Will COVID-19 Sicken Cars-20?

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

Highlights

• Vehicle demand was already expected to decelerate in 2020, but COVID-19 will further depress sales

• Purchases are likely to fall by 11% in Canada and 9% in the U.S. in Q2 compared to 2019

• Lower interest rates will support the recovery

Easing up on the Gas Pedal

Consumers in Canada and the United States have continued to tap the brakes on motor vehicle purchases. After peaking in 2016, combined sales volumes have dropped back below the 19 million mark for the first time since 2015. In 2020, we see these late-cycle dynamics persisting and COVID-19 related uncertainty driving vehicle sales down another 3.7% (Chart 1). Concerns about COVID-19’s impact on the global auto industry are also evolving. While it’s still too early to grasp its full scope, sales in North America will likely be weaker in 2020 H1 than in H2.

In the United States, sales volumes fell 1.9% in 2019. In Canada, the market decelerated harder with sales cooling by 3.7%. The market is being pulled in opposing directions by forces on the demand side. Debt remains a drag on sales in Canada, while demographics are restricting demand in the United States. Auto loan growth had been slowing in both countries, also limiting sales. With the Bank of Canada and the Federal Reserve cutting rates aggressively, sales will likely adjust downward slowly. But the risk is that uncertainty over COVID-19 will lead households to hit the brakes harder on sales.

With lower sales volumes, competition among automakers will ratchet up. Producers with better concentration in growing product segments (i.e., light trucks) are positioned to benefit more in the near-term. This trend will only be accommodated by lower gas prices. For dealerships, inventory mix will remain an important factor in driving growth. Some may experience a rougher transition from past supply mismanagement.
U.S.: Mixed Signals

U.S. vehicle sales are poised to downshift moderately given late-cycle conditions, with steady employment growth supporting demand above historical trends. With added downward pressure from COVID-19, we expect the pace to fall below 16.4 million units in 2020.

Several demand factors are sending weaker signals. Vehicle saturation continues to put downward pressure on sales as the ownership rate is above its peak in the past cycle (at more than one vehicle per person of driving age). Slowing population growth, coming in at only 0.5% for 2019, is curbing demand, and will be an ongoing headwind for the U.S. market. The improving durability of motor vehicles could temper sales going forward. In 2019, the average vehicle age crept up to an all-time high of 11.8 years—an increase of 1.7 years compared to a decade ago. Financing trends in the industry seem to be adjusting to the increase in vehicle durability as the average term for a new car loan reached 68.9 months in 2019, up from 62 months a decade ago according to Experian. While this may match vehicle age patterns, the potential for creating negative equity for American households is an issue to keep an eye on.

Partially counteracting these headwinds to demand are rate cuts by the Federal Reserve and steady job growth. If downward pressure on other rates spills over to auto loans, this will extend the lengthy cycle further. For now, conditions in the auto credit market suggest the downward trend in the U.S. market will persist. Signals of loan demand and credit standards remain relatively flat after showing signs of tightening (Chart 2). Interest rates on new auto loans, while above their trough in 2016, are expected to decline as the Fed eases policy (Chart 3).

A key secular trend is the changing composition of sales. Consumers have shifted toward light trucks at the expense of the (conventional) passenger car (Chart 4). The halving of oil prices from June 2014 to January 2015, where they’ve more or less remained until the recent slide, likely helped things along. As a result, sales are shifting to richer product segments to the benefit of producers with more market share in that space.

On the supply side, manufacturers have been deftly responding to demand-side pressures. Automakers scaled back production in the United States by 4.9% in 2019. But the average betrays a 14.8% drop in passenger
car production compared to only a 1.7% decline for light trucks. Ford, for instance, is highlighting only one car in its showcases for 2020, the Mustang, which admittedly is a halo product, while it phases out its other remaining passenger car, the Fusion. This pivot by manufacturers has helped dealership inventories adjust (Chart 5). Expect this trend to reduce the need for incentive spending and shift sales to higher-margin products, thereby boosting dealerships’ profitability. However, with the potential fallout from COVID-19, lower inventories also expose automakers and dealerships to more downside risk if supply-chain disruptions last longer than anticipated.

**Canada: Debt is a Downer**

In 2019, regional sales trends in Canada showed significant dispersion. There was a clear East-West divide with the West experiencing declines in light vehicle sales in excess of 5%. Ontario, Quebec, and the Atlantic Provinces, on the other hand, experienced milder sales reductions of around 2% or less. We anticipate that growth in Quebec and the Maritimes will slow in 2020. With WTI plunging below $35, provincial sales dispersion is likely to widen and contribute to slower overall vehicle sales in Canada, likely below 1.9 million units by the end of the year [1].

