

The U.S. Auto Industry's Historic Sales Run Will Taper Off Over The Next 12-24 Months; Negative Rating Bias Could Intensify Somewhat

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Key Takeaways

- S&P Global Ratings expects U.S. light-vehicle sales to decline by nearly 3% year-over-year in 2019 before stabilizing at about 16.2 million-16.5 million units in 2020 and 2021.
- Overall, we don't expect the modest dip in auto sales to lead to downgrades for automaker and supplier ratings in 2019-2020. However, it will compound the current negative ratings bias driven by pressures in the aftermarket, rising commodity costs, and firm-specific underperformance.
- We have increased the overall odds of a recession (12 months out) to 25%-30%, up from our assessment of 20%-25% in May. We believe the Fed will be cutting rates during the third quarter, which is likely to limit the sales decline in 2019 somewhat.
- With the large influx of late-model vehicles coming off lease, used vehicle prices will likely decline 2%-3% in 2019. The decrease would have been larger if not for the continued strong demand for these vehicles.
- Despite increasing sales at Tesla, electric and plug-in hybrid vehicles' combined market share will likely remain under 3% in 2019 because of the reduced tax subsidies for some manufacturers.

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With increased overall odds of a recession (12 months out), declining used vehicle prices and ongoing geopolitical risks, U.S. automakers face a tough road ahead. Overall, light vehicle sales declined about 2% in the first half of 2019, with higher fleet demand partially offsetting the decline in retail sales and sales of SUVs and trucks continuing to dominate the market. S&P Global Ratings now expects a 3% decline in light vehicle sales in 2019 to 16.7 million units (revised up from 16.6 million). We expect a further decline toward 16.2 million by 2021, the lowest level since 2014.

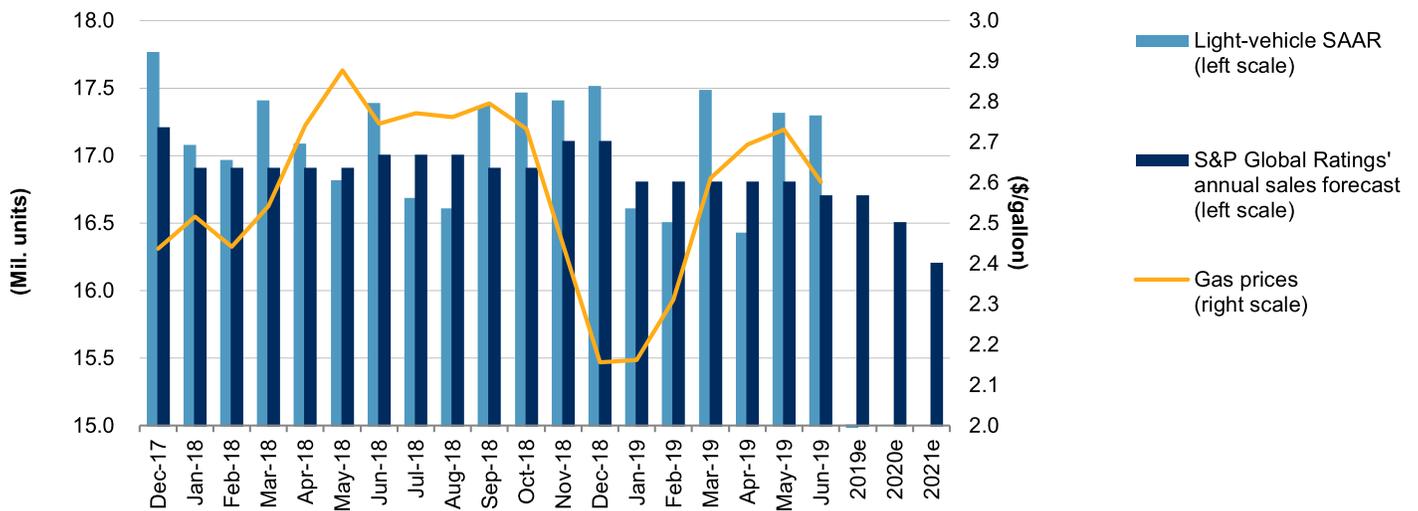
At the same time, we expect that weakening growth momentum and a benign inflation outlook will now prompt the Fed to lower interest rates--perhaps with a cut of 25 basis points (bps) during the

third quarter. Over the next 12 months, we do not expect a steep decline in auto sales as automakers launch newly updated trucks and utility vehicles, while largely maintaining incentive discipline amidst low gas prices and potentially lower financing costs later this year.

