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First Trust

Mar 23, 2009

Economic Commentary

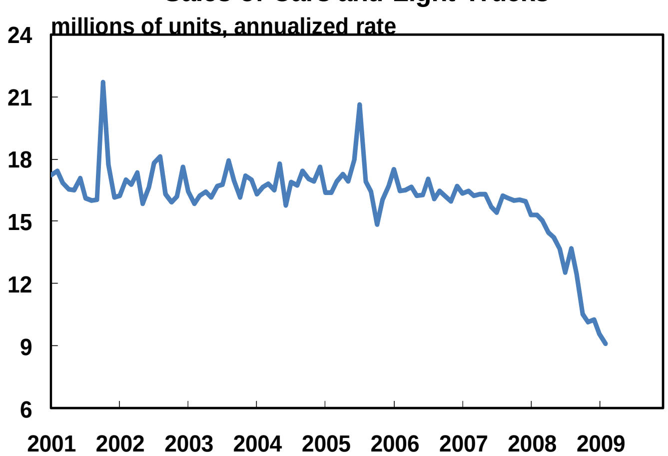
Bright Prospects for a Steep Auto Sector Recovery

Summary: *In recent months, auto sales and auto production have been stunningly slow. Sales are substantially below the long-term sustainable rate and production has slowed in reaction to slower sales and a pile-up of excess inventories. However, both sales and production have either already bottomed or are extremely close to the bottom. In the next two years, both will increase well above current levels.*

Auto Sales

Sales of cars and light trucks fell dramatically in 2008, particularly late in the year. The decline in sales has continued into early 2009; automobiles (cars and lights trucks, combined) sold at an annual rate of 9.1 million in February, the slowest pace since 1981 and the slowest pace relative to the US population since at least the 1960s.

Sales of Cars and Light Trucks



Source: Haver Analytics

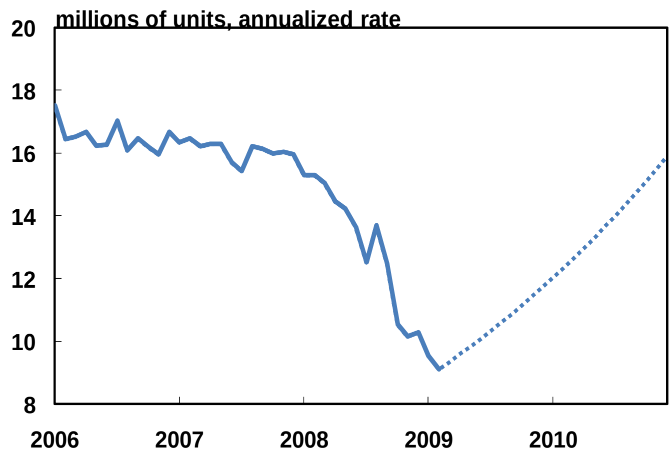
A 9.1 million annual rate of sales is far below the underlying trend, which can be calculated by adding:

(1) the number of autos scrapped every year (due to old age or accidents), *plus*
(2) the number of autos needed for population growth.

The scrappage rate was 5.6% last year, according to R.L. Polk & Company, a provider of auto information. That scrappage rate is roughly the average for the past decade. Applying this rate to our estimate of the number of autos on the road (235.5 million), suggests annual scrappage of 13.2 million autos. Meanwhile, the US population (age 16+) is projected to rise 1.13% this year, which translates into additional demand of 2.7 million autos (1.13% of 235.5 million).

Combined, these figures suggest the underlying trend in demand is 15.9 million autos per year. An annual sales pace of 15.9 million is about 75% faster than the February rate of sales and signals room for a huge recovery. (Note that a 15.9 million annual rate is below the typical pace of the past decade. However, the ratio of autos per adult increased during this period, a process which cannot go on forever.)

