Fixed Income Weekly

FOR PROFESSIONAL INVESTORS

The Shifting Winds in the US Auto Sector

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Key takeaways

- The recent Federal Reserve Senior Loan Officers survey showed that while demand for US auto loans has weakened, banks are tightening lending standards for the borrowers who are seeking loans. As the Federal Reserve continues to hike interest rates, it will only become more expensive for consumers to finance vehicle purchases.
- Auto sales have declined year to date despite used vehicle prices falling 7.6% since May 2016 and dealers increasing incentive spending by 11.9%.
- If current trends continue, the US auto sector will act as a negative headwind to US GDP and US CPI growth.

Full commentary

In case you missed it, US retail sales in May were a paltry -0.3% month-over-month (MoM) with a sequential deceleration year-over-year (YoY) to 3.8%. In the past I've written about the US retail department store sector and the challenges it is facing and will face until a new equilibrium has been reached. And you wouldn't be wrong to put the blame on this segment of the economy as the culprit holding down aggregate retail sales. But there is a new musty smell in the retail sector which will have far greater implications: US auto sales. On the Sector Rotation team, we focus on sequencing the business, economic, and earning cycles. The US auto sector is no different and has its own cyclical pattern that can largely be defined as <stable used car values -> stable trade cycles -> stable new car sales velocity-> positive contributions to GDP and Consumer Price Indexes (CPI) >.

The majority of new vehicle transactions involve a trade vehicle, and strong used vehicle values lead to a quicker trade cycle. Roughly one third of all new vehicle sales are from leases – with 2016 setting a new penetration record. The leasing market is driven by "residual value", or the lender's estimation of what a vehicle's value will be upon taking it back at the end of its lease. Residual value is almost exclusively determined by current and forward estimates of used vehicle prices. Therefore, the wider the residual value, the higher the monthly lease payment. New and used car buyers are price sensitive to monthly payment amounts.

When current used car values start to fall, future residual value widens. As a result, new vehicle lease payments will increase and new vehicle sales will slow. To counter this widening, auto producers implement incentive programs to keep monthly payments manageable and current vehicle sales growing. Data as of May 2017 shows that dealer incentives have increased 11.9% from May 2016 and represented the 26 consecutive monthly incentive spending increase.

But this strategy only delays the inevitable as used car prices continue to fall under the weight of off-leasing vehicles. Last year, 2016, saw off-leasing of 2.8 million cars, and we expect this figure to grow to around 4.8 million by 2021. If incentive programs are unable to offset the declining used vehicle values, it is very likely we will see a decline in new vehicle lease sales. Our first chart of the week shows exactly this with the Ward's Automotive US Auto Sales peaking at the end of 2016 to 16.58 SAAR at the end of May.

The broader implications of this trend will not be simply isolated to the share price value of auto producers as this sector is traditionally a positive contributor to US GDP growth. Looking at our second chart of the week we are starting to see US vehicle sales reversing their trend of a positive GDP tailwind and are now acting as a negative GDP headwind. The table on the bottom of the chart shows the deflationary drag vehicle prices are contributing to CPI.

Due to the public holiday in the US, the Fixed Income Weekly will not be published on Monday, July 3. The next issue will be delivered on Monday, June 10.

This week's market developments

Tuesday, June 20
- Germany PPI growth decreased to -0.2% m.o.m. for May

Wednesday, June 21
- Japan All Industry Activity Index increased to 2.1% m.o.m. for April
- US existing home sales growth increased to 5.62m for May

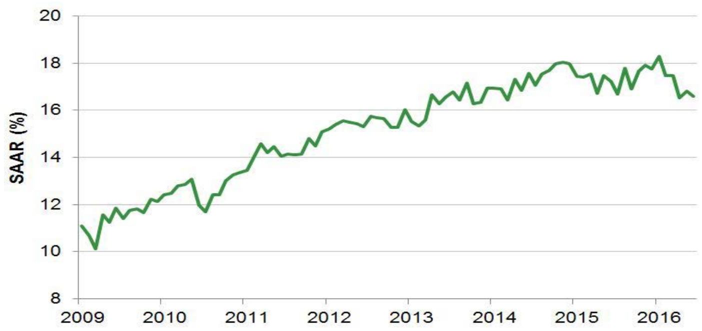
Thursday, June 22
- US Leading Index growth remained at 0.3% m.o.m. for May
- Eurozone consumer confidence (advance estimate) increased to -1.3 for June

Friday, June 23
- Markit Eurozone Manufacturing PMI (prelim estimate) increased to 57.3 for June
- Markit Eurozone Services PMI (prelim estimate) decreased to 54.7 for June
- Markit US Manufacturing PMI (prelim estimate) decreased to 52.1 for June
- Markit US Services PMI (prelim estimate) decreased to 53.0 for June
- US new home sales increased to 610,000 for May

Source: Bloomberg, as of June 26, 2017

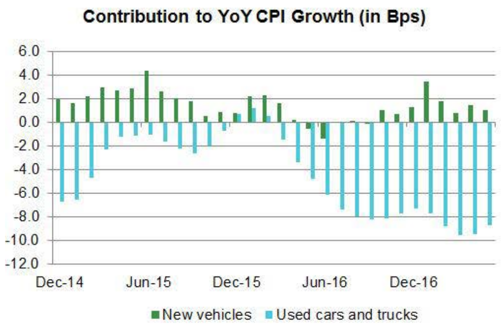
Charts of the Week

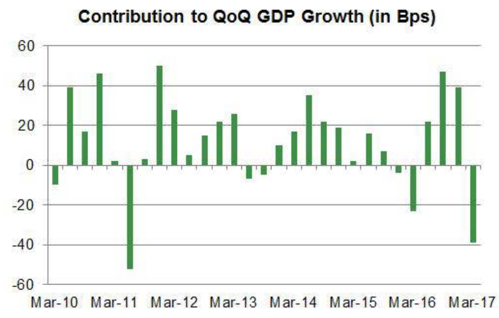
Chart 1: US Auto Sales Total Annualized SAAR



Source: Bloomberg, May 31, 2017

Chart 2: Contribution to YoY CPI Growth & QoQ GDP Growth (in Bps)





Source: Bloomberg, May 31, 2017

Next week's market developments

Monday, June 26

- US durable goods orders growth (prelim estimate) is expected to decrease to -1.1% m.o.m. for May

Tuesday, June 27

- US Conference Board Consumer Confidence is expected to decrease to 116.0 for June

Wednesday, June 28

- UK nationwide housing prices growth is expected to increase by 0.1% m.o.m. (s.a.) for June
- US whole inventories growth (prelim estimate) is expected to increase by 0.2% m.o.m. (s.a.) for May

Thursday, June 29

- UK mortgage approvals are expected to decrease to 64,000 for May
- US first quarter GDP growth (third estimate) is expected to remain at 1.2% q.o.q.
- Japan national CPI growth is expected to increase to 0.5% y.o.y for May

Friday, June 30

- UK first quarter GDP growth (final estimate) is expected to remain at 0.2% q.o.q.
- US personal income growth is expected to decrease to 0.3% m.o.m. (s.a.) for May
- US personal spending growth is expected to decrease to 0.1% m.o.m. (s.a.) for May

Source: Bloomberg, as of June 26, 2017

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on September 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	June 14, 2017	0.75% - 1.00%	1.17%	July 26
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	July 20
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.04%	July 20
BoE	-25 basis points	August 4, 2016	0.25%	0.37%	August 3

Source: Bloomberg, June 26, 2017