Following the Great Recession, U.S. auto sales hit a trough of 10.4 million units in 2009 before revving up again. Sales significantly outpaced GDP growth for six consecutive years and peaked at 17.4 million units in 2016. We believe the declines in 2017 and 2018 stemmed from historically low interest rates, tax refunds, abundant incentives, and low gas prices in previous years having motivated buyers to purchase vehicles sooner than they otherwise would have.

Chart 1

U.S. SAAR History



SAAR--Seasonally adjusted annual rate. e--Estimate. Source: Ward's AutoInfoBank, Energy Information Administration (Regular Conventional Retail Gasoline Prices). Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Negative Rating Bias In The Sector Intensifies, But Not Cycle-Related For Now

Downgrade potential for the U.S. automotive sector rose sharply in the second quarter, as the negative bias (the percentage of ratings with negative outlooks or on CreditWatch with negative implications) increased by eight percentage points (the highest amongst all corporate sectors) driven by pressures in the aftermarket, rising commodity costs, and firm-specific underperformance. Moreover, operational missteps have plagued some tier-1 auto suppliers.

Overall, we don't expect the modest dip in auto sales to lead to downgrades for automaker and supplier ratings in 2019-2020. For one, our forecast sales levels remain healthy enough for most automakers and suppliers to operate at historically high EBITDA margins, especially given the higher profits they earn on truck sales. And even though gas prices are rising, we believe significant new product launches--along with better fuel efficiency and steady incentives,

specifically for trucks--will support automakers' current product mix in favor of trucks, which accounted for nearly 70% of sales in the first half of 2019. Secondly, the U.S.-Mexico-Canada Trade Agreement (USMCA), once ratified, will reduce some of the uncertainty that worried the industry in 2018, though the situation concerning trade with China remains fluid.

We incorporate modest declines in automakers' EBIT margins in our forecast for 2019 and 2020 to account for:

- Higher expected commodity prices;
- Large engineering expenses for developing autonomous and electrification-related technologies; and
- Elevated pricing pressure in several key markets, which could be partly offset by improved cost efficiencies.

Trade And Geopolitical Risks: Base-Case Scenario

In our view, trade tensions between the U.S. and China are unlikely to have any meaningful impact on U.S. sales. However, other trade-related risks, including Section 232 tariffs on European and Japanese imports, a potential reemergence of Mexican tariff threats, would have an adverse impact on automotive demand because most of these costs will be passed on to consumers.

China

While the trade war brewing between the U.S. and China will likely have minimal direct macroeconomic effects on either country in the near future, the longer-term consequences for global supply chains, U.S. business sentiment, and consumers' purchasing power are growing. In particular, together with other manifestations of friction--including investment and export restrictions--the risks of disruptions to China's supply chains in the medium term are rising.

The tariff threat could lead to reciprocal actions from Europe, Japan, and Korea. However, we currently incorporate only a limited ratings impact for Ford and General Motors because of their lower reliance on exports and higher level of localized content relative to foreign automakers. However, these tariffs will add incremental margin pressure for Tesla. After incorporating Tesla's overseas transport costs and import tariffs, the company was operating at a 55%-60% cost disadvantage earlier this year compared with the same car produced in China.

North America

Consistent with our base-case scenario, the U.S., Canada, and Mexico completed their renegotiation of the North American Free Trade Agreement (NAFTA) in late 2018, which has been renamed the USMCA. The USMCA has yet to be signed and likely won't be until the second half of the year. Further delays in ratification increase the risk of it being hostage to electoral politics.

As it relates to the recent developments around potential tariffs on Mexican imports, the auto industry should be able to absorb a 5% tariff with a negligible impact on volumes but if the tax increases to 25%, the impact could be severe. With new vehicle demand softening, automakers have limited wiggle room to pass along the tariffs through customer price increases. Though not our base case, any further escalation of this issue could complicate the passage/ratification of the USMCA.

