OBSERVATION

TD Economics

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CANADIAN AUTO SALES TO TREAD WATER IN 2012

Highlights

- Canadian auto sales had some ups and downs in 2011, but managed to eke out a gain for the year as a whole.
- Looking ahead, a weaker economic landscape will limit sales during the first half of the year, but the overall sales picture should improve in the latter half of the year and into 2013.
- Still, there is not much upside for new vehicle sales over the medium term, due to the fact that there is very little pent-up demand in the market and consumers are highly indebted.
- Overall, we expect sales to tread water in a slow economic growth environment over the next few years.

After a decent bounce back in 2010, Canadian auto sales lost some momentum in 2011, partly on the back of supply shortages for Japanese brands, a slowdown in job growth and the confidence-sapping impact of financial market volatility this past summer. While the first half of 2012 is likely to be marked by a more challenging economic environment, the overall sales picture is expected to brighten during the second half and into 2013. Nonetheless, a lack of pent-up demand and increasing indebtedness of consumers are expected to limit the upside potential for sales over the medium term. Our forecast for modest gains in national sales in 2012 and 2013 conceals some regional variation, with the Prairie region likely to lead the pack.

Auto sales rise modestly in 2011

Canadian auto sales were uneven in 2011, but still managed to eke out a 1.8% gain for the year as a whole. This pales in comparison to the 10% gain seen south of the border last year, but sales did not fall during the recession nearly as much in Canada. At the end of 2011, Canadian auto sales were sitting within 4% of their 2007 peak. The comparable figure for the U.S. is about 30%. (For details on our U.S. auto sales outlook, please see the report entitled "*U.S. Auto Sales Coming Back to Life*", available on our website.)

This past year, increased financial market volatility in light of the uncertainties surrounding the sovereign debt crisis in Europe took a toll on business and consumer sentiment, and likely contributed to the choppiness in auto sales. Moreover, the natural disasters in Asia, namely the March earthquake and tsunami and subsequent flooding in Thailand, were felt in the Canadian auto market, as Japanese automakers, most notably Toyota and Honda, were faced with supply shortages.

Table 1 shows the relative performances and rankings of key automakers in 2011. Toyota and Honda both saw sales slide during the year, resulting in a combined 1.8 percentage points of lost market share. Remarkably, even with the sizeable loss of market share, Toyota has managed to remain the fourth best seller in the country. Honda, on the other hand, slipped in the ranks from 5th place to 6th place behind Hyundai. Of the seven leading brands, Chrysler was the top performer, with a 1.4 percentage point gain

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in market share. Ford and GM were able to retain the top two spots in the country, and this is despite a loss in market share for GM. Overall, this performance puts the Detroit-3 combined market share back up to 47.2%, following two years at 44-46%.

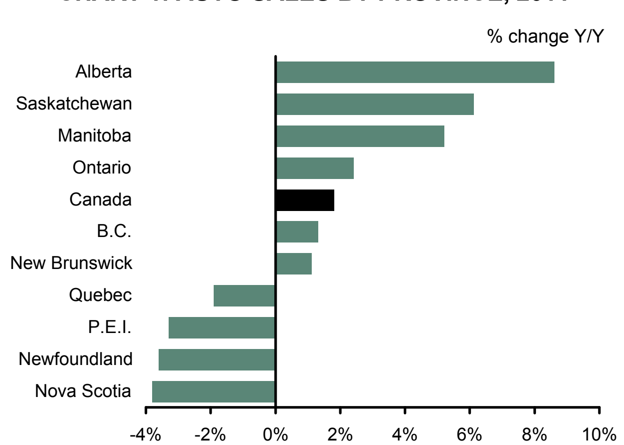
2011 auto sales driven by the West

While sales in Canada were up moderately, there was a great deal of regional divergence. Data available through November showed that sales were strongest in the resource-rich provinces of the west – led by an 8.6% jump in Alberta – while Quebec and all Atlantic provinces, except New Brunswick, had lower sales relative to 2010. Ontario, which accounts for nearly 40% of national sales, lay in the middle, with modest growth of 2.4%.

