Healthy U.S. Auto Market, Despite Soft Used Car Prices — Favourable Affordability And Credit Conditions Point To Further Gains

Recent Global Sales Development

Global car sales accelerated to a 5% y/y gain in March, up from a 3.5% increase during the previous two months. Asia led the advance, as double-digit growth resumed in China, following a moderation in February due to the lunar New Year holidays. Western Europe also continues to outperform alongside an improving labour market. In contrast, double-digit declines continue in Brazil and Russia. However, there are tentative signs that a bottom may have been reached in Russia. In March, the slide in Russian car sales lessened to only 10% y/y, the smallest decline since late 2014.

More recent data for April point to a further improvement across North America. The record-setting pace accelerated further in Canada, with purchases climbing to an annualized 2.03 million units last month, up from 2.0 million in the first quarter and a full-year 2015 total of 1.90 million. Sales in the United States also regained momentum in April, rebounding to an annualized 17.4 million units alongside soaring light truck purchases. In particular, sales of luxury crossover utilities rocketed ahead nearly 20% above a year ago, with notable strength in the larger luxury segment. This reflects low gasoline prices — still 20% below the 2015 full-year average — as well as strengthening income gains. Disposable income growth has picked up in the United States in recent months, and is now advancing by 4% y/y — the fastest pace since early 2015. Consumer confidence also remains elevated, with many consumers indicating that this is a good time to make a major purchase.

Overblown Fears Of Used Car Pricing In The United States

Despite record profitability for the two largest North American automakers in early 2016, concern about vehicle pricing and the U.S. sales outlook remains high among investors and many analysts. Auto manufacturers and parts suppliers are trading at multiples well below historical averages and at a large discount to the overall S&P500. The latest fear is that an increase in the number of vehicles coming off-lease has started to pressure used car prices and could eventually impact the new vehicle market, leading to weaker new car and truck prices and potentially lower sales. However, we do not see any evidence of this occurring. In fact, demand for both new and used vehicles continues to strengthen in the United States, with average transactions prices for new models climbing to record highs in early 2016.

Profitability for the two largest North American automakers surged 40% y/y in the opening months of 2016 alongside strengthening sales and a shift in consumer preference towards highly profitable light trucks. Pre-tax earnings now exceed US$3,300 per vehicle in North America, a 30% jump from the level prevailing in recent
years. However, equity valuations are well below the overall market, as investors remain concerned about the outlook. In fact, the discount on a price-to-book basis is the largest since the global economic expansion began in mid-2009.

Investors and many analysts believe that the slide in used car prices below a year earlier in recent months will accelerate as the number of vehicles coming off-lease increases by roughly 500,000 per year through 2018. They suggest that the downside pressure on pre-owned vehicle prices will spread to the new vehicle market and potentially lead to a replay of 2008. At that time, residual values plunged in response to a rising supply of used vehicles, significant weakening in overall vehicle demand and tightening credit conditions. However, we believe that these fears are overstated. It is not unusual for used car prices to weaken temporarily in response to increased supplies. In fact, this has occurred several times over the past three years without any impact on the overall U.S. auto market (see top chart on page 1).

U.S. vehicle demand continues to strengthen in both the new and pre-owned auto market. New vehicle purchases have climbed 3% so far this year, and used vehicle demand has advanced 6% y/y through March, only marginally below the gains of recent years. While the number of vehicles coming off-lease will increase over the next few years, the expansion is modest by historical standards, and represents only a 1% per annum increase in the number of total used vehicles for sale in the United States. Furthermore, data from Manheim Consulting indicate that more than half of all vehicles coming off-lease are normally bought by the lessee or grounding dealer, significantly reducing the number of cars and trucks that will be remarketed.

Furthermore, the increase in the supply of pre-owned models is occurring in an environment of favourable vehicle affordability, rising incomes and demand, as well as low interest rates. All of these factors will facilitate the absorption of these models into the market even with the Federal Reserve continuing to gradually normalize short-term interest rates. In particular, new and used vehicle purchases in the United States currently absorb less than 3% of annual household disposable income, roughly 25% less than the average required over the past three decades, and 35% less than what was necessary at the start of the millennium, when the industry was forced to escalate incentives to entice buyers into showrooms.

Credit availability also remains favourable, with the number of vehicle repossessions at finance companies and auto loan delinquencies at banks and other financial institutions all at low levels. For example, data from the Federal Reserve and major auto lenders indicate that only 1.4% of auto loans were delinquent for more than three months in early 2016, down from a peak of 2.2% as recently as 2011. This improving trend represents a sharp contrast to developments in 2008, when automotive delinquencies and the number of vehicle repossessions surged, as economic activity weakened and credit conditions tightened (see bottom chart on page 1). In fact, we believe that credit availability and level of delinquency rates and repossessions are the most important indicators to watch going forward to gauge the health of the U.S. auto market. All of these indicators remain positive, supporting a favourable sales outlook.

### International Car Sales Outlook (millions of units)

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*Includes light trucks. **Includes crossover utility vehicles from 2005.
### Canada/U.S. Motor Vehicle Sales Outlook

**Average**

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<td><strong>CANADA</strong></td>
<td>15.58</td>
<td>13.86</td>
<td>17.43</td>
<td>17.95</td>
<td>17.74</td>
</tr>
<tr>
<td><strong>UNITED STATES</strong></td>
<td>2.50</td>
<td>2.22</td>
<td>2.39</td>
<td>2.28</td>
<td>2.56</td>
</tr>
<tr>
<td><strong>MEXICO</strong></td>
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<td>2.37</td>
<td>3.37</td>
<td>3.57</td>
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*Includes transplants; light, medium and heavy trucks. **Canadian sales are Scotiabank estimates.

