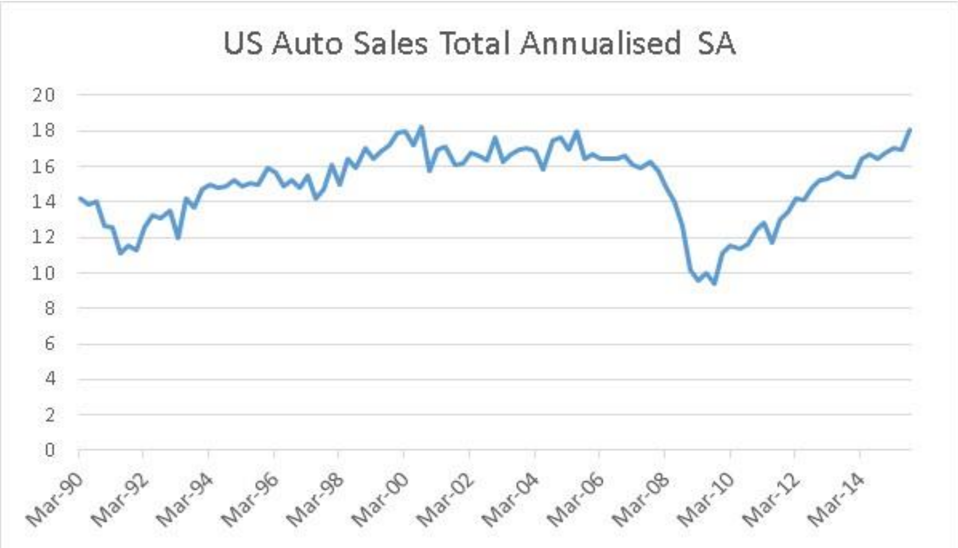
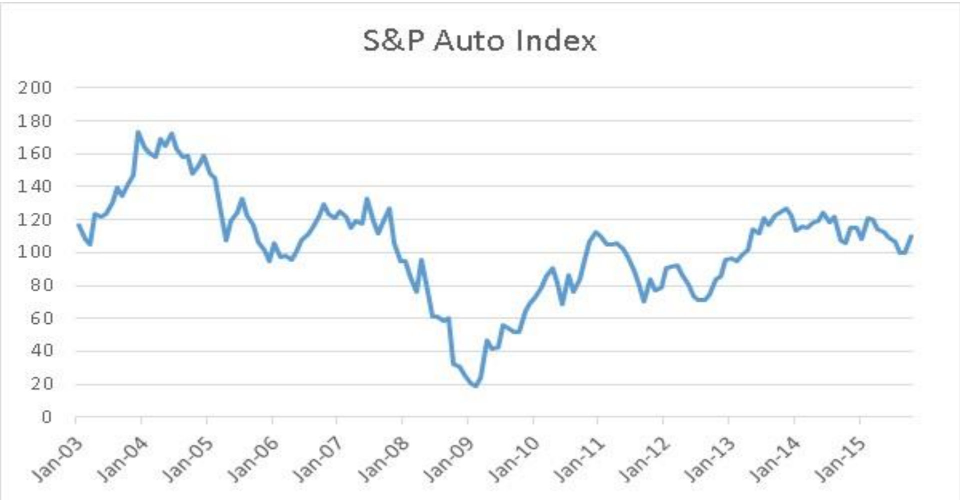
US AUTO MARKET – AN UPDATE

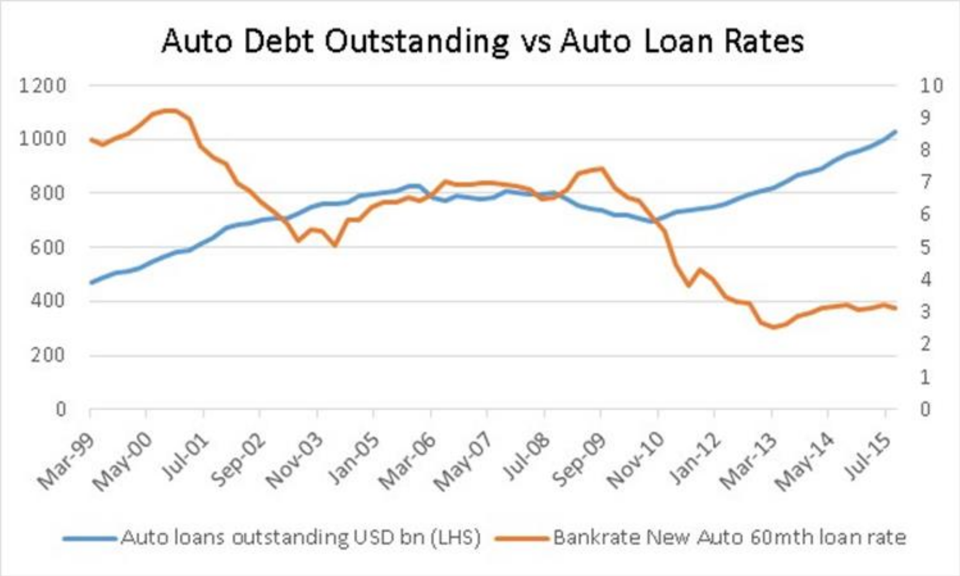
I wrote a note on the US Auto Market in January 2014. Since that note, US auto sales have continued to surge.