The secular movement toward the light truck segment is even more pronounced in Canada compared to the U.S. (Chart 6). Autos have never recovered from their Great Recession plunge. Consumers’ changing tastes have further diminished car sales in Canada, as light trucks comprised 75.6% of the market in 2019 compared with 49.3% back in 2007. This is moving consumers to more expensive vehicles to the benefit of producers. However, higher average vehicle prices are likely to lessen demand going forward. At the aggregate level, as in the U.S., cyclical demand factors are sending mixed messages on where the market is heading.

Household debt remains the largest drag on auto demand in Canada. Canadians, on average, are allocating 15% of their household income to service debt payments as of 2019Q4. The household debt-service ratio is now above its peak during the Great Recession despite much lower rates. This stands in sharp contrast to the U.S. where the comparable ratio is at record lows going back to the 1980s. With concerns

---

**Chart 4**

**U.S. Light Vehicle Sales by Segment**

(mlns of units : s.a.a.r. : 6-mnth m.a.)

![Chart 4](image)

**Sources:** BMO Economics, Haver Analytics, Autodata

**Chart 5**

**Days’ Supply of Vehicle Inventories**

United States (days : s.a. : 3-mnth m.a.)

![Chart 5](image)

**Sources:** BMO Economics, Haver Analytics

**Chart 6**

**Canada Light Vehicle Sales by Segment**

(mlns of units : s.a. : 12-mnth m.s.)

![Chart 6](image)

**Sources:** BMO Economics, Haver Analytics, Statistics Canada
over COVID-19 leading the Bank of Canada to cut rates, Canadian households will see some relief.

According to J.D. Power, 71% of new car purchases are being financed over terms exceeding six years. This compares to only 14% of auto loans back in 2008. Average bank financing rates for new auto loans are still more than 50 bps above their 2017 lows. But, with recent easing by the Bank of Canada, auto loan rates could fall, which would support vehicle sales.

On the positive side, demographics and a healthy labour market have reinforced vehicle sales. Population growth in 2019 was the fastest in three decades at 1.5%, which we see helping to sustain Canadian sales above their previous cyclical highs. Despite middling employment numbers across the Prairies in 2019, national employment growth remained robust at 2.1%. We see it cooling to 0.6% this year, which is consistent with vehicle sales softening in 2020.

The supply-side of the market responded sharply to the ongoing shifts in consumer tastes with passenger-car production falling 28.9% in 2019 while light trucks were up 7.1%, leaving overall production down 4.9%. And, the near-closure of GM’s Oshawa plant (it is retaining 300 employees) and the recent announcement of FCA Windsor’s third shift shuttering effective June 29 will likely see Canada further reduce its production volume in 2020, as together they represented 15.4% of national vehicle production in 2019.

Following the overall industry trend, average sales per dealership fell to 517 units compared to 530 in 2018. However, better alignment with developments in the sector by certain firms and dealerships led to improved performance. In growth terms, Lexus, Volvo, Toyota, Hyundai, and Kia rounded out the top five with year-over-year increases in sales per dealership of at least 15 units, while also outperforming the Canadian light vehicle sales market. This reinforces the view that suppliers able to respond to industry dynamics will be more profitable at this stage of the cycle.

For dealers, emerging risks include the potential for the USMCA to raise average vehicle prices and the possibility of a federal luxury vehicle tax. When the new trade agreement comes into force, possibly this summer, the North American rules of origin (ROO) requirements will increase from 62.5% to 75% by 2023. The higher ROO thresholds, along with the added labour value content (LVC) and steel and aluminum minimums, will require some producers to adjust their North American vehicle production if they wish to remain compliant. Producers may respond by switching from their cost-minimizing parts suppliers to North American alternatives or maintain their supplier network and instead pay the 2.5% import tariff. Both of these alternatives would contribute to higher overall vehicle prices and put more downward pressure on sales.

The luxury tax would have a similar effect on prices and vehicle demand, albeit with more of a concentrated effect on the Vancouver and Toronto markets where most luxury vehicles are sold. The luxury vehicle tax implemented by the B.C. government in April 2018 provides evidence of the possible effects of a federal tax. Luxury truck sales (think Audi, BMW, Jaguar, Maserati, Mercedes, and Porsche) were growing by at least 5% y/y in Ontario and B.C. when the tax was introduced. Afterward, sales in B.C.
decreased by more than 10% y/y in 2018Q3 compared to a nearly 10% y/y increase in Ontario. Ontario luxury truck sales have continued to grow faster than the overall segment, while in B.C. they were lagging the overall trend as of 2019Q1. For luxury car sales, the secular movement away from passenger cars has dominated any further downside pressure from the tax in B.C. For luxury dealers, it appears that the burden of a federal tax is more likely to fall on their light truck sales, and so maintaining service and aftermarket customer relationships would be increasingly important under that scenario. However, since being included in Finance Minister Morneau’s mandate letter, the luxury vehicle tax has only seen brief coverage in the Finance and International Trade Committees during the 43rd Parliament. With the announcement on Windsor’s third shift and COVID-19 concerns, the government might be reluctant to move forward with adding further downside pressure on the auto industry at this time.

