CANADA AND U.S. AUTO SALES: ROOM FOR FURTHER GROWTH?

October 2014

Canadian and U.S. auto sales have strengthened significantly from recession lows. Canadian new motor vehicle sales have surprised solidly on the upside in 2014 with year-to-date sales through September tracking a record 1.86 million pace in 2014 that would build on the already record-setting 1.78 million units sold in 2013. Sales in the country declined to an annual low of 1.48 million in 2009 as a result of the 2008/09 recession. In the U.S., strong sales over the summer and early fall leave annual overall light vehicle sales on track for a 16.3 million annual pace in 2014, up solidly from 15.4 million in 2013 and the recession-low 10.4 million units in 2009.

Looking ahead to 2015, this note argues that there is still room for further improvement in the U.S. while Canadian sales are likely to remain elevated although perhaps slightly below recent outsized rates.

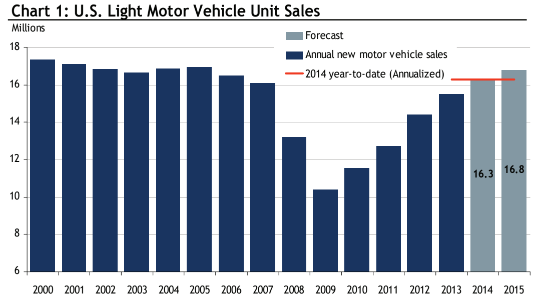
Factors supporting the U.S. sales outlook:

The outlook for further gains in U.S. auto sales remains favourable, underpinned by the persistence of at least some pent-up demand created during the recession, a pickup in job growth, improving household net wealth, low financing costs, and eased credit conditions. We forecast that U.S. light vehicle sales will total 16.3 million units in 2014 and strengthen to 16.8 million units next year.

- **Employment Growth**

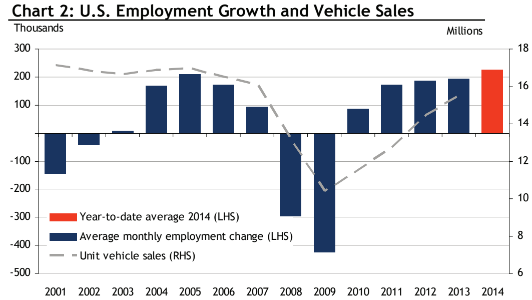
The most important "driver" of auto sales in any market is the state of labour markets. Job growth has an obvious direct impact on household incomes but corresponding declines in the unemployment rate also have an important impact on consumer confidence. Households are more likely to make a major purchase if they feel secure in their jobs, so an improving labour market typically impacts both the ability and willingness of households to spend. U.S. employment growth has strengthened notably in 2014, averaging 227K per month year-to-date which is up from 194K per month in 2013 (Chart 2). The 5.9% unemployment rate in September is down sharply from 6.7% at the end of last year and 7.2% a year earlier. With the improvement, consumer confidence in the labour market recovery has continued to strengthen as evidenced by an upward trend in the number of consumers reporting jobs are plentiful relative to those saying jobs are hard to get in the closely watched Conference Board's Consumer Confidence report (Chart 3). We expect improvement in labour markets will remain a supportive factor for overall consumer spending and auto sales in particular.

Chart 1: U.S. Light Motor Vehicle Unit Sales



Source: Bureau of Labor Statistics, RBC Economics Research

Chart 2: U.S. Employment Growth and Vehicle Sales



Source: Bureau of Labor Statistics, RBC Economics Research

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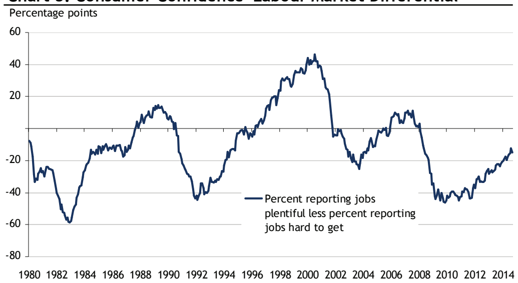
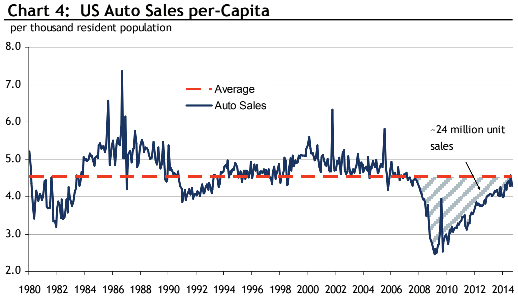
Chart 3: Consumer Confidence 'Labour Market Differential'



