U.S. Sales to Slow Modestly, Production to Gain Ground

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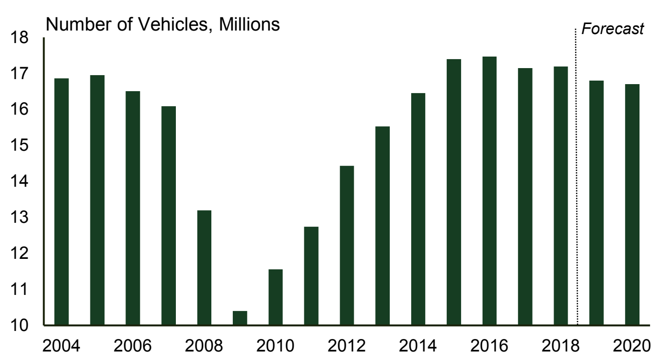
Highlights

- 2018 was another strong year for U.S. light vehicle sales. Sales rose by 0.2% to 17.2 million units – marking the fourth year in a row that sales remained above the 17 million mark. With pent-up demand appearing satiated and yields likely to edge up further from current levels, some modest deceleration in sales activity is expected for this year and next.
- On the supply side, North American production should remain strong, rising by 1.1% to 17.1 million units in 2019. Gains will be concentrated in the U.S. and Mexico, while production in Canada will continue to slide following the closure of GM's Oshawa facility.
- GM will also be closing four U.S. plants at the end of this year, but significant investments made by other automakers will more than offset the production and jobs lost at GM. Moreover, with companies directing investment dollars towards ensuring facilities are meeting the growing demand for electric light trucks, automotive manufacturing appears to have secured a strong foothold in the U.S. for years to come.
- The North American auto industry breathed a huge sigh of relief late last year following the new trilateral U.S.-Mexico-Canada (USMCA) trade agreement. While similar to the existing NAFTA deal in many respects, USMCA does contain several changes on the autos side, including export quotas for both Canada and Mexico as well as higher regional content requirements and wage provisions.

The U.S. automotive industry has come a long way from the lows of the Great Recession, with 2018 sales coming in at 17.2 million units, or roughly 65% above its 2009 trough. Last year's gains were particularly impressive. Not only did they surpass what most had been forecasting, but also came in 0.2% higher than 2017 – a year when demand was said to be boosted by more than 500,000 units due to a high replacement following the devastating impacts of Hurricane's Harvey and Irma. This occurred at the same time that the Federal Reserve to raised its benchmark interest rate four times last year, leading to higher financing costs and smaller incentives.

From a production standpoint, North American output has remained strong, with 2018 vehicle assembly's reaching 16.9 million, or roughly 7% above pre-recession levels. While production remains healthy, the headline number masks diverging performances across countries. Production in both the U.S. and Mexico continues to gain ground, as previous investments are now paying dividends, with output across both countries expected to rise by 1.5% in 2019. Moreover, a number of automakers including Toyota, Mazda, Ford and FCA have all committed to significant U.S. based investment projects over the coming years, aimed at increasing production efficiencies, and meeting the growing demand for fuel efficient SUV/CRVs.

Chart 1: U.S. Auto Sales to Soften From 2016 Highs, But Still Remain Strong



Source: Wards Auto, TD Economics

Table 1: North American Production						
	Number of Units (millions)			Per Cent Change		
	2018	2019F	2020F	2018	2019F	2020F
North America	16.9	17.1	17.1	-0.5	1.1	0.1
U.S.	11.0	11.1	11.4	0.6	1.5	2.5
Canada	2.0	2.0	1.8	-7.6	-1.8	-6.9
Mexico	3.9	4.0	3.9	0.5	1.5	-3.1