### Vehicle Sales Outlook By Province*

**thousands of units, annual rates**

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<tr>
<td>Atlantic</td>
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<td>207</td>
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*Includes cars and light trucks. **Scotiabank estimates.

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1991-05 to 2015 data includes cars and trucks (light, medium and heavy). Shaded bars indicate U.S. recession periods.
# Auto Market Share By Manufacturer — Canada*

(Thousands of units, not seasonally adjusted)

<table>
<thead>
<tr>
<th></th>
<th>2015 Jan to Apr</th>
<th>2016 Jan to Apr</th>
<th>2015 Apr</th>
<th>2016 Apr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units</td>
<td>Units % of Total</td>
<td>Units % of Total</td>
<td>Units</td>
<td>Units</td>
</tr>
<tr>
<td>TOTAL</td>
<td>219.0</td>
<td>100.0</td>
<td>217.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Big Three</td>
<td>47.0</td>
<td>21.4</td>
<td>41.5</td>
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</tr>
<tr>
<td>General Motors</td>
<td>21.6</td>
<td>9.6</td>
<td>22.1</td>
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<tr>
<td>Ford</td>
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<td>6.6</td>
<td>13.3</td>
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<td>7.0</td>
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<td>28.8</td>
<td>13.1</td>
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<td>Other</td>
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*Source: Dealer sales from the Global Automakers of Canada.

# Truck Market Share By Manufacturer — Canada*

(Thousands of units, not seasonally adjusted)

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<tr>
<th></th>
<th>2015 Jan to Apr</th>
<th>2016 Jan to Apr</th>
<th>2015 Apr</th>
<th>2016 Apr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Units</td>
<td>Units % of Total</td>
<td>Units % of Total</td>
<td>Units</td>
<td>Units</td>
</tr>
<tr>
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<td>350.3</td>
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<td>100.0</td>
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<td>Big Three</td>
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<tr>
<td>General Motors</td>
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*Source: Dealer sales from the Global Automakers of Canada.
### Auto Sales By Province

(thousands of units, not seasonally adjusted)

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<th>Province</th>
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<th>2016 Jan to Feb</th>
<th>2015 Feb</th>
<th>2016 Feb</th>
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<td>1.1</td>
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*Light, medium and heavy trucks.

### Truck Sales By Province*

(thousands of units, not seasonally adjusted)

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<th>Province</th>
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*Light, medium and heavy trucks.
Canadian Motor Vehicle Production*
(Thousands of units, not seasonally adjusted)

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*Production data from Ward’s Automotive Reports.  **Light, medium and heavy trucks.

Canada — Motor Vehicle Production

Canada — World Auto Trade Balances

Millions of units, seasonally adjusted annual rates.
*Light, medium and heavy trucks.

2016 data are January-March annualized.
New & Used Car Prices

Scotiabank Car Price Indicators — Canada

*Scotiabank estimate from Canadian Black Book data.

Scotiabank Car Price Indicators — Canada

Scotiabank estimate from Canadian Black Book data.

Scotiabank Car Price Indicators — United States

Consumer price indices for new and used cars.
Shaded areas indicate recession periods.
## Canadian Corporate Financial Performance

### Motor Vehicle Dealers and Repair Shops

<table>
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<tr>
<th></th>
<th>Net Income After Tax</th>
<th>Pre-Tax Profit Margin (%)</th>
<th>Inventory Turnover Ratio</th>
<th>Interest Coverage Ratio</th>
<th>Debt/Equity Ratio</th>
<th>Return on Shareholders Equity (%)</th>
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| Quarterly at annual rates |          |                           |                          |                        |                   |                                   |
|---------------------------|----------|---------------------------|--------------------------|------------------------|                   |                                   |
| 2014Q4                   | 2480     | 2.34                      | 5.07                     | 6.12                   | 1.90              | 19.38                             |
| 2015Q1                   | 1668     | 1.75                      | 4.82                     | 5.22                   | 1.98              | 12.92                             |
| Q2                       | 2748     | 2.21                      | 5.05                     | 6.10                   | 2.00              | 21.17                             |
| Q3                       | 2940     | 2.41                      | 5.34                     | 7.29                   | 1.80              | 21.72                             |
| Q4                       | 2750     | 2.34                      | 5.04                     | 6.54                   | 1.90              | 19.45                             |

**Average (89-15)**: 881 1.27 6.03 3.24 2.34 11.73

**Low (89-15)**: -68 0.10 4.38 1.10 3.57 -1.20

**Definition of Ratios:**
- **Interest Coverage Ratio:** \(\frac{\text{pre-tax income and interest payments}}{\text{interest payments}}\)
- **Debt/Equity Ratio:** \(\frac{\text{short-term and long-term debt}}{\text{total equity}}\)
- **Return of Shareholders’ Equity:** \(\frac{\text{after-tax income}}{\text{total equity}}\)

### Retail Auto Dealer Bankruptcies

![Number of Bankruptcies](chart)

*New car dealers only; cumulative total during the year.*