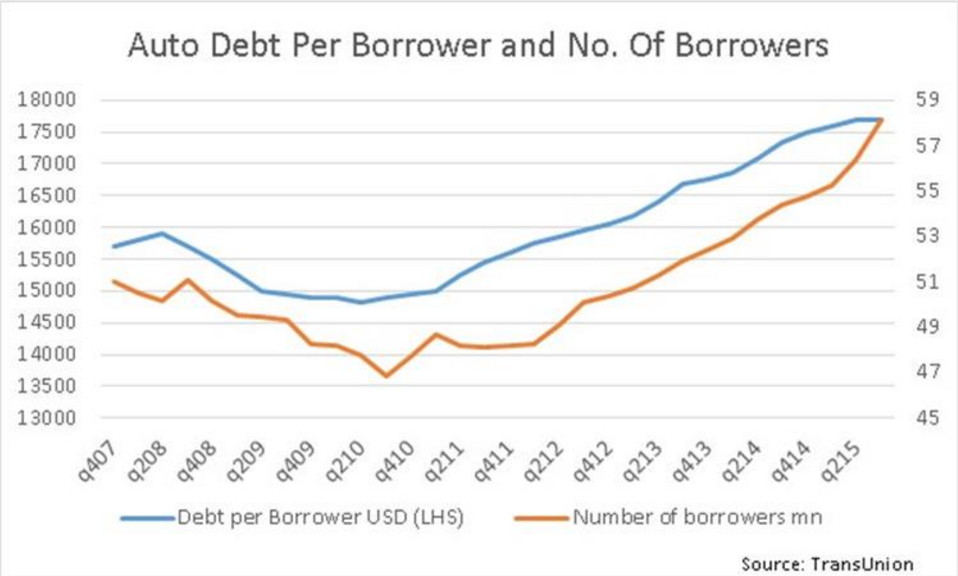
The note also suggested that the weak yen would invigorate Japanese auto makers, and likely cap the performance of the US Auto Sector. This has largely been correct.



Strong sales in the US auto market have been supported by strong loan growth and low interest rates.

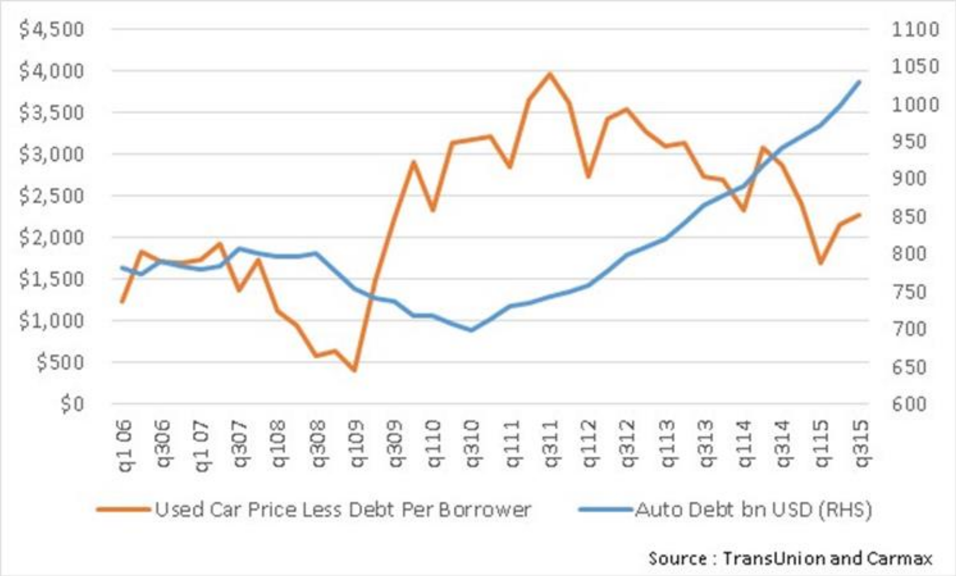


TransUnion, a US based credit bureau, provides us with auto loan debt per borrower. We can use that data to also calculate total number of borrowers with auto loans. This allows us to see that more Americans than ever before have US auto debt, and that the amount that they owe has never been greater. This increase in debt is generally confirmed with data from another credit bureau, Experian.