Source: Wards Auto, TD Economics

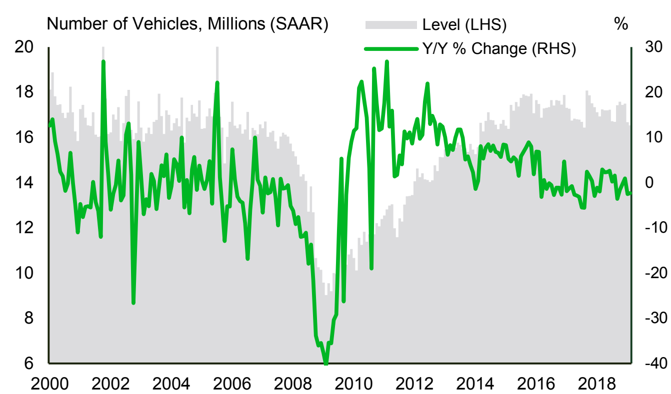
Canada has not experienced the same level of investment. Less lucrative government incentives and higher electricity costs have helped to erode Canada's competitive edge, and as a result, its share of North American production has been on the decline for the last decade. The recent announcement by GM to close its Oshawa manufacturing facility was the latest blow, accounting for roughly 7% of annual production and employing 2,900 workers.

American auto manufacturers were also likely relieved to see a new trilateral trade agreement reached between U.S., Mexico, and Canada (see text box - page 7). After nearly two-years of termination threats and combative negotiations, the cloud of uncertainty hanging over the North American auto industry was lifted with the signing of USMCA. While not that much different than the existing NAFTA deal, USMCA will offer more protection to U.S. and Canadian manufacturers through both higher regional value content (RVC) and higher wage requirements. Moreover, should the U.S. push ahead with imposing higher (25%) auto tariffs through the use of Section 232, both Canada and Mexico would be exempt. This last exemption is particularly critical for cars sold in the U.S.. The Center of Automotive Research estimates that the average new vehicle price could rise by as much as $4,400 if the U.S. administration were to impose a 25% tariff on all motor vehicle imports. Exempting Canada and Mexico from these tariffs cuts the price increase to $2,450. Auto tariffs remain a real possibility given the lack of progress the U.S. has made in its trade negotiations with most of its other major trading partners.

Sales strong through 2018...

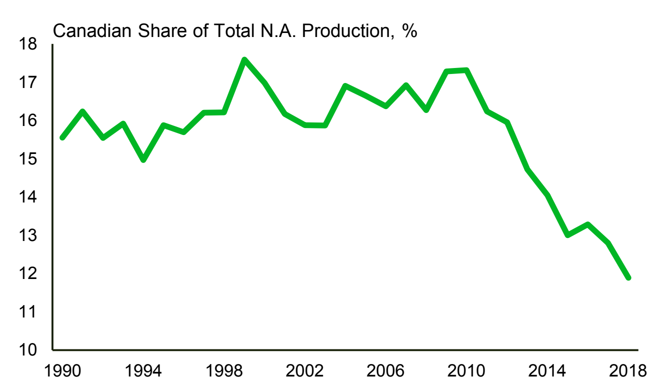
At 17.2 million units, U.S. light vehicle sales not only topped last year's reading, but also stands as the fourth best sales year on record – with two of the other record years happening earlier this cycle. Besting last year's reading is particularly impressive, as sales were said to be boosted by over 500,000 units due to replacement demand following Hurricane's Harvey and Irma. Not only that, but affordability has eroded over the last year, as strong economic growth led the Federal Reserve to raise its benchmark rate by 100 basis points in 2018. Higher interest rates have forced dealers and manufacturers to start reducing incentives, particularly those tied to 0% financing terms. Even still, the income boost from last year's tax reform – expected to have saved the average household $1,200 in 2018 – alongside solid employment and wage growth appears to have more than offset the erosion in affordability. That being said, there are a few reasons for caution moving forward.