Once ratified, we expect the USMCA to have a modestly negative, but manageable, effect on profitability because the automakers and their suppliers will bear the costs of repositioning their supply chains. This assumes higher production costs, the preservation of manufacturing for key components in the U.S. and Canada, and an increase in wages for Mexican autoworkers. We assume the auto industry will have adequate time to adapt its supply chain to adhere to the new rules. For example, the new country-of-origin rules for cars will likely phase-in annually through January 2023, while the rules for heavy trucks will phase-in through 2027.

Over the longer term, the changes could lead to elevated margin pressure for GM relative to Ford given GM's higher volume of truck imports from Mexico. Overall, our understanding is that Volkswagen A.G. is the most reliant on exporting vehicles from Mexico into the U.S. GM, Renault-Nissan-Mitsubishi, and Fiat Chrysler rely on Mexican exports to a lesser--but still significant--extent.

Europe

Auto-related tariffs with Europe are another immediate concern. Among U.S. automakers, Tesla faces the largest exposure, as it exports to Europe from the U.S. The impact to Ford would be very limited, and GM wouldn't be affected. (For more details, see "Trump's Tariffs Could Hurt EU Carmakers--Not The Economy," March 26, 2019.)

Most Automakers Are Committed To Incentive and Inventory Discipline

We believe automakers such as GM and Ford will stay committed to cutting production as demand slows rather than boosting their sales through incentives to avoid creating excess supply. Incentive spending as a percentage of average transaction prices (ATPs) will likely remain around 10%-11% over the next few quarters. This is higher than the typical 7.5%-9.5% over the past eight years but lower than the 12% in 2017 and most of 2018. Incentive spending through May 2019 has declined (year-over-year) for nine consecutive months before rising slightly in June.

Inventory levels have remained flat year-over-year but are slightly above historical levels (10-year average of 65 days), with lower passenger car inventory offset by higher inventory for more-profitable pickups.

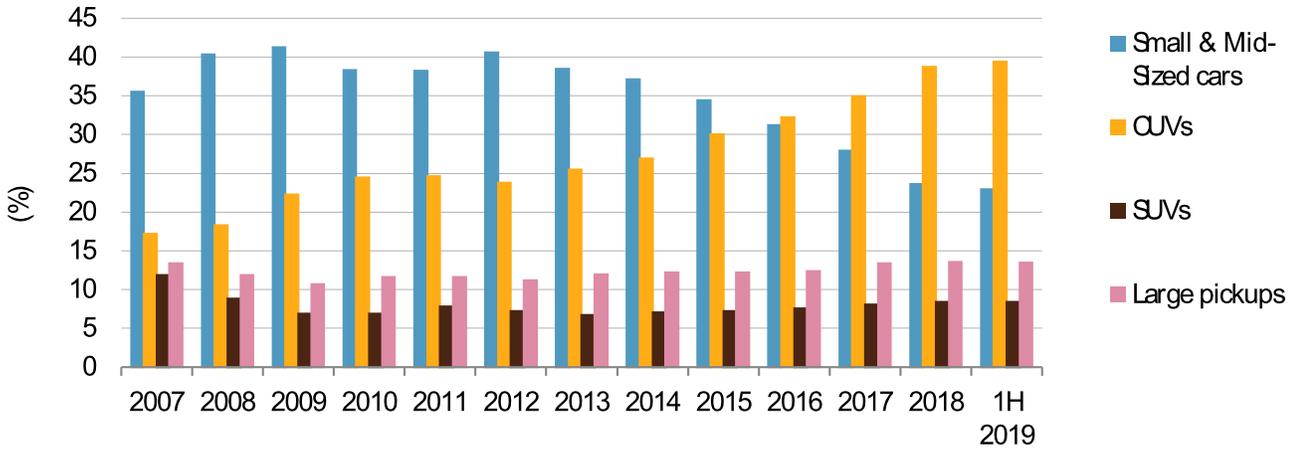
A Stronger Product Mix Also Offers Some Relief From Sales Declines

The product mix in the U.S. remains favorable for automakers. Increasing demand for light trucks--including SUVs, CUVs (crossover utility vehicles), minivans, and pickups--will lower passenger car sales to about 30% of sales in 2019 compared with over 50% in 2012, and we expect automakers to shrink their passenger car footprints further. We also expect trucks' share to improve only marginally over the next 12-24 months.