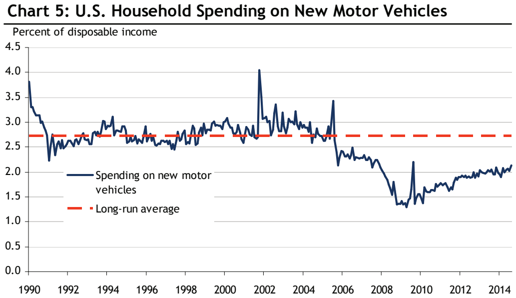
Source: Conference Board, RBC Economics Research

Chart 4: US Auto Sales per-Capita



Source: Bureau of Economics Analysis, RBC Economics Research

Chart 5: U.S. Household Spending on New Motor Vehicles



Source: Bureau of Labor Statistics, RBC Economics Research

- **Trend sales**

U.S. unit auto sales are on track in 2014 to outpace their pre-recession 2007 annual sales rate of 16.1 million for the first time in this economic recovery. With that said, taking population growth into account, the sales pace likely remains somewhat below its longer-run ‘trend’ rate. Notwithstanding cyclical volatility, vehicle sales per-capita have trended broadly sideways for decades (Chart 4). This has, notably, been true despite a persistent increase in the number of vehicles in operation per-capita, likely in large part because improvements in vehicle quality have increased the service life of new vehicles, resulting in existing vehicles being replaced less often.

At their low point during the last recession in February 2009 auto sales per-capita were more than 45% below their 30-year average rate. The sales pace has improved substantially from that low; however, notwithstanding a temporary spike in August 2014 which was likely influenced by an earlier-than-usual Labor Day holiday, it remains slightly below its long-run average. A per-capita sales rate in line with its average rate in recent decades would imply a current sustained pace of sales over 17 million units. Moreover, due in part to slow price growth, the share of household disposable incomes spent on the purchase of new motor vehicles remains well-below pre-recession averages suggesting there is still some room for increased spending on vehicles in household budgets as labour markets continue to improve (Chart 5).

- **Pent-up demand**

There also remains some potential for sales to exceed their longer-run trend rate for a time, especially if even a portion of the foregone sales during the recession were simply delayed rather than lost altogether. If instead of falling, per-capita sales had held steady at their 30-year average level, there would have been about 24 million additional US auto sales-to-date since the beginning of the recession (Chart 4). Many of these represent permanently lost sales, related to the loss of income associated with cyclical job losses; however, some may also have reflected a loss of confidence in the economic backdrop, rather than actual job losses, and financing constraints during the credit crunch. The prospect that even a small share of these sales were delayed rather than permanently lost suggests that pent-up demand could provide significant support to sales going forward as consumers continue to gain confidence in the durability of the labour market recovery.

- **Improved affordability**

Despite rising demand, price growth for new motor vehicles has been restrained which, along with historically low interest rates, has lowered the carrying cost of a new car loan. Low interest rates only help if a customer can qualify for a loan; however, indicators suggest that, after slowing sharply alongside a rise in delinquencies during the recession, auto loan growth has been increasing (Chart 6). The combination of easing credit constraints and low growth in sticker prices have made vehicle purchases more affordable which should support sales growth going forward. Our forecast assumes interest rates are set to rise gradually going forward; however, such will only occur alongside stronger growth in household incomes which will limit the impact of rate increases on vehicle affordability.

