TD Economics

Canadian Automotive Outlook: Charting a Gradual Recovery

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Highlights

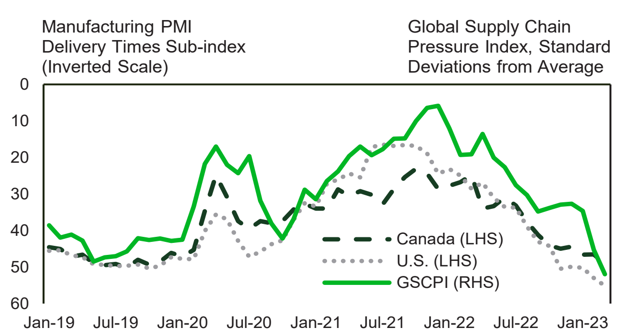
- Canadian vehicle sales rose by 4.4% year-on-year (y/y) in the first quarter of 2023, with recent strength in the labour market supporting demand.
- North American auto production is expected to rise by 9.3% y/y in 2023 to 15.5 million units as supply chain issues recede.
- Inventory improvements are expected to help Canadian sales track higher in 2023 to 1.6 million units, although sales are expected to remain below pre-pandemic levels as economic headwinds weigh on demand.

Light vehicle sales rose modestly to begin 2023, with sales averaging 115k units per-month during the first quarter. This marks a 4.4% increase relative to 2022 Q1, with light truck volumes up 6.7% year-on-year (y/y) and car volumes down 7% y/y. The outperformance of light trucks matches the aggregate trend seen in North America, as the shift towards higher end vehicle production in recent years coupled with the pre-pandemic trend of consumer preferences provided support to light truck sales.

Canadian demand for automobiles has remained robust despite the weight of higher rates and higher prices on consumers, as labour market tightness buttressed wage growth and kept pent-up demand solid. The accumulation of pent-up demand over the past three years, if measured against the pre-pandemic average annual level of sales, is roughly equal to half a year's worth of sales. As auto manufacturers continue to recover from the supply chain issues seen in recent years, production is expected to increase in 2023, bringing some of the much-needed supply, particularly in the affordable vehicle segment of the market, back online. However economic headwinds are expected to restrain both production and demand in 2023 as the cumulative effects of monetary policy tightening slow the economy.

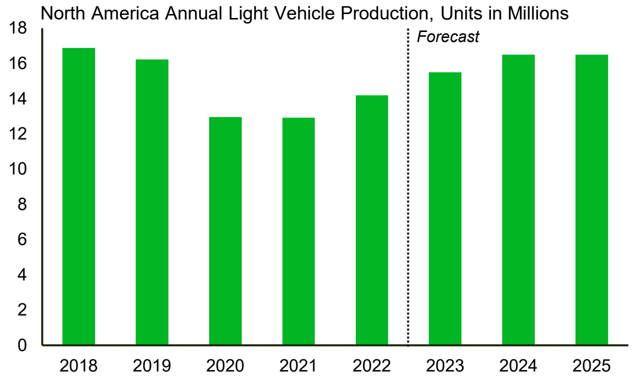
For 2023 we expect that vehicle sales in Canada will grow by roughly 2.4% y/y, rising to 1.6 million units. While this represents a modest improvement, sales volumes are expected to continue to lag the pre-pandemic level of roughly 2 million units. North American auto production is expected to increase by 8.6% y/y this year, helping to alleviate supply shortages although a full return to pre-pandemic levels is expected to remain evasive until 2024.

Chart 1: Easing Supply Chain Pressures Help Improve Delivery Times



Note: The delivery time sub-index is inverted to illustrate that a higher reading indicates shorter delivery times.
Source: S&P Global, New York Federal Reserve Bank, TD Economics. Last observation: March 2023.

Chart 2: N.A. Auto Production Expected to Recover Gradually



Source: Wards Automotive, TD Economics.

North American Auto Production Charts Gradual Recovery

The vast majority of automobiles purchased by Canadians are manufactured in North America, however the production of each vehicle relies on a complex network of interconnected supply chains. This left the industry acutely vulnerable to the pandemic-related disruptions which affected the transportation & logistics sector, and the subsequent strain created by the period of excess demand for manufactured goods in 2021. This led to an increase in procurement times and a decline in production, which greatly reduced the ability of manufacturers to replenish inventories after they were severely depleted in 2021. More recently, these supply chain disruptions have seen notable improvement (Chart 1), which should position the North American auto sector for a gradual recovery over the next two years.