Consistent with our earlier expectations, for the first time ever, the overall market share for crossovers (nearly 39%) surpassed that of all passenger cars combined (about 31%) in 2018. Since 2012, the crossover segment has cannibalized the combined market share of small and midsize cars (see Chart 2). Over time, high pricing pressure amid declining year-over-year demand will likely lead to some compression in profit margins for automakers, especially as competition intensifies in the high-volume segments such as CUVs.

Chart 2

U.S. Light-Vehicle Product Mix



CUV--Crossover utility vehicle. SUV--Sport utility vehicle. Source: Ward's AutoInfoBank. Copyright © 2019 by S&P Global. All rights reserved.

We believe volatility in automakers' sales performances (see Table 1 and Chart 3) could persist over the next few months. This is because of the differences in product-refresh cycles among companies as well as elevated pricing pressure in the passenger car segment, which will eventually affect the crowded CUV segment.

Table 1

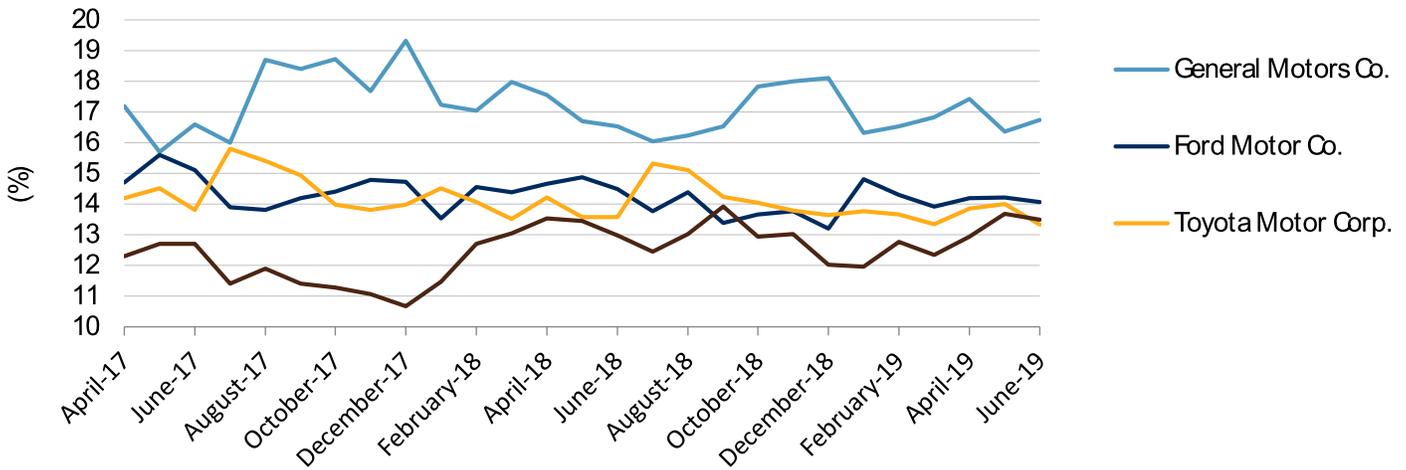
U.S. Auto Unit Sales And Market Share Comparison

	--First-half 2018--		--First-half 2019--		Change (%)
	Units	Share (%)	Units	Share (%)	
General Motors Co.	1,473,237	17.2	1,409,448	16.8	(4.3)
Ford Motor Co.	1,239,302	14.5	1,200,021	14.3	(3.2)
Toyota Motor Corp.	1,189,312	13.9	1,151,641	13.7	(3.2)
Fiat Chrysler Automobiles N.V	1,107,864	12.9	1,089,067	12.9	(1.7)
Honda Motor Co. Ltd.	787,824	9.2	776,995	9.2	(1.4)
Nissan Motor Co. Ltd.	780,695	9.1	717,036	8.5	(8.2)
Hyundai Motor Co.	335,048	3.9	343,373	4.1	2.5
Others	1,662,337	19.4	1,725,335	20.5	3.8
Total	8,575,619	100.0	8,412,916	100.0	(1.9)

Source: Ward's AutoInfoBank.