Chart 2: US Auto Sales Remain Elevated in 2018



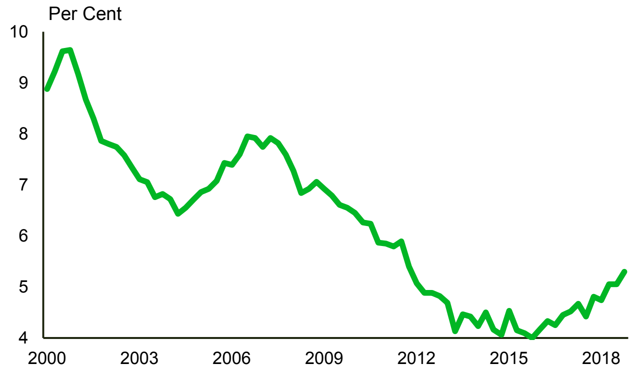
Source: Wards Auto, TD Economics.

Chart 3: Canada Losing Share in Production



Source: Wards Auto, TD Economics.

Chart 4: Auto Loan Financing Rates Creeping Higher



Source: Federal Reserve Board, TD Economics.

... but reasons for caution moving forward

First is a lack of pent-up demand. Sales have run above trend growth – the rate of sales required to meet replacement and population growth – in each of the last four years. Still, the sales-to-population ratio has declined over the last two years, and now sits only slightly above trend, suggesting the pent-up demand that accumulated during the global financial crisis has now been exhausted. Without this demand, sales can only rise so far.

In that same vein, 2018 sales were propped up by strong fleet demand – up 10% on the year – as rental car companies and other commercial buyers took advantage of the new full expensing deduction on equipment. Given the pull through in commercial sales over the past year, it is unlikely that this pace of sales will be matched in 2019. This is particularly true given that retail demand, which accounts for 80% of light vehicle sales, had already started trending lower in recent years – declining by 2% in 2018.

The trend of weakening retail demand should continue into 2019, particularly as the wealth effects from lower personal tax rates start to fade later this year. At the same time, we expect yields to edge up slightly from current levels, which combining these two forces should imply less discretionary spending, especially on big ticket items.

Third, the used vehicle market will continue to provide increased competition for new vehicle sales. Leasing has become an increasingly popular financing option in recent years, leading to a steady rise in off-lease vehicles. As the pool of used vehicles continues to grow, it should put some downward pressure on prices, providing consumers a suitable and more affordable alternative.

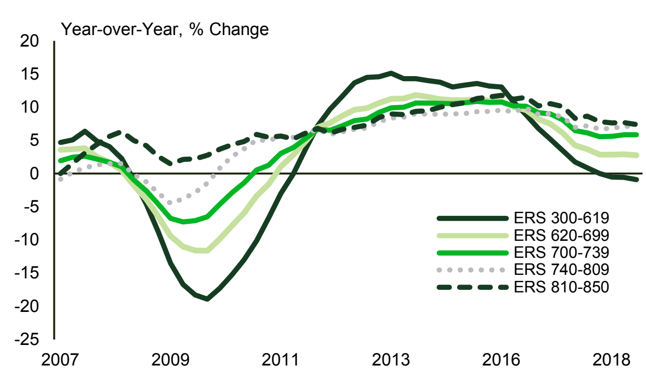
For those that are choosing to finance, it would appear that the longer 72 and 84-month loan terms have become the most popular financing option. Longer loan terms have allowed buyers to increase the amount of debt, without leading to higher monthly payments. The downfall, however, is that consumers are in negative equity positions for a longer period of time. It also means that individuals are tied to their vehicles for longer, potentially stretching out the buying cycle. While some may opt for an early trade-in, and roll the remaining balance into the new vehicles financing, they run the risk of falling into a state of negative equity – making payments on a vehicle they no longer own. This cycle of negative equity can persist until the buyer no longer qualifies for a new loan due to loan-to-value constraints.

Putting all these factors together, we expect U.S. light vehicle sales to decelerate modestly in 2019, falling by roughly 2% to 16.8 million units. Sales are expected to hang in this range for several years before gradually edging higher, consistent with growth in the driving age population.