Reflecting the shift in sales to the west, where trucks are in higher demand, the light truck segment outperformed the passenger car segment. Indeed, light trucks account for over 60% of sales in Alberta and Saskatchewan, and only about 40% in the Atlantic Provinces. Accordingly, light truck sales were up 4.7% last year, led by a 12% gain in the Prairies. Meanwhile, passenger car sales were down 1.6% on the year.

The recent popularity of light trucks is more than a one-year blip, as Canada has witnessed a major shift in sales towards light trucks over the past two years. Up until 2009, passenger cars sales had always accounted for more than half of total sales. But a surge in light truck sales (while passenger cars sales declined) in 2010 reversed the ratio, with more light trucks sold in Canada for the first time ever. The trend continued into 2011, with the share of light truck sales rising to 56.2%. What's more, this swing away from passenger cars took place at a time when gas prices were on the rise. Automakers have introduced several new products in the segment over the past few years which have aided in its success.

CHART 1: AUTO SALES BY PROVINCE, 2011*



Source: DesRosiers Automotive Consultants
*Jan-Nov 2011 data

TABLE 1: 2011 CANADIAN LIGHT VEHICLE SALES PERFORMANCE BY BRAND

	Y/Y chg	Market Share	
	%	%	↑ / ↓
Ford	3.0	17.4	0.2
GM	-1.6	15.3	-0.5
Chrysler	12.5	14.5	1.4
Toyota	-5.6	9.4	-0.7
Hyundai	9.1	8.2	0.6
Honda	-12.8	6.8	-1.1
Nissan	3.9	4.9	0.1

Source: DesRosiers Automotive Reports, Ward's Automotive

Weaker economic landscape to limit near-term sales

Auto markets are likely to be affected by a worsening in economic conditions during the winter and spring months. We expect the debt crisis in Europe to escalate in the coming months, which is likely to translate into new waves of financial market turbulence. Knock-on effects will filter through to the Canadian economy. Although we are not anticipating a recession, gains in both real GDP and employment are expected to be minimal over the first half of the year, negatively impacting consumer confidence. With crisis usually comes action, however. We assume that Europe's political leaders undertake stepped up action to tackle the crisis by mid-year, setting the stage for an improved global economic and financial environment. Accordingly, economic and job growth in Canada is expected to accelerate in the latter half of 2012 and into 2013.

Despite the weaker economic landscape, the auto market will continue to benefit from some supportive factors in the months ahead. Notably, with the Bank of Canada expected to leave the overnight rate unchanged until 2013, borrowing costs will remain low through 2012, providing attractive terms for consumers to purchase big-ticket items.

Moreover, competition among automakers is set to heat up in the coming months. Sales incentives in Canada are already relatively generous. In fact, Toyota Canada's president, Seiji Ichii, recently conveyed his surprise that some automakers offered more than $7,000 in rebates[1]. That said, there is widespread speculation that Toyota and Honda will ramp up incentives to recoup their lost market share. Using high incentives to move vehicles off lots is an unprofitable tactic that the Detroit-3 brands had been known for up until the recession and subsequent bankruptcies at GM and Chrysler. Since that time, all three automakers have been quite disciplined in sticking to a demand-pull strategy. Should other automakers begin to increase incentive spending, the new pricing models of the Detroit-3 brands will be put to the test. Automakers will also be stepping up the competition with the introduction of several new models throughout the year, which typically leads to increased demand relative to the status quo. Either way, automakers will be firing on all cylinders as they compete for sales and try to gain (or maintain) market share – an especially difficult task in a slow (or no) growth market.