Chart 3

U.S. Light-Vehicle Market Share



Source: Ward's AutoInfoBank.
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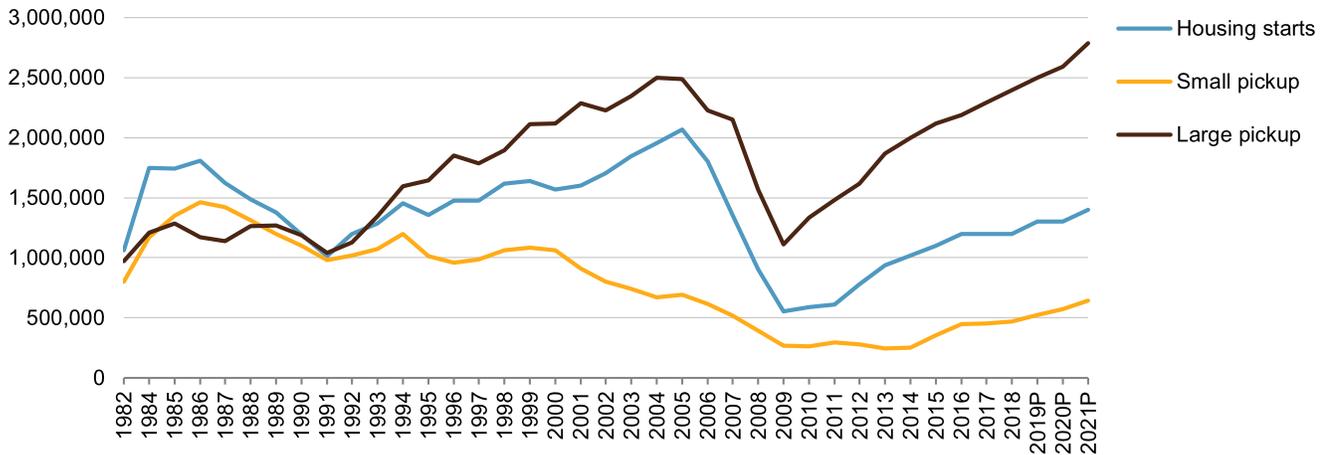
Rivalry In The Pickup Segment Will Intensify

Our assumption is for a modest lift for housing starts this year--to 1.3 million units from 1.2 million in 2018. Newer pickup truck models with better interiors, ride quality and technology, coupled with a steady housing market in 2019-2020 will likely lead to an expansion of share for pickup trucks. Competition in this segment will intensify as absolute inventories on large pickup trucks remain about 14.2% higher year-over-year and sales need to be robust in order to wind down inventories at dealer lots. At June 30, 2019, the average inventory days for full size pickup trucks for the Detroit 3 was at 95 days (up from 89 days in May and from 83 days last June).

We estimate a 6%-8% year-over-year increase in housing starts would support a 3%-5% increase in full-size pickup sales over the next 12 months (see Chart 4), holding all else constant. Despite marginal growth in the housing market, in the current low-gas-price environment and with new products available, we expect pickups to outsell most other vehicle segments and account for about 13% of total sales, slightly higher than previous years.

Chart 4

U.S. Housing Starts And Pickups



P--S&P Global Ratings' forecasts/estimates. Sources: Ward's AutoInfoBank and U.S. Census Bureau. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

The significant drop in Silverado sales so far this year (see Table 2) was likely due to a lack of regular and double-cab pickups, which were scarce on dealer lots as GM rolled out new models. We will actively monitor the company's crew-cab sales, especially those with premium trims and significantly higher profits. We expect FCA to gain some share as it continues to produce its older pickup truck alongside its new offering and maintains elevated incentives.

Ford is re-entering the mid-size pickup segment (3% of U.S. light vehicle sales) with its Ranger, and FCA is introducing its Gladiator product. We see risk to GM's profits in the segment, as its GMC Canyon and Chevrolet Colorado have about a 30% market share in the U.S., which will likely decline.