Credit growth moderating

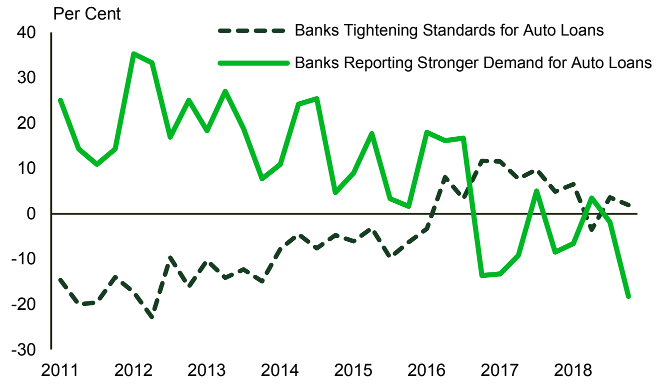
Earlier in the expansion cycle, growth in auto loans was eye catching, with combined auto finance and bank lending averaging annual growth of 10% between 2013 and 2017. Of particular concern, however, was the subprime segment (Risk Scores < 620) which nearly doubled in credit out-

Chart 5: Growth in Auto Loans Disproportionately Slowing Across Lower Credit Quality Segments



Note: ERS: Equifax Risk Score.
Source: Equifax, TD Economics.

Chart 6: Lending Standards For Auto Loans Continue to Ease



Source: Senior Loan Officer Survey, TD Economics.

standing between 2011 and 2016. Over the last two years, however, rising delinquency rates across this segment led to a substantial tightening in underwriting standards. According to Equifax data, lending into the subprime segment has now declined in each of the last eight months, with the biggest declines coming from the lowest credit quality (i.e. Risk Score 320-529) tranche. This is in contrast to higher credit quality segments, where loan growth is still averaging 5-7.5% year-on-year. Overall credit growth has appeared to stabilize in the 4% (annualized) range more recently, though according to the 19Q1 Senior Loan Officer Survey, the number of banks reporting weaker demand for auto loans is the highest it has been since the data started being collected in 2011. This in part reflects the recent shift towards away from bank lending in favor of captives and credit unions.

It is worth noting that U.S. household debt levels remain in good shape. At 95.8%, the debt-to-income ratio remains well off the pre-recession peak of 128.7%. Moreover, with income gains expected to outpace growth in household credit and our current forecast expecting rates to edge up slightly higher, overall debt servicing costs are expected to remain manageable by historical standards over the coming years.

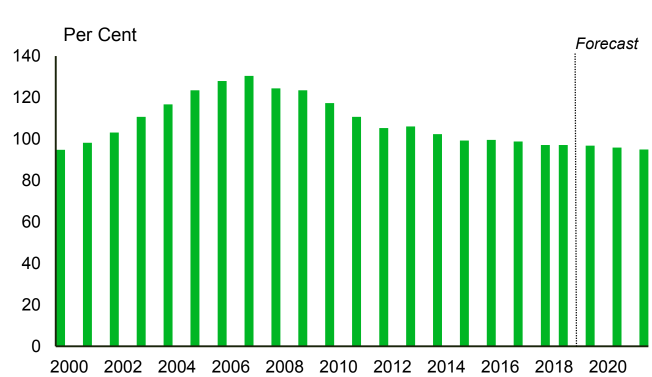
North American production to remain healthy, led by growth in U.S. and Mexico

On the production side, we expect to see a modest gain across North America in 2019 before leveling off in 2020. That being said, gains at the aggregate level mask diverging trends across countries. Production in Canada continues to slip, with the GM announcement to close five plants across the U.S. and Canada likely to shave about 145,000 units (~7% of total assemblies) from overall Canadian production. From a U.S. standpoint, the unit reduction of the Hamtramck and Lordstown facilities is slightly bigger at 190,00, but given that total production in the U.S. is far greater, the overall impact is quite small, accounting for just 1% of U.S. assemblies.

While GM is scaling back in Michigan and Ohio, FCA just announced that they will be investing $4.5B to expand capacity at five of its existing Michigan plants. The investment program will introduce two Jeep-branded products, a 3-row full-size SUV as well the Jeep Wagoneer/Grand Wagoneer and also allow three of the assembly facilities to produce plug-in hybrid models. The move is expected to create nearly 6,500 jobs, or roughly double the number of layoffs expected from the GM plant closures.