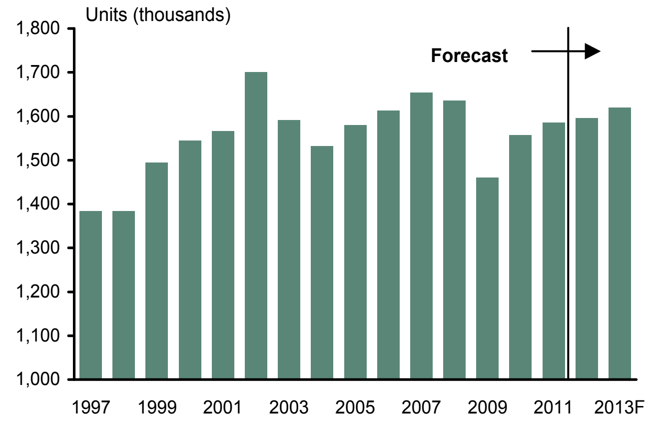
The new vehicle market is also likely to steal some buyers from the used car market in the coming years. A combination of the drop in new auto sales during the recession and lower leasing volumes over the same period (lease sales accounted for just 7% of total sales in 2009, down from about 30-40% earlier in the decade) have put a big dent in the supply of younger pre-owned vehicles. This resulting supply shortage will likely translate into upward pressure on used car prices, and reduce competition from this alternative.

Little pent-up demand will leave auto sales soft

Despite some of these positive factors working under the surface, there is limited upside for new auto sales over the medium term. Perhaps the most difficult challenge facing automakers is the likely absence of any meaningful pent-up demand in the Canadian market. Similar to other G-7 countries, Canadian auto sales were on a tear in the years leading up to the 2008-09 recession. While Canadian sales suffered a setback during the recession, it proved relatively moderate and temporary. Indeed, as we noted earlier, sales are now back up to levels just short of the pre-recession peak. A solid financial system and strong credit availability during the recent downturn goes a long way in explaining Canada's relative economic resilience. Still, this longer-term strength suggests that there no longer exists – at least from a medium-term national perspective – much untapped potential. Instead, sales will be driven primarily by drivers who need to replace aging vehicles. And unlike in the U.S., where the average age of vehicles on the road has risen to 11 years, the average age of vehicles on Canadian roads has remained within a tight range over the last decade, averaging 8.4 years.

On top of lackluster demand, a deterioration in household finances will also put a lid on sales growth going forward. With interest rates at ultra-low levels, consumers have been taking on excessive levels of credit. Household debt

CHART 2: CANADIAN LIGHT VEHICLE SALES



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

in Canada has hit record levels, with the debt-to-income ratio sitting at 151%. As well, personal disposable income growth is projected to decelerate to just 3.5-4% over the next few years, down from a trend rate of closer to 5%. As such, consumers are likely to begin exercising more caution when spending – particularly on big-ticket items.

Slow but steady gains in auto sales in 2012-13

Overall, we expect Canadian auto sales to be roughly in line with 2011 levels this year, rising by a slight 0.6%. In 2013, an improvement in economic conditions and consumer sentiment should help underpin another modest 1.6% increase in new vehicle purchases.

Regionally, the trends will likely be similar to those seen in 2011, as we expect the Prairie Provinces to continue to outperform over the next two years, particularly Alberta and Saskatchewan. Newfoundland and PEI are also expected to see stronger economic growth relative to the national average; however, this won't likely translate into robust growth in new vehicle sales given that these provinces have recorded solid gains in auto sales over the past five years. On the flipside, economic activity in Nova Scotia, New Brunswick and Quebec is expected to lag behind next year, suggesting a weaker performance in auto sales as well. Ontario will likely continue to operate close to the national average, with auto sales volumes on par with those recorded last year. Given that the regional breakdown is expected to be similar to 2011, we expect sales of light trucks to continue to outpace sales of passenger cars in Canada.

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Notes

1. "Toyota Canada's new head lays out a recovery plan" Greg Keenan. Globe and Mail. January 8, 2012. http://www.theglobeandmail.com/globe-drive/new-cars/auto-news/toyota-canadas-new-head-lays-out-a-recovery-plan/article2295445/

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