Auto manufacturers also have outsized exposure to the semiconductor industry, as modern vehicles rely heavily on electronic subcomponents. As many employers adopted some form of remote work in 2020, demand for electronics skyrocketed, greatly increasing the competition for semiconductors that automakers faced. In the absence of sufficient resources, many manufacturers allocated what resources they did have towards higher-end models in the interest of sustaining profitability. This resulted in the current market inventory skew towards higher-end models, particularly for light trucks.

In recent months there have been clear signs that semiconductor supply chains are improving, with General Motors noting in their 2022Q4 earnings report that "greater semiconductor availability drove ~25% YoY wholesale volume improvement and mix normalization [in 2022]". It is expected that improvements will continue throughout this year, allowing production to rise steadily and rebalancing the market towards more affordable models.

We expect that North American auto production will grow by 8.6% y/y in 2023 to 15.5 million units, followed by a return to pre-pandemic levels in 2024 (Chart 2). This will help to bring much-needed supply to the market and help to rebalance it towards more affordable models. Auto manufacturers are expected to see normalizing supply side dynamics this year, but economic headwinds are expected to weigh on production as the economy slows.

Canadian Auto Production Recovery Lags N.A. Peers, But Investments Abound

Canada, Mexico, and the U.S. all lost some light vehicle production output during the past three years, but Canada's losses were more severe (Table 1). Relative to 2019, Canada's production of light vehicles in 2022 was down 35%, which is nearly three times the North American average. The U.S. saw a decline of 7% during the same time period, while Mexico's was twice that at 14%. Within North America, the U.S. share of regional production increased by 3.5 percentage points, with

Table 1: Auto Production Losses Widespread in Canada

Brand	Plant	Model Type	2019-2022 % Change
Ford	Oakville	Light Truck	-49%
GM	Ingersoll	Light Truck	-80%
GM	Oshawa	Light Truck/Car*	-21%
Honda	Alliston	Light Truck/Car	-41%
Multimac	Markham	Car	-9%
Stellantis	Brampton	Car	-18%
Stellantis	Windsor	Light Truck	-53%
Toyota	Cambridge	Light Truck	+0.4%
Toyota	Woodstock	Light Truck	-16%
Canada Total	-	-	-35%
U.S.	-	-	-7%
Mexico	-	-	-14%
North America	-	-	-12%

*Oshawa's plant for car production was shutdown in 2020.
Note: All of Canada's light vehicle production plants are located in Ontario.
Source: Wards Automotive, TD Economics.

most of the increase coming from Canada's 3.1 percentage point decline (Table 2). While most of the auto production losses in Canada in recent years were consistent with the trends seen in the industry, some were related to pre-pandemic plans to reorganize production within North America.

The largest declines in Canada were seen at General Motors' (GM) CAMI plant in Ingersoll, Ontario, which ceased production of the Chevrolet Equinox last year and has been converted to produce electric light commercial vehicles. The 2022 numbers for the Ingersoll plant were almost solely driven by the last Equinoxes produced in the first quarter, with the facility spending most of the year undergoing retooling for production of the new vehicle which began at the end of the year. GM's other production facility in Oshawa, Ontario also saw notable declines, although these declines would have been 100% if the firm's plans to shut the plant down after 2019 had not been reversed to increase production of the Chevrolet Silverado in 2021. In 2022, Oshawa's light truck production was 17% higher than in 2019. GM announced last year that its total investments in the two Ontario facilities will be over $2 billion[1].

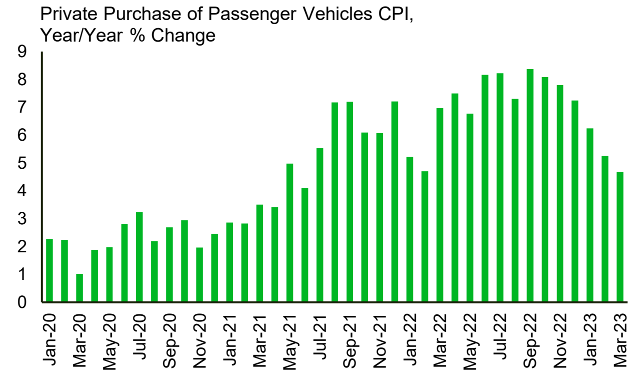
Ford's only Canadian vehicle production facility in Oakville, Ontario has seen lower production levels as well, some of which was driven by pre-pandemic cuts in early 2020 related to model discontinuation. Looking ahead, the plant is expected to begin retooling in the second half of next year as it prepares to build next generation electric vehicles starting in 2025, with Ford having committed $1.8 billion towards upgrading the facility[2]. Stellantis has also committed $3.6 billion to upgrade its Ontario facilities in Windsor and Brampton for electric vehicle production, with the former slated to begin retooling upgrades this year[3].

