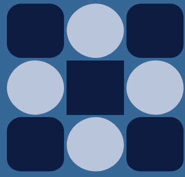

Perspectives

American Auto Market

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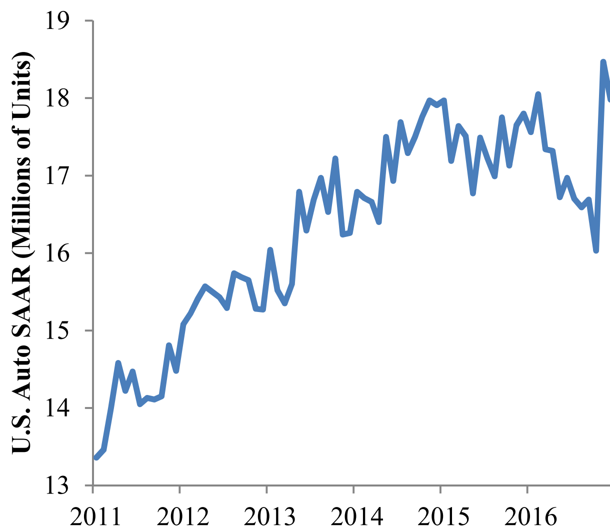
The U.S. auto industry has undergone a tremendous turnaround from the depths of the great recession. Since 2008, sales have skyrocketed from a seasonally adjusted annual rate (SAAR) of 9 million vehicles sold in 2009 to 17.5 million* vehicles in 2016. Despite the stellar performance of the past few years, there are numerous signs of peaking auto sales. Incentives are running at elevated levels. Lease rates and loan terms have become more lenient, with longer term leases at favorable interest rates, marking similar signs in the run up to 2008, while 60 and 90 day delinquencies on payments have ticked up slightly. We view the industry as well positioned to weather the profit impact of these types of normal cyclical events and believe economic conditions remain supportive. From an investment perspective, we maintain a cautious outlook on the sector given the concerns outlined below and full valuations following recent bond outperformance.

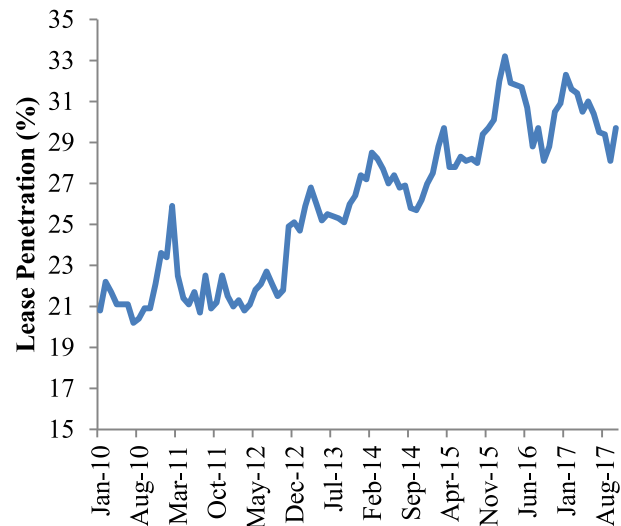
Exhibit 1: U.S. auto sales showing signs of peaking with recent strength due to replacements from Hurricanes Harvey and Irma



Source: Ward's Automotive

One of the key drivers of moderating U.S. sales right now is the glut of vehicles rolling off lease and hitting the used market, which is lowering used prices and making them more attractive on a relative basis to new vehicles. Industry watchers pay attention to used pricing as not only is it a big driver of profitability through lowering new vehicle sales, but also through residual values, as overly weak residual values force the OEMs' (original equipment manufacturers like Ford) financing companies to take write-downs on their balance sheets. Edmunds reports that leases accounted for nearly 31% of all vehicles sold in 2016, and have grown nearly 50% over the past five years.

Exhibit 2: Lease penetration has been increasing, pressuring car prices as vehicles come off lease



Source: Edmunds.com

Additionally, as new vehicle sales moderate due to an overheated market, some financing companies have been known to ease lending terms, especially in the sub-prime credit category (defined as a credit score of 600 or below) to drive new vehicle sales in a tiring market. This type of lending behavior became particularly problematic as the recession hit in 2008. While we see evidence of looser lending reoccurring, delinquencies have remained within historical norms and financing companies have publicly commented on remaining disciplined.

We also see pressure on profit margins as automakers contemplate the future of cars (and car ownership itself), and begin developing new technologies in reaction to new competitor offerings and increasing government focus on global emissions reductions. OEMs are heavily investing both internally and externally on developing autonomous driving capabilities and fully electrified or low emission engines, becoming acquirers and investors in Silicon Valley startups like Lyft. Not only are OEMs competing with each other, but also with non-incumbents like Google and Apple, companies that have arguably better balance sheets and engineering talent.

Given these market dynamics, our expectation is for SAAR to moderate in the coming years to the 15.5-16.0 million vehicle range. We view this event as within historical norms and believe economic conditions remain supportive. From an industry perspective, the auto manufacturers are largely different from their previous iterations in the pre-2008 time period. OEMs have cleaned up their balance sheets and are now more conservatively structured. They have cut labor costs and shifted production costs to be more variable than fixed, which gives them flexibility to slow down production to control inventory levels (and avoid having to over-discount to get vehicles off dealer lots). As a result, U.S. automotive SAAR break-even, the level of U.S. auto sales that the OEMs need to hit to remain profitable, has decreased from around 14 million vehicles to 11 million. There would need to be an over 30% reduction in U.S. auto sales to hit that level.

The OEMs have also commented about discipline with respect to production and incentive spending, and are willing to sustain lower levels of vehicle sales at competitive profit margins as opposed to higher sales driven by excessive incentives. For example, since last year, GM and Ford have significantly curbed fleet sales to rental companies like Hertz and Avis, who account for a historically high volume of total sales but much lower profit margins.

Today's macroeconomic environment is much more constructive than 2008 and should also help mitigate the impact of any correction in auto sales. Low unemployment, wage growth, rising consumer confidence, steady increases in home ownership among young adults, single-family building permits at ten year highs, and a favorable low rate environment should prove to be supportive of auto sales in the coming years if trends sustain themselves at current levels.

As for 2017, year to date vehicle sales are tracking around the low 17 million SAAR* range. Hurricanes Harvey and Irma proved to be surprising positive catalysts for the industry since an estimated 400,000 vehicles were damaged during Hurricane Harvey alone, which will need to be repaired or replaced, with an additional 200,000-400,000 damaged during Irma. Monthly SAAR figures released immediately following the hurricanes significantly beat estimates, partially attributable to replacement demand, but industry forecasters expect this to be temporary.

Auto OEM bonds have outperformed the Barclays Corporate Aggregate Index this year, with significant outperformance after the positive uptick in sales from hurricane replacement demand. In the context of these tighter spreads, we are cautious on the sector as we view future profitability as pressured due to a moderate decline in U.S. auto sales and increased capital expenditures as OEMs invest in new technologies and M&A to prepare for the future.

*Data sources: Ward's Automotive, J.P. Morgan

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