**COVID-19: Making a Slower Year Worse**

It was already looking like a down-year for the global auto industry even before the outbreak of novel coronavirus. Emission standards' compliance has been weighing heavily on sales in Europe, and North American sales had been declining in late-cycle fashion. Understandably, COVID-19 has led some to take a more pessimistic view of the sector for 2020. For example, Moody’s revised down its projection to a 2.5% decline in global sales from 0.9%. Automobile purchases, like all durables, can typically be postponed over the near-term and, so, are at greater risk of declining as a result of the uncertainty caused by the spread of the virus than say consumer staples. We remain more bearish on U.S. vehicle sales, with a forecasted decline of 3.6%, than many of the revised forecasts. At the moment, most of the initial effects of the outbreak are being felt in China, with sales down 80% y/y in February.

Attention is also now turning to China’s role in global supply chains and, for some automakers, the downside risks remain high. Global supply chains have become highly complex. One recent study of Toyota’s supply chain showed it relied on 2,192 distinct firms [2]. The spillover effects of disruptions in one part of a network can therefore be difficult to predict. Toyota has indicated it is receiving parts from China for its 16 facilities in Japan, but will reassess its ability to maintain its operations beginning the week of March 9. The outbreak recently led Lamborghini to close its factory for two weeks. The quarantine measures imposed in Italy will also add further pressure on FCA’s production network. Any further closures would be damaging for the global industry, but indications so far are that North American producers are relatively better positioned to weather the disruptions in the near-term. Part of this goes back to the trade war with China, which led some North American automakers to reduce their dependence on Chinese suppliers. U.S. imports of motor vehicle parts from China over this period are consistent with this

---

**Chart 7**

**U.S. Imports of Motor Vehicle Parts from China**

1 (share of total motor vehicle parts imports : lhs); 2 (rhs)
Sources: BMO Economics, Census Bureau
anecdotal evidence, showing a significant drop-off after tariffs rose from 10% to 25% in May 2019 (Chart 7). If the supply disruptions stretch into April, however, expect the situation to worsen for North American producers as well.

The Auto Cycle: It Goes On and On My Friend
Another important secular trend in the auto sector has been the lengthening of the cycle since the 1960s (Chart 8). Manufacturing is highly cyclical and it is important to understand what point of the cycle the industry is in for both investors and firms for allocating capital. The puzzle over the last two cycles, in particular, has been why they are lasting longer than they used to. The reduction in the volatility of macroeconomic indicators since the 1980s is cited as one cause of extending business cycles. This has been attributed to the increasing sophistication of monetary policy tools and a shift toward inflation targeting. U.S. Real GDP, unemployment, and industrial production have seen their volatility fall by at least half comparing the 1948-to-1984 period with the post-1985 period (Table 1). At the same time, the volatility of consumer sentiment shifts and oil price shocks have not fallen by nearly the same factor, adding weight to the notion that central banks have become more effective at stabilizing the macroeconomy.

The rising role of services in advanced economies is also emerging as a key contributor to the lengthening of the cycle. From the late 1960s, services have gone from just over 50% of nominal GDP to more than 70% in Canada and the United States. Services are much less cyclical than the goods sector, so GDP will be less cyclical as services continue their increasing importance in the economy. The bottom line is bank on generally longer recoveries from future recessions and, hence, longer auto sales cycles.

Endnotes:
General Disclosures

“BMO Capital Markets” is a trade name used by the BMO Investment Banking Group, which includes the wholesale arm of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K., Bank of Montreal Europe Plc in Ireland and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited, Bank of Montreal Europe Plc and BMO Capital Markets Corp are affiliates. BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries (“BMO Financial Group”) has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections expressed in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, accepts no responsibility for any errors or omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets without its consent. The information in this report not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referred herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information be construed as an invitation or inducement to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor’s particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates shall not buy from or sell to, customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Economic Publications

Our publications are disseminated via email and may also be available via our web site https://economics.bmo.com. Please contact your BMO Financial Group Representative for more information.

Additional Matters

This report is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Its contents have not been reviewed by any regulatory authority. BMO Capital Markets does not represent that this report may be lawfully distributed or that any financial products may be lawfully offered or dealt with, in compliance with regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. To Australian residents: BMO Capital Markets Limited is exempt from the requirement to hold an Australian financial services licence under the Corporations Act and is regulated by the UK Financial Conduct Authority under UK laws, which differ from Australian laws. This document is only intended for wholesale clients (as defined in the Corporations Act 2001) and Eligible Counterparties or Professional Clients (as defined in Annex II to MiFID II).