- **Housing markets and net worth**

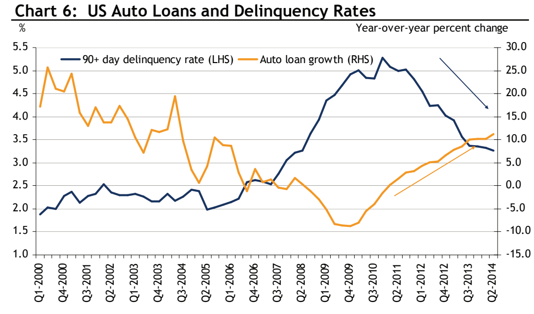
Adding to continued growth in employment and household incomes has been a shift in the housing sector from a headwind to a tailwind for consumer spending growth overall and auto sales in particular. Housing markets have a direct impact on the composition of vehicle demand, with home-building activity often associated with sales of light trucks; however, more broadly, housing markets have a substantial impact on household balance sheets. Sharp declines in net worth during the recession associated in part with the collapse in equity markets but also with the sharp drop in home values caused households to increase saving at the expense of consumption in an effort to rebuild lost wealth. Gains in equity markets and a return to growth in house prices have supported recent gains in household net worth while household deleveraging, which likely restrained growth in overall consumer spending, appears to be winding down (Chart 7).

Factors supporting the Canadian outlook:

Auto sales in Canada were not hit as hard during the recession and have recovered more quickly than in the U.S. Sales did decline by more than 10% in 2009 but subsequently strengthened each year since, reaching an all-time annual sales record in 2013 at 1.78 million units. Sales slowed earlier this year as colder-than-normal temperatures appeared to keep some shoppers at home; however, a strong rebound through the spring and summer leaves unit sales through September tracking another annual sales record in 2014 with our own monitoring pointing to an annual sales rate of around 1.86 million units this year (Chart 8).

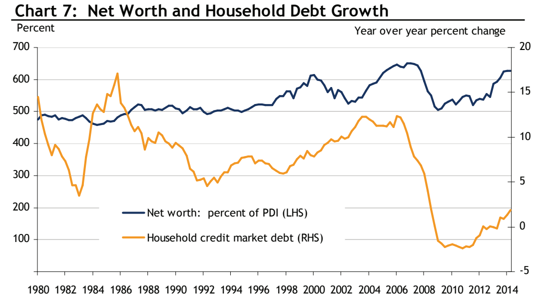
Moreover, there remains reason to believe that a near-record sales pace can be sustained in the near-term though with less scope than in the U.S. for sales to trend even higher. Interest rates are still historically low and are expected to rise only gradually going forward while, in part because of slow price growth, automobile purchases as a share of household incomes are still below pre-recession levels. Labour markets have shown signs of strengthening recently after a sluggish performance earlier this year with indications that economic activity is picking up suggesting that an underlying improving trend will be sustained for the remainder of this year and into 2015. There also likely remains some leftover pent-up demand from the recession, albeit substantially less than in the U.S. Our forecast assumes minimal slowing in unit vehicle sales to a 1.82 million unit pace in 2015 from the expected second consecutive record annual sales pace in 2014 (Chart 8).

Chart 6: US Auto Loans and Delinquency Rates



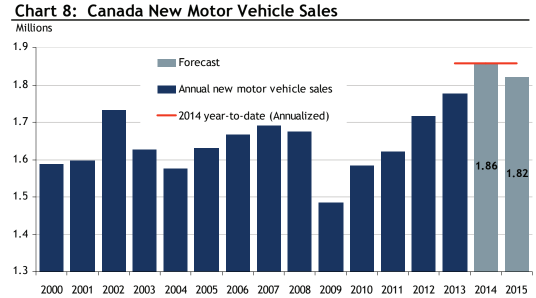
Source: FRBNY, Equifax, RBC Economics Research

Chart 7: Net Worth and Household Debt Growth



Source: Bureau of Economics Analysis, U.S. Federal Reserve, RBC Economics Research

Chart 8: Canada New Motor Vehicle Sales



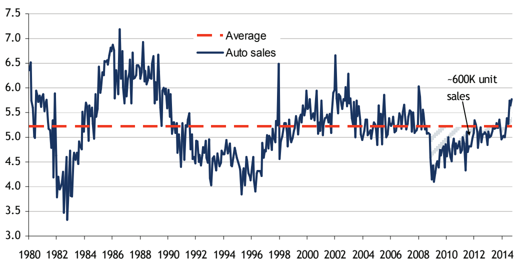
Source: Statistics Canada, RBC Economics Research

