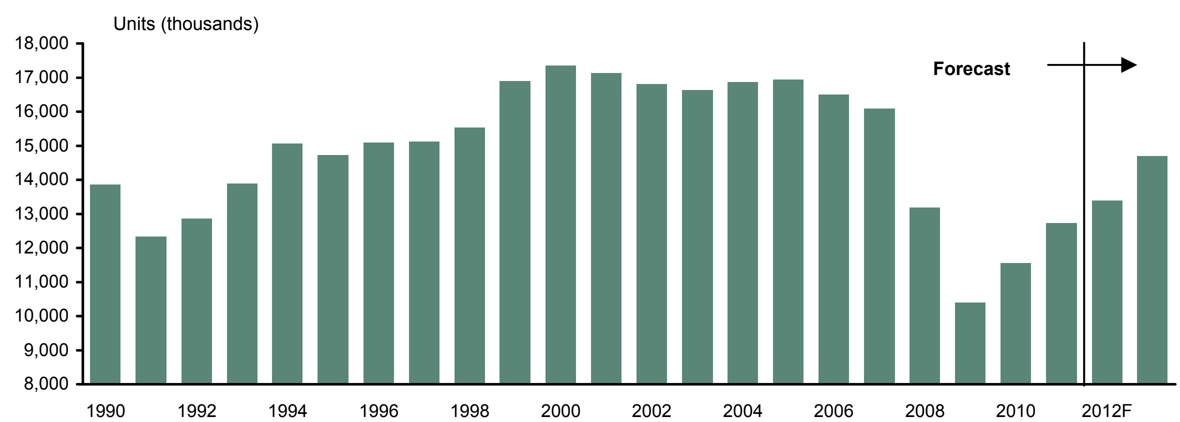
- U.S. auto sales sputtered in the middle of 2011 as the industry was faced with some unexpected challenges. However, the fourth quarter saw a sharp bounce back, and sales entered 2012 on a high note.
- The outlook for U.S. auto sales remains bright. Fierce competition among automakers, increased affordability and a considerable amount of pent-up demand will lead to further growth in auto sales.
- We forecast new light vehicle sales to rise modestly in 2012, reaching 13.4 million units. In 2013, as economic conditions and market sentiment improve, sales are expected to tally 14.7 million units.

After a robust gain in 2010, auto sales are expected to turn in another decent advance in 2012-13 but not without some ups and downs. While chill-winds emanating from Europe are expected to exert a cooling force on both U.S. job growth and sales activity at new car dealerships, we don't anticipate this softness to persist into the second half of the year. As the global economic picture brightens later this year, U.S. economic growth is projected to record a moderate rebound. At the same time, a combination of highly favorable affordability and considerable unsatisfied demand for vehicles are poised to provide both a floor under which sales can drop in the near term and pull sales higher over the medium term.

Automakers encountered some unfortunate surprises in 2011

Auto sales kicked off 2011 with some gusto, but this momentum quickly ran out of steam, due in part to Mother Nature. The earthquake and tsunami that hit Japan in March was followed by massive

CHART 1: U.S. LIGHT VEHICLE SALES



Source: WardsAuto.com; Forecast by TD Economics as at Jan. 2011

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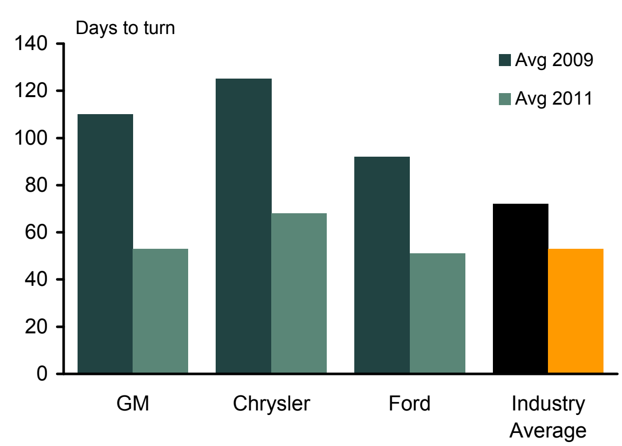
flooding in Thailand, leading to supply chain issues and, consequently, a shortage of inventory for Japanese automakers – particularly Toyota and Honda. Complicating matters was the heightened volatility in financial markets stemming from growing concerns about sovereign debt in the U.S. and Europe, which likely sent many consumers to the sidelines. Accordingly, vehicle sales slowed markedly during the spring and summer months.