Table 2: North America Auto Production Shares by Country

	2019	2022	Difference
Canada	11.7%	8.6%	-3.1%
U.S.	65.0%	68.6%	3.5%
Mexico	23.3%	22.9%	-0.4%

Source: Wards Automotive, TD Economics.

Chart 3: Auto Price Growth Cooling, But Remains Elevated



Source: Statistics Canada, TD Economics.

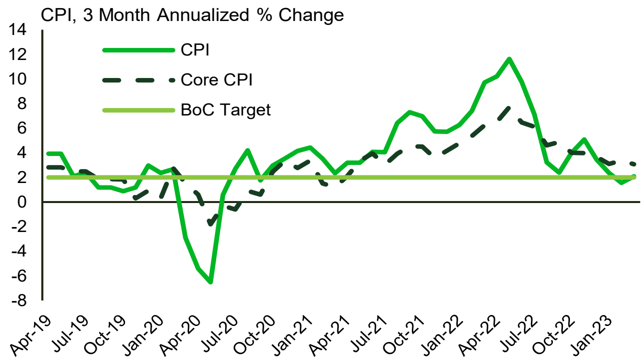
Honda's production declines at its Alliston plant were roughly 40% - equal to the percentage declines seen at its Greenburg, Indiana plant which produces the same vehicle models. Honda Canada announced last year that it intends to invest more than $1.38 billion over six years to upgrade the Alliston plant to produce hybrid-electric vehicles[4]. Toyota's Cambridge, Ontario plant was the only Canadian production facility to see slight growth over the past three years, as the start of Lexus NX production in 2022 offset the loss of the Corolla in 2019. Plans to begin producing the Lexus NX were announced in 2019, with the firm announcing a $1.4 billion investment in the plant in the previous year.

While the impact of the pandemic on Canadian auto production has been acute, the host of investments announced in the past year offers hope to a sector that was plagued by divestments in the years leading up to the pandemic. In addition, Volkswagen announced last month that its subsidiary PowerCo will build its first North American battery cell factory in St. Thomas, Ontario, with production expected to commence in 2027[5]. As the industry ramps up electric vehicle production, these investments should help to bolster Canada's position within the North American market.

Higher Rates and Prices Weigh on Pent-up Demand

For the past three years, light vehicle sales in Canada have undershot the pre-pandemic trend of roughly 2 million sales per year. The worst year for sales since the

Chart 4: Canadian Inflation Trending Downward, But Core Remains Persistent



Source: Statistics Canada, TD Economics. Last observation: March 2023.

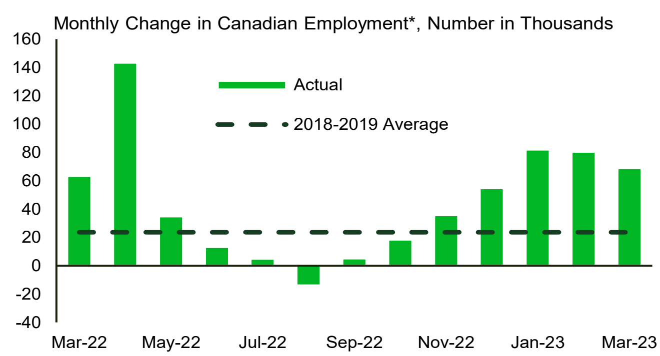
onset of the pandemic was 2022, as supply chain issues weighed on production and subsequently reduced vehicle availability, dragging annual sales down 6% y/y in 2022. Relative to 2019, annual sales in 2022 were about 20% lower. If Canadians had continued to purchase light vehicles at the pre-pandemic rate for the past three years, there would have been a little over 1 million additional sales. This accumulation of pent-up demand is likely what was underpinning the 4.4% y/y growth in 2023Q1 sales but building economic headwinds are expected to moderate that growth moving forward.

One of the key factors which is expected to prevent the entirety of the build-up in demand from coming to market is the run-up in vehicle prices over the past few years. Although the average transaction price (ATP) has been declining slightly in recent months, prices remain 5.3% above year-ago levels (Chart 3). While limited supply and robust demand have played a leading role in explaining the run-up in the ATP, the market supply skew towards higher end models has also played a part. However, in recent months we have seen preliminary indicators of pricing power tipping back towards the consumer as inventory levels improve, with retail incentive spending ticking up albeit from rock-bottom level. As auto supply continues to improve in 2023 and the economy slows, price growth is expected to continue to moderate gradually.