Table 2

U.S. Top-Selling Light Vehicles

Rank	--First-half 2018--		--First-half 2019--		Year-over-year change (%)
	Vehicle	Units	Vehicle	Units	
1	F Series	418,726	F Series	416,965	(0.4)
2	Silverado	254,174	RAM pickup	292,437	29.4
3	RAM pickup	225,927	Silverado	220,401	(13.3)
4	RAV4	198,391	RAV4	200,610	1.1
5	CR-V	179,580	CR-V	176,944	(1.5)
6	Camry	178,795	Camry	176,008	(1.6)
7	Civic	176,242	Equinox	174,157	11.4
8	Rogue	167,483	Civic	169,172	(4.0)
9	Equinox	156,365	Corolla	150,159	0.2

Table 2

U.S. Top-Selling Light Vehicles (cont.)

Rank	--First-half 2018--		--First-half 2019--		Year-over-year change (%)
	Vehicle	Units	Vehicle	Units	
10	Corolla	149,805	Rogue	138,556	(17.3)

Source: Ward's Automotive Group, a division of Penton Media Inc.

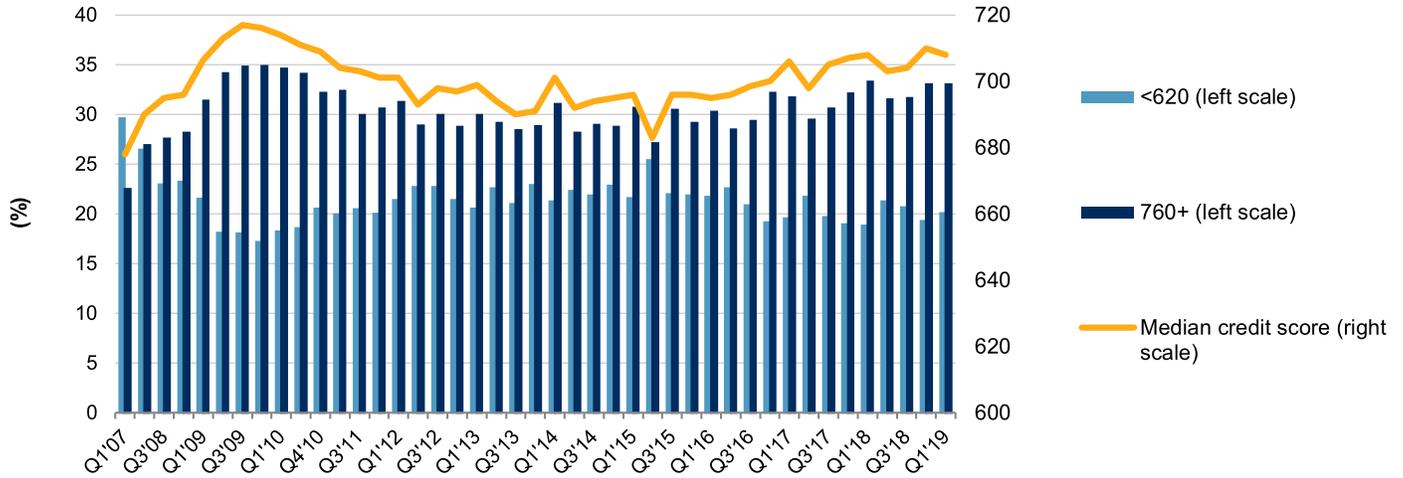
A Less-Supportive Financing Environment Adds Some Risk

Lenders are still willing to support loans of 72-84 months to attract borrowers with lower credit scores. Moreover, they're frequently offering loans that exceed the value of the vehicle. The downside risk is that it could prevent many buyers from re-entering the new-car market for several years because vehicle owners who would usually trade in for a new model could end up owing more than the car is worth. With higher vehicle prices and increased borrowing costs, average new vehicle loan payments were up 3.5% to \$567 in the first half of 2019 compared to last year, and average lease payments are up 2.8% to \$500.

From a historical perspective, total subprime auto lending hasn't returned to pre-crisis levels. Subprime loans as a percentage of all U.S. auto loans have averaged about 20% during recent quarters. This is only slightly higher than 17.2%, which is the lowest since the end of the Great Recession. Notably, captive debt is predominantly owned by prime borrowers and has performed relatively strongly. Superprime borrowers (those with credit scores greater than 760) accounted for one-third of all U.S. auto loan originations, which is the highest level since early 2011 and a significant improvement from average levels of about 22% in 2006 and 2007 (see Chart 5).

