Volume 20 | Issue 23 | December 15th, 2006

OBSERVATIONS

Dennis DesRosiers

Outlook for the North American Automotive Industry

The question most frequently asked of me during this time of year is, "How do you think sales will be over the next year?" It's the most popular time of year to hash these things out because we're at something of a crossroads: we know how 2006 turned out, but we're not yet into the 2007 calendar year. Consider this *Observation* our "initial call" for the North American market during 2007 - specifically, sales and production forecasts for the U.S., Canada, and Mexico.

The cyclical downturn that was forecast for North America has now begun in earnest. Our major concern for the U.S. involves the collapse of housing prices. Real estate in the U.S. has been buoyed for several years by the popularity of low interest mortgage refinancing deals. With housing prices falling and the amount of capital available to owners concordantly reduced, the new vehicle market has taken a fairly predictable hit. Think about this: a large number of U.S. consumers tapped into the equity in their homes to buy a new vehicle. The most popular finance vehicle was a 35 year open mortgage. How smart is it for consumers to use 35 years of money to buy an asset that will be largely worthless in less than a decade? Not very smart at all! The freefall in the U.S. housing market has just about killed this finance option. Consequently, we are fairly negative for U.S. vehicle sales.

It looks as though the U.S. market will end the year with approximately 600,000 fewer sales than in 2005. Given that the economy is otherwise strong (with energy cost relief in the last few months of 2006 potentially helping the new vehicle market), it is likely that the issue of mortgage refinancing - and the inflationary effects it has had on the vehicle market over the past five years - is responsible for the current drop-off.

We believe that 2007 will see U.S. market sales (including passenger cars, light trucks, and heavy duty trucks) fall a further 3.9 percent, or roughly 650,000 units. This decline will continue into 2008.

The past year also saw a decrease in U.S. production, with an estimated 7.1 percent fewer vehicles produced in 2006 than in 2005. This decline in production is a positive sign, as it represents significant

(continued on next page)

(continued from previous page)

progress on the road towards "right-sizing" that GM, Ford, and DaimlerChrysler have finally decided to travel. Every time we've written this *Observation* over the last decade, we have harped on the issue of overcapacity and its hugely negative effects on the North American auto industry. 2006 marks the first time that we can observe large scale positive changes taking place in this area.

With regards to the Canadian situation, we foresee a steeper decline than in the U.S. Specifically, it is forecast that Canada will witness 6.7 percent fewer new vehicle sales in 2007 versus 2006. It is our belief that the value of the Canadian dollar will negatively impact sales in the coming year. Virtually everyone who is knowledgeable in the sphere of Canadian economics feels that our dollar is heading away from parity with its U.S. equivalent, likely settling close to 80 cents U.S. With the Western resource/energy boom petering out and our high dollar settling back into the 80 cent-range, vehicle manufacturers will be restricted in their ability to offer aggressive pricing and incentive strategies. Mildly higher new vehicle prices will likely result in mildly reduced sales volumes - we predict a total loss of around 100,000 units relative to 2006. This is the most difficult variable to call for Canada. If our dollar stays in the high 80-cent range, we will see vehicle sales similar to last year. We believe the dollar will weaken, so we have sales declining.

Mexican new vehicle sales have been relatively healthy in recent years. We foresee a slight drop-off in 2007 Mexican sales, but not to the same degree as will be witnessed in the U.S. and Canada. The Mexican economy is outperforming both the U.S. and Canadian economies.

In general, the North American market will continue to perform over the 18 million units per year mark at which it has been tracking since 1998. In all, final 2007 sales results are expected to show a deficit of roughly 800,000 vehicles relative to 2006. Considering the over performance of the market in recent years, this is a relatively soft downtown.

The coming decline will be felt at every level of the automotive value chain, starting in the car dealer showroom and extending to every player in the industry. OE auto parts and raw materials manufacturers will need to adjust production for a slightly smaller market, as will the vehicle manufacturers themselves.

The 2007 downturn will be felt most strongly by GM, Ford, DaimlerChrysler as these companies continue to restructure. Import nameplate manufacturers are not expected to experience as distinct a sales decline as the U.S.-based automakers.

In spite of all these ominous predictions, the fact remains that the North American automotive industry is healthy, stable, and well-positioned for future growth. Cyclical downturns historically occur every three to five years, and - if history is any indicator - the coming decline is relatively minor. We believe that the industry will return to its growth cycle by 2009 and that current sales and production volumes will be surpassed in 2010.

As such, we will end this *Observation* on a high note. Have a happy and healthy new year! DAR

December 15th, 2006 | ISSN 0841-9957