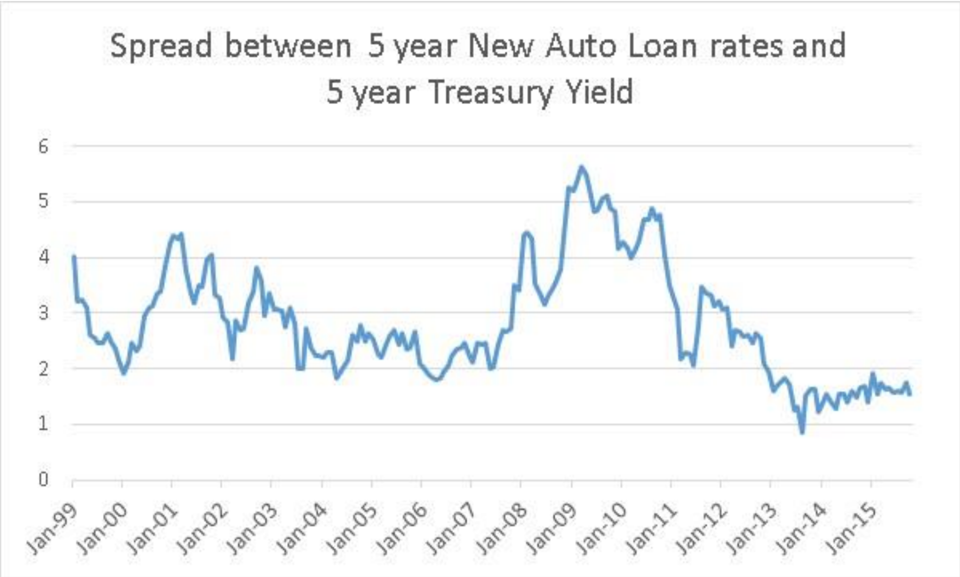
Auto loans are very different to housing loans. While the value of homes can rise over time, car values (with the exception of collector's cars) fall over time to zero. This means that auto lenders know that the collateral of the car will fall, and that if a borrower defaults and they seize and sell the auto, it is very likely that the value will have fallen from the time the car was purchased. This means you will never see the auto loan equivalent of interest only loans, or home equity loans that marked the top of the housing lending market.

However, auto lenders take risk in a different way. All auto lenders know that the collateral they have lent against is a used car. Hence, if the market for used cars is strong, then they know that if the borrower defaults, they can sell the car easily and for a good price. One way we can think about the risk that an auto lender is taking is looking at how much debt the average borrower has (using the TransUnion data from above) and comparing it to used car prices which we can take from CarMax (http://investors.carmax.com/Financial-Reports/Investor-Materials/default.aspx), a large listed used car seller.

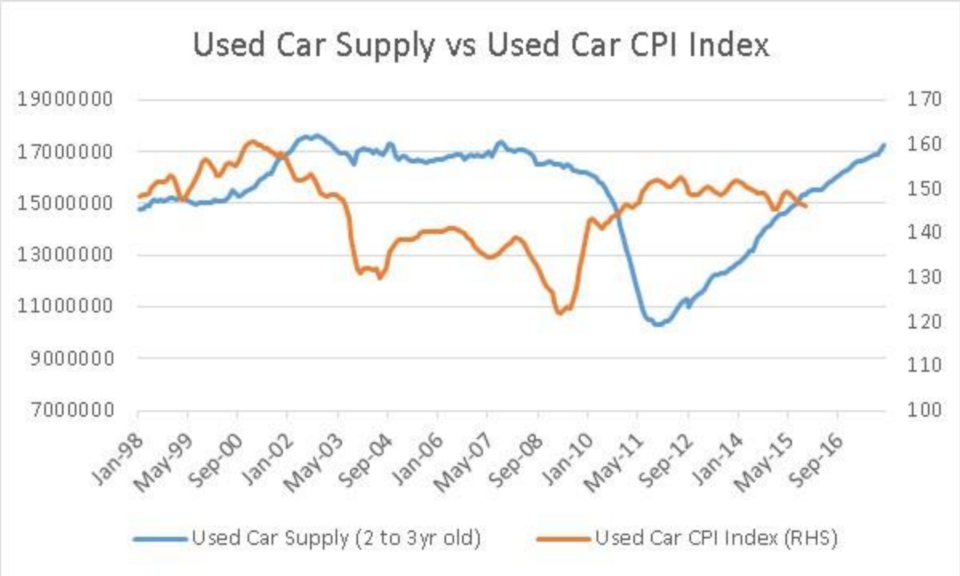


We can see that after the financial crisis when the value of the car declined to close to the level of debt a borrower has, lenders began to reduce loans to the auto sector, and raised lending standards. The bullish argument would be that lending standards while not as tight at 2011 or 2012, are still higher than they were in 2007. However, this measure of lending standards is flattered by very strong pricing in the used car market.

The other way auto lenders can take risk is the spread that they are willing to lend at versus market rates. When we look at the spread of 5 year new auto loan rates versus 5 year treasury yields, we can see that auto lenders are already very aggressive in their pricing.



The used car prices have been very strong as auto production was shut down in late 2008 and early 2009, severely cutting supply of used cars. This has largely been reversed, and we are now looking at a huge increase in used car supply.



If we assume used car prices fall 10% from current levels, which is what we saw in 2001 and in 2008, collateral values will fall below level of debt outstanding.

Given that more Americans than ever before have auto debt at a higher level than ever before, with a large increase in used car supply coming, I would suspect auto lenders will start slowing loan growth. I think the US auto sector looks a good short.

INFORMATION

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