However, the tide turned again during the fourth quarter of 2011. Despite several uncertainties – both domestically and abroad – economic growth in the U.S. accelerated to an estimated rate of about 3.2% (annualized), providing a shot in the arm to U.S. employment. With the creation of over 400,000 net new jobs during the quarter, the unemployment rate fell to a three-year low of 8.5% in December. Meanwhile, a normalization of inventories among the Japanese brands helped auto sales gain some traction during the quarter as well. In fact, U.S. light vehicle sales in November and December (on a seasonally adjusted annualized rate basis) shot up to the highest level since August 2009 when the government-backed cash for clunkers program gave sales a post-recession boost. Aside from that artificially inflated month, the level of sales during the last two months of the year was the highest since August 2008. Overall, new vehicle sales in the U.S. tallied 12.7 million units, marking a 10% improvement over 2010. Although this tally is still a far cry from the 16+ million level recorded prior to the recession, sales are up some 20% above their lows seen in 2009.

The improvement in sales in 2011 did not benefit all automakers. The relative performances and rankings of key automakers are shown in Table 1. Toyota and Honda each suffered a drop in sales of 7% last year and lost a combined 4 percentage points in market share. Despite losing market share for two consecutive years, Toyota was able to remain the third best seller in the country. Honda, on the other hand, slipped in the ranks from 4th place to 5th place, behind Chrysler, who saw sales jump 26% during the year. Ford and GM were also able benefit from the losses of the biggest Japanese automakers in the U.S. market, with the Detroit-3 total market share rising to 47%, up from two years at 44-45%.

CHART 2: U.S. LIGHT VEHICLE INVENTORIES



Source: Edmunds.com, Ward's Automotive

TABLE 1
2011 U.S. LIGHT VEHICLE SALES PERFORMANCE BY BRAND

	Y/Y chg	Market Share	
	%	%	↑ / ↓
GM	13.2	19.7	0.6
Ford	10.8	16.6	0.1
Toyota	-6.7	12.9	-2.4
Chrysler	26.1	10.7	1.4
Honda	-6.8	9.0	-1.6
Nissan	14.7	8.2	0.3
Hyundai	20.0	5.1	0.4

Source: DesRosiers Automotive Reports, Ward's Automotive

2012 to begin where 2011 left off

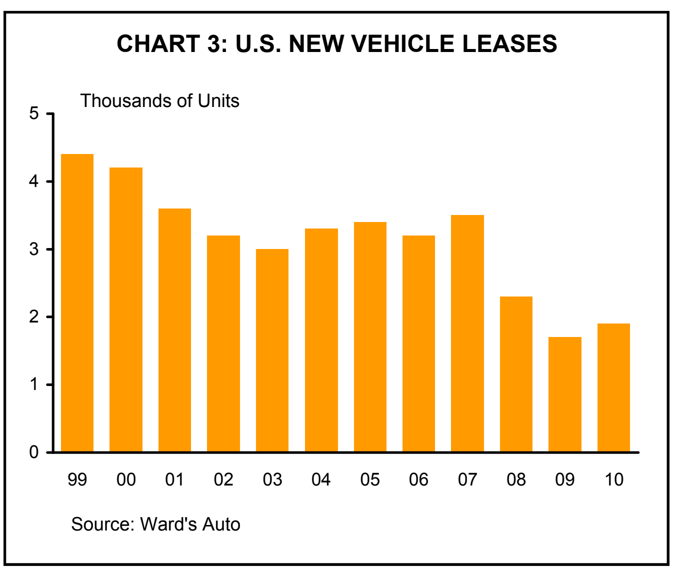
We expect the momentum witnessed at the end of 2011 to carry into the early part of 2012. Ongoing improvements in inventory levels of brands affected by the natural disasters will continue to deliver a boost to sales. More importantly, competition in the industry is set to become fierce. There is some speculation that Toyota and Honda will attempt to recoup their lost market share by boosting incentives which have been relatively lean over the past year compared to incentives on other brands. If this is the case, it will be a real test for the Detroit-based automakers, which in the past have resorted to high incentives to respond to competition challenges, but have vowed to stay away from that game. The Detroit-3 have indeed been much more disciplined in the post-recession and post-GM and Chrysler bankruptcy era, with incentives down a combined 22% from 2009 levels. These automakers have been able to keep incentive spending down because inventories have also been slashed since 2009 (see Chart 2), suggesting that the automakers are sticking to a demand-pull strategy. Despite the drop seen this year, incentive spending is still above the industry average for all three, suggesting that they may not have much more room to maneuver. Either way, with two key automakers returning to the market at full – or near-full – strength and others trying to retain the market share that they have just gained, competition is likely to intensify. This bodes well for consumers.