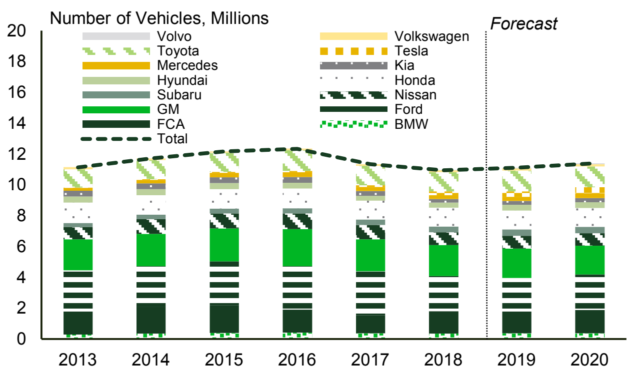
Production at Toyota's Blue Springs facility in Mississippi is also expected to increase dramatically starting this year. As part of Toyota's larger commitment to invest $10B in its U.S. facility's over the next five years, $170M was directed towards the Blue Springs plant with the intended goal of producing electric vehicles more efficiently. It would appear that the investment is already paying dividends, with 2019 assemblies expected to increase by over 125,000 units compared to average output levels measured over the last several years.

Chart 7: U.S. Debt-to-Income Ratio to Remain Low



Source: Federal Reserve Board, Bureau of Economic Analysis, TD Economics.

Chart 8: U.S. Production to Edge Higher



Source: Wards Auto, TD Economics

Outside of the Blue Springs investment, Toyota and Mazda recently announced a $1.6B joint venture on a new manufacturing facility which will be located in Alabama. The plant is expected to be finished and operational by 2021, and will produce approximately 300,000 vehicles per year.

Ford has also committed to investing over $1B in its Chicago operations as it prepares to launch three new SUVs this year. The investment is part of a bigger restructuring move where Ford will be discontinuing production of its least profitable sedan models - currently produced in Europe - and shifting the focus towards electric vehicles. The end result will be thousands of jobs lost overseas, and onshored back on North American soil.

Keeping with the theme of electric cars, Tesla continues to ramp-up production of its Model 3, with 2018 assemblies reaching 150,000 units. It is expected that production will continue to grow through 2019, with approximately 250,000 Model 3's to be produced, along with 80,000 Model S.

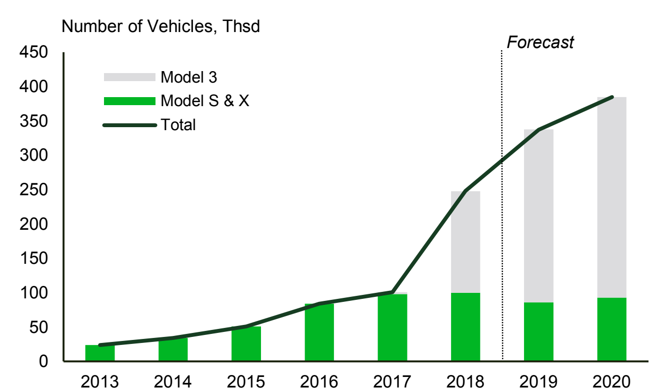
Mexican production continues to gain ground

Looking beyond stateside, production across Mexico also remains solid. 2018 assemblies were up 0.5% to 3.9 million vehicles, and now account for 23% of overall North American output – nearly double its pre-recession level. While cheaper labor is certainly one reason why Mexico has become a key destination for car manufacturers – studies show assembly compensation is about 80 lower in Mexico compared to the U.S. – it's not the only reason. Mexico offers workforce and development training programs as well as a host of other development incentives to ensure workers are equipped with the required skills to work on assembly floors. At the Federal level, the Mexican government has been pursuing multiple coordinated strategies to support and grow a strong manufacturing base. Recent efforts have included strengthening its educational system, improving the legal system, investing in public infrastructure, and combating crime and violence.