Chart 5

Auto Loan Origination Volume By Credit Score Segment*
Subprime versus superprime



*Credit score is Equifax Risk Score 3.0. Note: Superprime borrowers are defined as those with credit scores greater than 760, while subprime borrowers are defined as those with credit scores less than 620. Source: New York Federal Reserve Consumer Credit Panel/Equifax.

Residual Values Are Not Yet A Major Roadblock

With the record high influx of late-model vehicles coming off lease in 2019, used-vehicle prices will likely decline by about 2%-3% in 2019. Car buyers turned off by high sticker prices are finding attractive used-car deals as a surge of newer SUVs coming off lease wind up on used-vehicle lots. Used-car sales grew by around 9% in the first half of the year, according to an estimate from J.D. Power. We expect off-lease vehicle volume to reach a peak of 4.1 million in 2019 (up from 3.9 million last year) and then stay at those levels in 2020 because of high leasing penetrations over the past few years. Our forecasted decline would have been higher if not for demand for these vehicles remaining strong, especially as new car prices remain at all-time highs, making late-model used cars (from Model Year 2017) a good bargain. At the same time, the potential impact of higher tariffs on new vehicles could add some support to used-car prices and keep them steady, which is contrary to our base-case assumption.

Auto lease volumes are approaching peak levels and accounted for about 28% of industry sales in recent periods, though nearly 75% were to prime or superprime consumers and millennials (a segment that reported the highest increase in lease volume over the past few years). Both manufacturers and consumers will become less enthusiastic about leasing over the next couple of years as used-car prices and retention rates fall. However, we still expect lease penetration to remain above the historical average (about 20%) because these programs serve as a mechanism for building customer loyalty.

The key risk to this prediction will be subventions and subsidies, which automakers use to reduce

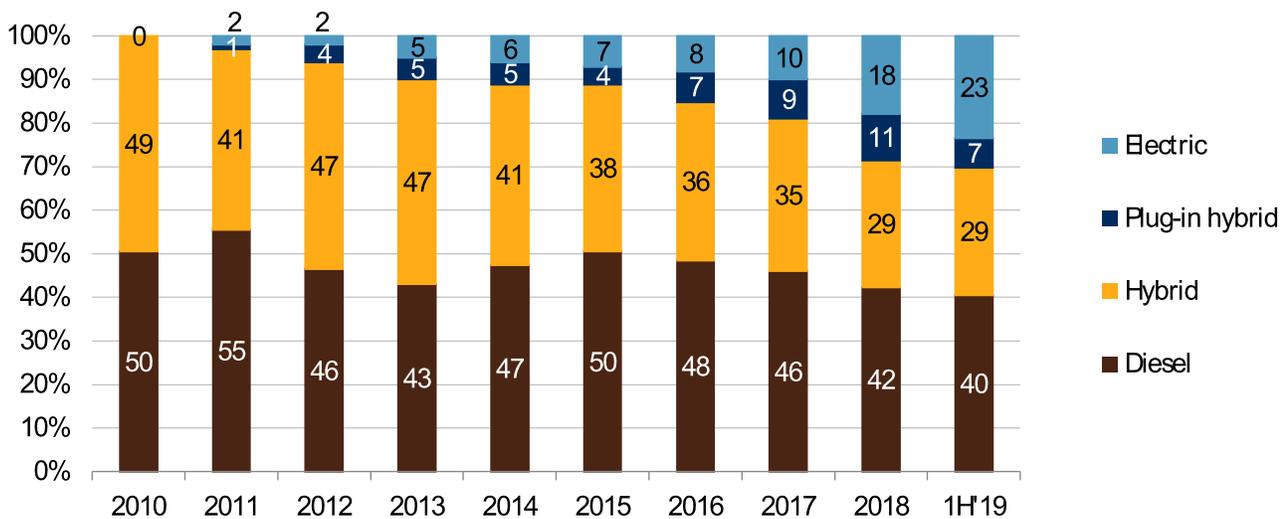
the cost of a lease on weak-selling vehicles (usually by increasing the estimated residual value of the leased vehicle or decreasing the interest rate on the lease). In turn, this reduces the monthly payments required over the lifetime of the lease. To protect residual values, automakers have launched improved and more aggressive marketing strategies aimed at areas such as the certified preowned segment.