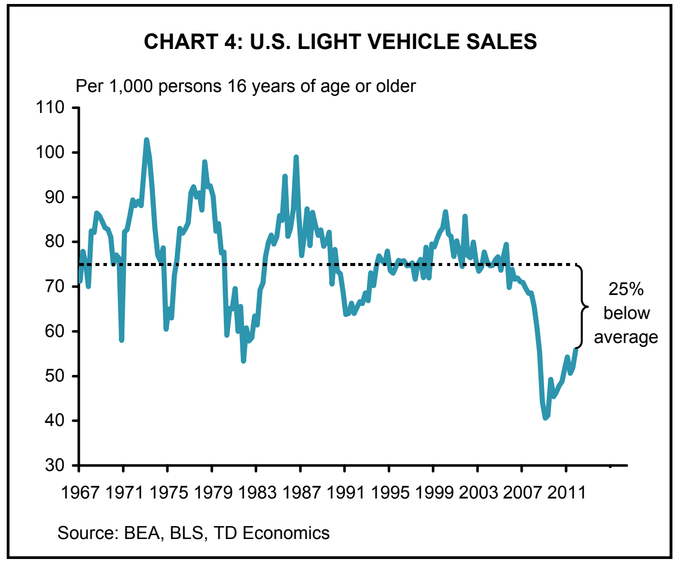
Weaker economic backdrop to limit sales this spring

Much like 2011, sales trends this year are unlikely to follow a straight line upward. The debt crisis in Europe is expected to worsen in the first half of the year, sending further shockwaves through global markets and knock-on effects to the U.S. economy and job market. We believe the U.S. will avoid a recession, but economic growth is unlikely to average more than 1.5% (annualized) during the first half of the year. Under the assumption that the crisis eases later this year, the U.S. economic expansion would gain renewed strength. However, the moderate sub-3% growth rate projected would not be strong enough to put a further major dent in the jobless rate. On top of our expectation of tepid economic growth in the near term, sales are likely to be hit by softening consumer confidence.

The setback can only be so deep and prolonged

The good news is that sales managed to record some decent gains last year notwithstanding the challenging environment. What's more, the fact that auto sales have been rising at a time when consumer confidence is quite low relative to historical standards just goes to show how much pent up demand exists in the market. In fact, using the 16 million unit pace of sales seen prior to the recession as a benchmark, the cumulative drop in sales over the past three years was roughly 13 million units. That is more than





the number of vehicles that were sold in 2011 as a whole! Furthermore, as shown in Chart 4, auto sales relative to the driving age population remain 25% below the average seen over the past four decades.

The need to replace an aging fleet is expected to be a key factor helping to drive underlying sales demand. It is true that cars are generally made to last longer nowadays. And since the recession began, many drivers have been hanging onto their vehicles for longer, with the average age of vehicles on U.S. roads now at 11 years – about 1 year longer than in 2007. But cars don't last forever and as vehicles age, drivers become increasingly anxious to replace them. Pre-owned vehicles have been a great substitute, but we expect to see a shift in favor of new vehicles over the next few years. Weaker new vehicle sales since 2007, combined with lower volumes of leasing over the same time frame (lease sales in 2009 tallied less than half of what they were in 2007), suggests that the supply of 2-4 year-old vehicles is dwindling. This short supply is likely to put upward pressure on prices, thus sending purchasers of the younger vintages of used cars into the new vehicle market. What's more, several automakers will be introducing new and redesigned models in the coming year, which typically results in increased demand relative to the status quo, as consumers tend to put off purchases until the new models become available. This, coupled with the increased availability of the models affected by the natural disasters, should lead to increased traffic in showrooms.

Other ingredients will help to sustain the recovery in sales this year despite choppiness in the economic environment:

- *Household balance sheets have been strengthening:* the massive de-leveraging that has taken place over the past couple of years has led to a considerable improvement in household balance sheets. In fact, the household debt-to-income ratio has fallen to 145%, from a peak of 164% in 2007.

- *Credit conditions have been improving:* average credit scores on new auto loans have been on a downslide since the first quarter of 2010, as more subprime borrowers have been gaining access to credit. And given that 90% of sales require some type of financing, this easing in credit conditions increases the pool of potential buyers. Moreover, after falling through much of 2010, non-revolving credit rebounded in 2011 and has been growing by about 5% Y/Y for the past six months. This is as good a signal as any that credit availability is improving and low interest rates are helping to stimulate demand.
- *Interest rates are expected to remain low:* we expect the Fed Funds rate to hold steady until mid-2013, keeping retail borrowing rates anchored at low levels and making it easier for consumers to purchase big-ticket items.

Recovery to continue – slow but steady

All told, pent up demand, a positive outlook for consumer finances, fierce competition, increased availability of some vehicles, and the introduction of several new models will set the stage for a further rise in auto sales this year. We expect new vehicle sales to advance by a modest 5.2% in 2012, which will bring sales back up to 13.4 million units. The outlook for 2013 is even better, as economic conditions and market sentiment are expected to gain some further traction. Accordingly, we foresee sales climbing to 14.7 million units in 2013, marking a 10% rise. This forecast profile suggests that, like the economy in general, the recovery in auto sales will likely be slow and steady, rather than a V-shaped bounce back that would typically be seen after such a sharp drop.

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