To Canadian Residents: BMO Nesbitt Burns Inc. furnishes this report to Canadian residents and accepts responsibility for the contents herein subject to the terms set out above. Any Canadian person wishing to effect transactions in any of the securities included in this report should do so through BMO Nesbitt Burns Inc.

To UK/E.U. Residents: In the UK, Bank of Montreal London Branch is authorised and regulated by the Prudential Regulation Authority and the Financial Conduct Authority (“FCA”). BMO Capital Markets Limited is authorised and regulated by the FCA. The contents hereof are intended solely for clients which satisfy the criteria for classification as either a “professional client” or an “eligible counterparty”, each as defined in Directive 2014/65/EU (“MiFID II”). Any U.K. person wishing to effect transactions in any security discussed herein should so through Bank of Montreal, London Branch or BMO Capital Markets Limited; any person in the U.K. wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Limited in the UK. This document is published by BMO Capital Markets Limited which is authorised and regulated by the Financial Conduct Authority. The contents hereof are intended solely for the use of, and may only be issued or passed on to, (i) persons who have professional experience in matters relating to investments falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the “Order”) or (ii) high net worth entities falling within Article 49(2)(a) to (d) of the Order (all such persons together referred to as “relevant persons”). The contents hereof are not intended for the use of and may not be issued or passed on to retail clients. In an E.U. Member State this document is issued and distributed by BMO Capital Markets Limited which is authorised and regulated in each E.U. country as a “credit institution” and is considered to be an intermediary firm as defined in 2014/65/EU (“MiFID II”).

To Hong Kong Residents: This document is issued and distributed in Hong Kong by Bank of Montreal (“BMO”). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (“SFC”) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). This document has not been reviewed or approved by any regulatory authority in Hong Kong. Accordingly the material must not be issued, circulated or distributed in Hong Kong other than (i) for “situations” as defined in the Securities and Futures Ordinance, in circumstances which do not constitute it as a “Prospectus” as defined in the Companies Ordinance or which do not constitute an offer to the public within the meaning of that Ordinance, or (2) to professional investors as defined in the Securities and Futures Ordinance and Professional Investor (Provisional Investor) Rules made thereunder. Unless permitted by the securities laws of Hong Kong, no person may issue in Hong Kong, or have in its possession for issue in Hong Kong this material or any other advertisement, invitation or document relating to the products other than to a professional investor as defined the Securities and Futures Ordinance and the Securities and Futures (Professional Investor) Rules made thereunder.

To Korean Residents: This material is not provided to make a recommendation for specific Korean residents to enter into a contract for trading financial investment instruments, for investment advising, for discretionary investment, or for a trust, nor does it constitute advertisement of any financial business or financial investment instruments towards Korean residents. The material is not provided as advice on the value of financial investment instruments or any investment decision for specific Korean residents. The provision of the material does not constitute engaging in the foreign exchange business or foreign exchange brokerage business regulated by the Foreign Exchange Transactions Act of Korea.

To HK Residents: This material does not constitute a solicitation to buy or sell the solicitation of an offer to buy any financial products in the People’s Republic of China (excluding Hong Kong, Macau and Taiwan, the “PRC”). BMO and its affiliates do not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered, in compliance with any applicable registration or other requirements in the PRC, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. This material may not be distributed or published in the PRC, except under circumstances that will result in compliance with any applicable laws and regulations.

To Thai Residents: The contents hereof are intended solely for the use of persons qualified as Institutional Investors according to Notification of the Securities and Exchange Commission No. GorKor. 11/2547 Re: Additional Matters. The provision of the material does not constitute engaging in the foreign exchange business or foreign exchange brokerage business regulated by the Foreign Exchange Transactions Act of Korea.

To U.S. Residents: BMO Capital Markets Corp. furnishes this report to U.S. residents and accepts responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal.

These documents are provided to you on the express understanding that they must be held in complete confidence and not republished, retransmitted, distributed, disclosed, or otherwise made available, in whole or in part, directly or indirectly, in hard or soft copy, through the Internet, to any mean, to any person, except with the prior written consent of BMO Capital Markets.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A. (Member FDIC). Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets.

BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A. (Member FDIC), Bank of Montreal Europe Plc, and Bank of Montreal (China) Co. Ltd. and the institutional brokerage businesses of BMO Capital Markets (Member FINRA and SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, Bank of Montreal Europe Plc in Europe, BMO Capital Markets Limited in the U.K. and Australia and BMO Advisors Private Limited in India.

© Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.