While this should be a reprieve for Canadians, it will be occurring against the backdrop of roughly two years' worth of elevated price growth in everything from food to housing. In particular, the outsized growth in shelter costs over the past three years continues to directly affect those currently in the housing market, in addition to those who are looking to enter at some point in the future. For the 10% of Canadians who own a variable rate mortgage, they will have already felt the effects of higher rates on their personal finances. Those who own fixed rate mortgages will also be affected, but the impact will be spread out over time based on term renewals, with the peak impact expected to be in 2023 for most term types. The third of Canadians who rent are also seeing their finances pinched due to the rapid rise in market rents seen over the past year, though the aggregate effect will be mitigated to a certain extent by existing rent control regulations in some provinces which caps yearly increases. Regardless, as households allocate a higher share of their income towards either meeting these higher costs in the present or saving up to meet them in the future, this is expected to curtail auto demand moving forward.

In order to quell the rapid price growth seen in the economy in the past two years, the Bank of Canada has raised the overnight interest rate by 4.5 percentage points in the span of 12 months. While this has had the desired effect on inflation (Chart 4), it has (intentionally) added another obstacle to the purchase of automobiles. With financing rates elevated, the average monthly payment on new loans in March was roughly 16% higher than its year-ago level[6]. Over the past few years, tight supply was the central factor restraining sales activity, but shifting into 2023 higher prices (both in autos and elsewhere) in addition to higher financing costs are expected to play a larger role in moderating demand as the economy slows.

Chart 5: Canadian Job Growth Remained Strong to Start 2023



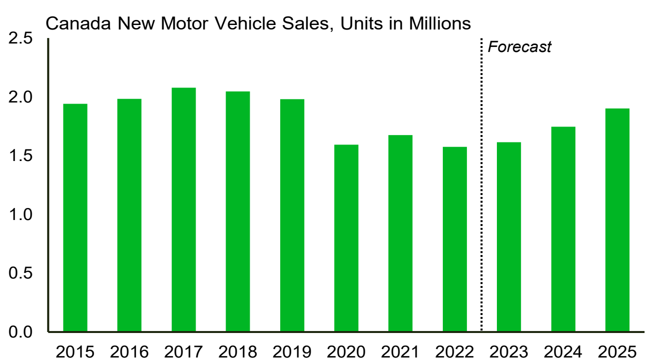
*Seasonally Adjusted 3 Month Moving Average.
Source: Statistics Canada, TD Economics.

Labour Market Resilience Underpins Solid Start to Sales in 2023

The main reason why the current price and interest rate environment hasn't already pushed sales growth lower in 2023 is because strength in the Canadian labour market has proven to be more resilient than previously expected. After job growth slowed considerably in the third quarter of 2022, it rebounded in the fourth quarter and continued that upward trend into 2023 (Chart 5). This brought the unemployment rate back down to its multi-decade low of 5%, which has sustained the continued tightness seen in the labour market. These conditions have fostered strong wage growth, which although not sufficient to fully offset inflation has continued to support consumer spending. Moving forward, we expect that the labour market will slow with the broader economy in 2023 as the cumulative effects of past rate hikes continue to filter through the economy.

We still expect light vehicle sales to grow by 2.4% y/y in 2023 to 1.6 million units, but this is relatively modest growth considering last year's sales activity was atypically low due to supply issues (Chart 6). Supply improvements this year will help to raise vehicle availability and offset some of the pent-up demand that has accumulated over the past three years, but the trifecta of higher prices, higher interest rates, and an expected increase in the unemployment rate is expected to keep a fair share of that demand on the sidelines. Looking to 2024, we expect sales to grow by 8.4% y/y to 1.7 million units as the economy gradually recovers.

Chart 6: Canadian Auto Sales Expected to Recover Gradually As Headwinds Weigh on Demand



Source: Statistics Canada, TD Economics.

Bottom Line

Light vehicle sales began 2023 on strong footing as inventory levels improved and labour market strength helped to partially offset higher sales prices and higher financing costs. While annual sales are expected to grow by 2.4% this year relative to 2022 as production levels increase on the back of easing supply chains issues, the second half of the year is expected to see a notable slowdown as the economy cools. Next year we expect that sales will grow by 8.6% y/y, bringing the level of sales to 1.7 million units. On aggregate, auto purchasing activity is expected to remain subdued relative to pre-pandemic levels for the foreseeable future, as production recovers gradually and demand is restrained by higher costs and financing rates.

Footnotes

1. GM Press Release
2. Ford Press Release
3. Stellantis Press Release
4. Honda Press Release
5. Volkswagen Press Release
6. J.D. Power Canada via Canadian auto dealer