Electric Vehicle Sales Remain Highly Sensitive To Tax Subsidies

We expect the combined share of electric vehicles (including plug-in hybrids) to remain under 3% of overall U.S. vehicle sales in 2019 despite significantly increased sales for Tesla's Models 3, S, and X. This will lead to some market-share losses for some competitors in alternate fuel segments (see Charts 6 and 7 and Table 3). We expect some downside risks to our prior base-case assumption, under which electric vehicles (including plug-ins) approach 10% of light-vehicle sales by 2025 because of ongoing customer concerns regarding range, price, and charging infrastructure. These concerns are being compounded by the lower cost of ownership for non-electric vehicles given the current low gas prices, reduced tax incentives, and the high likelihood that the Trump administration will roll back fuel-efficiency targets in 2025.

Chart 6

Composition Of U.S. Alternate Fuel Vehicle Market (% Share)

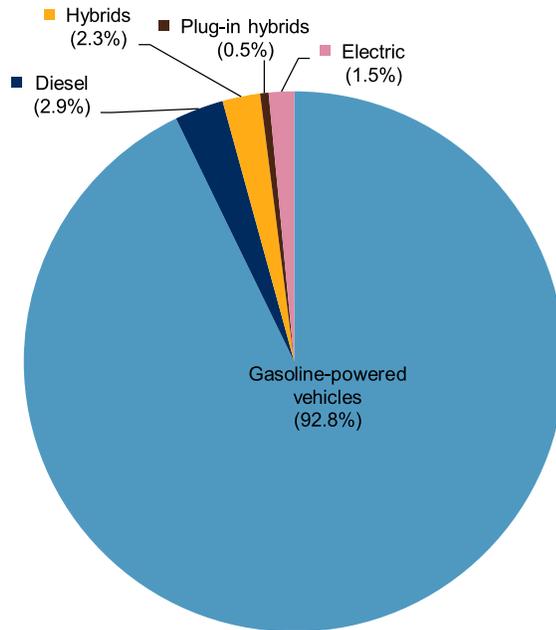


Source: S&P Global Ratings.

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Chart 7

Light-Vehicles Sales By Power Type: First Half of 2019



Source: Ward's AutoInfobank
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Table 3

U.S. Top 10 Electric Vehicles/Plug-In Hybrids Market Share

Brand	Subseries	--Fourth-quarter 2018--		--First-quarter 2019--		--Second-quarter 2019--	
		Units sold	% share	Units sold	% share	Units sold	% share
Tesla	Model 3	54,461	46.3	57,554	57.5	53,551	67.1
Tesla	Model S	7,567	6.4	5,701	5.7	2,716	3.4
Tesla	Model X	6,772	5.8	5,597	5.6	2,850	3.6
Chevrolet	Bolt	6,212	5.3	4,316	4.3	3,965	5.0
Toyota	Prius	7,072	6.0	4,026	4.0	4,924	6.2
Honda	Clarity	6,635	5.6	3,756	3.8	2,796	3.5
Nissan	Leaf	4,029	3.4	2,685	2.7	3,323	4.2
Chevrolet	Volt	5,063	4.3	2,520	2.5	1,146	1.4
Chrysler	Pacifica	2,005	1.7	1,745	1.7	1,894	2.4
Ford	Fusion	2,374	2.0	1,741	1.7	2,664	3.3

Source: S&P Global Ratings.

Related Research

- Economic Research: For The U.S. Expansion, Are Trade Troubles "Just A Flesh Wound"? June 25, 2019
- In Europe's Auto Market It's All About Curbing CO2 Emissions, June 17, 2019
- ESG Industry Report Card: Autos And Auto Parts, May 13, 2019
- Worldwide Auto Sales Will Slump More Than Expected In 2019, May 6, 2019
- Trump's Tariffs Could Hurt EU Carmakers--Not The Economy, March 26, 2019
- The Future Is Electric: Auto Suppliers And The Emergence Of EVs, Feb. 21, 2019
- 10-Year Retrospective: Changes In U.S. Auto ABS In The Decade Since The Great Recession, Feb. 15, 2019
- Industry Top Trends 2019: Autos, Nov. 14, 2018

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