Sales of Cars and Light Trucks (with Projections)



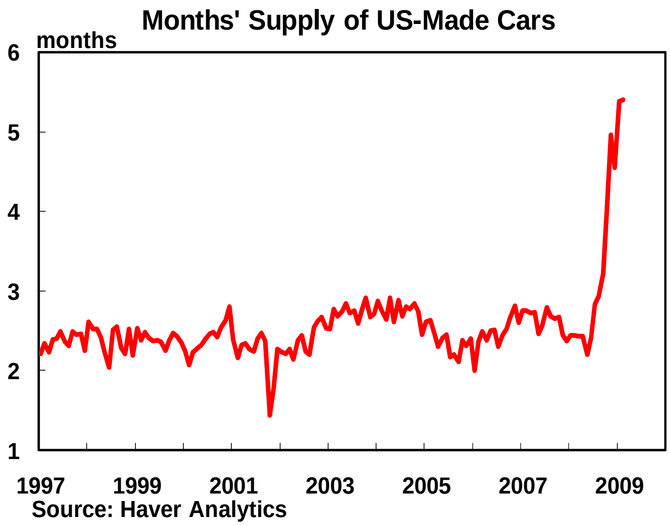
Source: Haver Analytics

Based on past recessions when auto sales fell substantially and then rebounded, we believe the most likely path for sales is a return to the underlying trend of 15.9 million per year by the end of 2010. In order for this to happen, sales must increase 2.6% per month for the next 22 months, or 36% on an annualized basis.

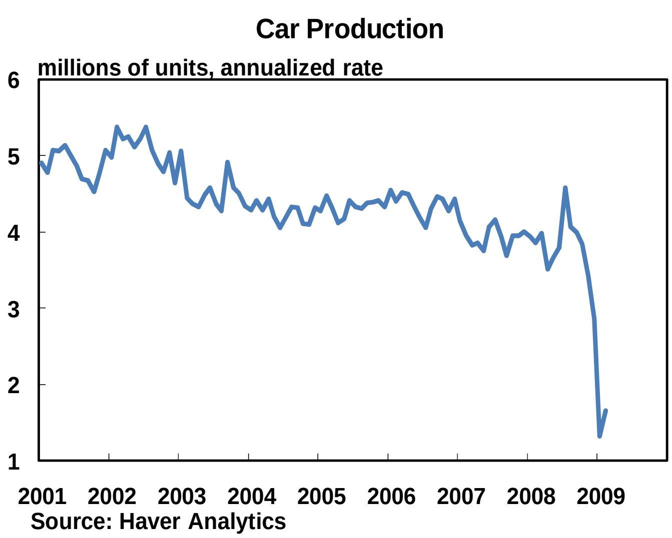
Auto Production

At present, auto dealers have way too many vehicles on their lots. Dealers usually keep in inventory a months' supply of 2.5, or 75 days worth of sales of US-made cars.

For example, if a dealer typically sells 200 cars per month, it keeps 500 cars in inventory. In February, 239,500 US-made cars were sold (a 2.9 million annual rate), which means dealers should keep inventories of about 600,000. Instead, they had 1.3 million. That's 5.4 months of supply, or an excess of 700,000 US-made cars.



Three factors should drive down the excess inventory back to normal levels. First, despite the very slow rate of sales, auto assemblies in the US are already so low that inventories should gradually decline even if sales do not improve at all.



Second, and more important, will be the increase in sales we forecasted in the previous section. If sales increase as we project and assemblies remain at current levels, inventories will fall to the norm in 10 months.

Finally, as sales increase, the level of inventory dealers are willing to hold will rise. Remember: dealers like to hold 2.5 months worth of sales. So if car sales improve and assemblies remain unchanged, inventories will be at desired levels by the fourth quarter of this year.

The problem with this reasoning is that once inventories are reduced to normal levels (2.5 times the rate of sales), auto assemblies would have to increase substantially to prevent inventories from continuing to fall. Cars were assembled at a 1.65 million annual pace in February. By December, the annual assembly rate required to maintain normal inventories would be 3.11 million.

The notion that car assemblies are going to stay at current levels through November and then magically and almost instantaneously spike up by 88% at year end is a fantasy. It's not going to happen. Automakers are forward-looking. As sales increase they will be able to foresee future declines in inventories and will adjust their production schedules accordingly.

As a result, assemblies are likely to start rising well before inventories are back to normal. If sales rise as anticipated and auto dealers are willing to wait until the end of December 2010 for the inventory correction to run its course, assemblies can rise 4.8% per month (75% annualized) starting this month. Postponing the rise in assemblies only makes these increases even faster once they begin: the longer the postponement, the faster the increase.

The bottom line: the US is setting up for a surprisingly strong rebound in economic growth during the second half of 2009, or sooner.

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