Perhaps even more importantly than the above factors, is the fact the Mexico's exchange rate vis-à-vis other currencies has made them the most advantageous manufacturing location across North America. Moreover, low production costs and low tariffs as a result of Mexico's free trade agreements, has made it possible for the country to emerge as a prime export base both within NAFTA and more globally. As a result, Mexico has been attracting increasingly more investment from not only U.S. automakers but also Asian and European automakers as well.

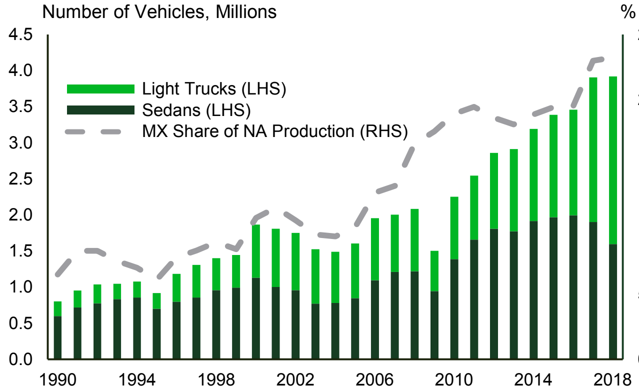
In looking at the segment breakdown, growth in Mexican production has been the result of both sedans and light trucks, though up until last year, a disproportionate amount of the growth came from sedans. This is not surprising, as passenger vehicles have a smaller margin than light trucks. By moving sedan production to Mexico, automakers are able to maximize their margin, through lower manufacturing costs, and by gaining access to non-NAFTA markets where passenger cars are still the preferred vehicle.

Chart 9: Tesla Ramping-up Production



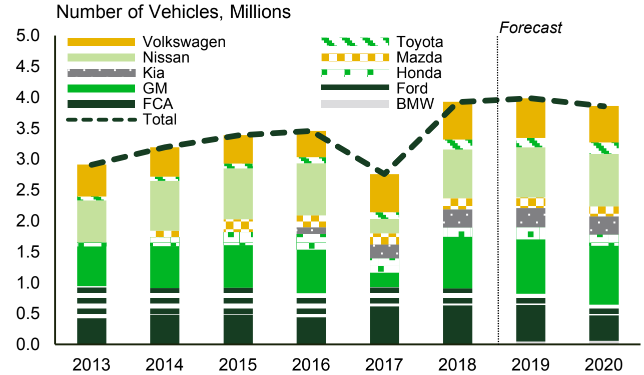
Source: Wards Auto, TD Economics

Chart 10: Mexico Has Significantly Grown Its Production Base Over Last Decade



Source: Wards Auto, TD Economics.

Chart 11: Mexican Production Also to Gain Ground in 2019



Source: Wards Auto, TD Economics

Over the last two years, Mexico's production of light trucks has also increased noticeably, now accounting for 20% of all NAFTA light truck production – up nearly 7pp from 2016 levels. The growth is the result of GM shifting more production of its Equinox to Mexico, and Volkswagen opening the doors to its new facility where it will be producing the Audi Q5 - previously assembled in Germany. Chrysler also relocated the production of its Jeep Compass from Belvidere, Illinois to its Toluca facility in Mexico.

Bottom Line

U.S. vehicle sales continue to hum along at an impressive speed, particularly given how late we are in the business cycle. That being said, we do expect some moderation in sales over the next few years. Fundamental analysis suggests that sales have been running above trend growth for quite some time, exhausting most of the pent-up demand created following the global financial crisis. Moreover, higher yields and reduced incentives will continue to weigh on affordability and put upward pressure on debt servicing costs. The new vehicle market will also have to contend with the growing pool of gently used vehicles, which are providing a more affordable option for some buyers.

From a production standpoint, North American output is expected to continue to edge higher over the next two years, though gains will be entirely concentrated in the U.S. and Mexico. Several automakers have already made or at the very least committed to significant investment projects to their U.S. based operations, with the intention of increasing production efficiencies and meeting the growing demand for hybrid SUVs/CRVs. A similar story has played out in Mexico, with production having nearly doubled over the last decade.