- **Pent-up demand still a support, although less than in the U.S.**

The decline in Canadian auto sales during the recession was not as severe as that seen in the US, at least in part reflecting the greater stability of the Canadian banking sector and the fact that Canadian housing markets, and consequently household balance sheets, held up better than elsewhere. With that said, Canadian auto sales, on a per-capita basis, still fell more than 20% below their thirty-year average by early 2009. If instead of declining, the per-capita sales rate had held constant at its long-run average, there would have been more than 600K additional new vehicle sales since the summer of 2008 (Chart 9). As in the US, many of these sales are likely permanently lost, related to the declines in jobs and incomes during the recession that will have had a permanent impact on lifetime incomes for some households; however, a portion were also likely simply delayed with aging vehicles replaced once conditions improve. There have already been signs that some pent-up demand generated from the recession may be supporting current sales. The per-capita sales pace in July through September of this year, for example, was significantly above its longer-run average level despite, on balance, a less than spectacular pace of improvement in labour markets year-to-date. We are not assuming that sales will be able to be sustained at their Q3 2014 pace; however, the further release of pent-up demand will likely be one factor supporting a still solid pace of motor vehicle sales going forward.

Chart 9: Canada Auto Sales per-Capita

per thousand people (aged 15 and over)



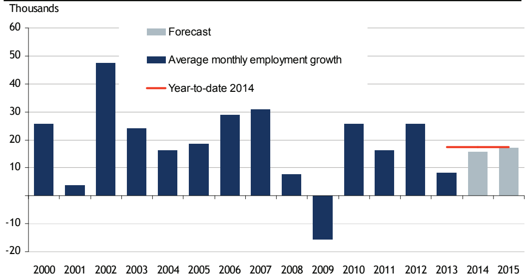
Source: Statistics Canada, Desrosiers Automotive, RBC Economics Research

- **Employment growth**

As in the case of the US, a key factor providing support to the Canadian auto sales outlook is our expectation that labour markets will improve going forward. The early recovery in auto sales in Canada following the 2008/09 recession was supported by a relatively quick recovery in labour markets. The level of employment returned to its pre-recession peak in January 2011, well ahead of most other developed economies, and the unemployment rate declined to levels in line with its 10-year average by the end of 2012. More recently, labour market improvement has slowed; however, a decline in the unemployment rate to 6.8% in September, its lowest level since December 2008, and signs of a pickup in economic growth both in Canada and in its key U.S. export market should support job growth through the remainder of this year and into 2015 (Chart 10). This strengthening in employment growth is a key component of our forecast that Canadian motor vehicle sales will, on balance, post a record sales gain in 2014 with minimal moderation expected in 2015.

Chart 10: Canada Employment Growth

Thousands



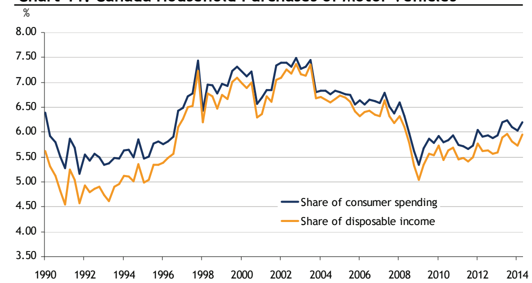
Source: Statistics Canada, RBC Economics Research

- **Affordability**

Although overall consumer loan growth has slowed in Canada (see [here](#)), it is still likely that low interest rates have, as in the United States, benefited Canadian auto sales. Affordability has been further aided by slow growth in motor vehicle prices, which have continued to modestly under-perform growth in the overall Consumer Price Index (CPI). A consequence of the slow price growth is that, despite vehicle sales reaching record highs, the amount consumers are spending on the purchase of motor vehicles as a share of total consumption expenditures and incomes is still well below pre-recession levels (Chart 11).

We do not expect consumer loan growth to strengthen substantially going forward given households debt levels are already high. As well, we expect stronger economic growth will eventually prompt higher interest rates going forward. With that said, our forecast assumes the pace of increase in interest rates will be slow, which will leave unusually favourable financing conditions in place for some time, and higher interest rates are only likely to occur alongside strengthening labour markets and rising household disposable incomes. Moreover, a trend towards longer amortization periods on vehicle loans, which are now offered over periods up to 8 years, have reduced the level of monthly payments associated with a given purchase price or interest rate. On balance, vehicle affordability is likely to remain a support to the new vehicle sales pace through 2015.

Chart 11: Canada Household Purchases of Motor Vehicles



Source: Statistics Canada, RBC Economics Research