The USMCA agreement removes a significant amount of uncertainty for North American automakers. New wage and higher regional content requirements suggest higher new vehicle prices in the long-run. That being said, USMCA still needs to be voted into legislation by all three countries, which is unlikely to be an issue in Canada and the Mexico but could be more drawn out in the U.S. given a more divided Congress following the midterm elections. Moreover, once USMCA does come into effect, it will be gradually phased-in over a three period, so the full impact of the new auto rules will not be felt until (at least) mid-2022.

U.S.-Mexico-Canada Trade Agreement

Following nearly two years of termination threats and combative negotiations, the U.S., Canada, and Mexico found a compromise and agreed to terms on a revised trade deal last fall. While similar to the existing NAFTA trade deal, the US-Mexico-Canada Trade Agreement (USMCA) does contain some meaningful changes for the automotive sector. The first is an update to the existing regional content requirement. Under NAFTA, 62.5% of the parts used in the assembly of North American vehicles needs to be produced within one of the three NAFTA countries. This regional content requirement will go to 75% under USMCA. Second, there are also requirements regarding wages paid in the production plants, where 40% of the content must be produced by workers earning at least $16/hour. Lastly, both Canada and Mexico will face quotas both on the number of vehicles (2.6 million) and the amount of parts (CA: $32B; MX: $108B) that they can export (tariff free) to the U.S. on an annual basis. Exceeding these quotas will result in either country paying the Most Favored Nations (MFN) tariff rate, which is currently set at 2.5% on passenger vehicles and parts and 25% on light trucks. It should also be noted that a side agreement was reached exempting Canada and Mexico from the potential 25% motor vehicles & parts tariff that could still arise should the U.S. administration push ahead on the Section 232 automotive tariffs.

From a Canadian standpoint, the production and parts quotas are unlikely to be a game changer. Based on 2017 export data, Canada's exports of motor vehicles and parts remain 30% and 50%, respectively, below the quotas set out in USMCA. Conversely, while Mexico is still well below the quota set on parts, it will almost definitely hit the unit quota on vehicle exports over the next few years. The question then will be whether or not it makes economic sense to exceed the quota and pay the tariff or look to relocate production facilities. Obviously the latter option has high associated costs, and is unlikely to happen should the MFN remain at current rates. However, if the U.S. pursues Section 232 on the grounds of "national security", then the MFN could rise as high as 25%, (provided Mexico and Canada aren't given special exemptions) which could have very real implications for Mexican production.

On the surface, the new wage requirement should lead to higher wages in Mexico, helping to level the playing field for both Canada and the U.S. Should this be the case, it would almost certainly lead to higher new vehicle prices. That being said, it is still unclear how the wage requirement will be enforced and more importantly, the types of jobs that will be included in the average wage calculation. Should companies be able to include higher paying jobs such as research & development or information technology, then the status quo is likely to remain. This would imply that Canada and the U.S. would remain less competitive on both the assembly and parts manufacturing front, particularly given the current wage disparity with equivalent Mexican workers.

Increasing the regional value content (RVC) requirement also has implications for the cost of new vehicles. In order to be compliant, more of the intermediate parts used in the final assembly will need to be sourced from North America. However, this will only happen if it is cheaper than the alternative option where manufacturers chose not to be compliant with the RVC and simply pay the tariff. Because each vehicle earns a different margin, manufacturers will have to conduct a cost benefit analysis assessment on a case-by-case basis to see whether or not it makes sense to renegotiate global supply chains.

This will take some time to do, and luckily for automakers, they still have plenty of leeway on this front. While USMCA has been formally agreed on by all three countries, it has not yet made it to any legislative floor for ratification. For Canada and Mexico, government approval is all but a sure thing. However, with the Democrats now in control of the House, the U.S. approval process could become far more drawn out. Moreover, once USMCA is approved, the new trade deal will be gradually phased in over a three year period, so the full effect of the new auto rules won't be felt until (at least) mid-2022.

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