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Sixth annual Auto Outlook Symposium

Light vehicle sales for 1994–97 averaged 14.9 million units, with unprecedented stability. Sales for 1994, 1995, 1996, and 1997 were 15.0 million, 14.7 million, 15.0 million, and 15.0 million units, respectively. Sales during 1998 were not quite as stable. In the first quarter, sales were in line with the previous year at 15.1 million units and then jumped to 16.1 million units in the second quarter. This surge was caused by very aggressive discounting referred to as the “coupon war” in the vehicle industry as well as a “rush” to get a General Motors (GM) product before stocks ran out due to the strikes that began to affect GM in early June. Light vehicle sales fell to 14.6 million units in the third quarter as the GM strikes shut down production for the world’s largest vehicle maker. The strikes were settled at the end of July and once GM began to replenish inventories, sales in the fourth quarter rocketed to 16.3 million units, the strongest quarterly sales pace since 1986. After such a strong quarter, it was expected that sales would slow in the first quarter of this year. Sales did slow, but by just 0.1 million units. It was with such strength in the light vehicle industry that on May 28, 1999, the Federal Reserve Bank of Chicago held its sixth annual Auto Outlook Symposium. This *Chicago Fed Letter* summarizes the consensus outlook from the symposium, as well as the presentations from vehicle producers, dealers, and vehicle research organizations.

Consensus outlook for the economy

The economy began 1999 on a fairly strong note. In the fourth quarter of 1998, the economy expanded at a 6.0% rate, and preliminary estimated growth for the first quarter of 1999 was a solid 4.1%. The symposium participants expect the overall economy, as reflected by real gross domestic product (GDP), to grow by 3.8% for 1999 and then slow to 2.4% next year (see figure 1). The unemployment rate is anticipated to decline 0.2 percentage points to 4.3% in 1999 and then rise by 0.3 percentage points next year. The consensus forecast for light vehicle sales for this year, 15.6 million units, is just slightly higher than last year’s sales pace. Given that when these forecasts were made sales had already averaged 16.2 million units for the first four months of the year, the group was expecting sales to slow to an average of 15.3 million units for the remaining two-thirds of the year. For next year vehicle sales are expected to ease somewhat, to 15.3 million units, which would make it the third highest yearly average after 1998 and 1999 for the current expansion. Even with the relatively robust performance of the economy, the participants anticipate only a modest rise in the rate of inflation—from 1.6% in 1998 to 2.0% this year and 2.2% in 2000. The inflation rate for new vehicles illustrates how competitive the light vehicle market has been. In May new vehicle prices were 0.3% lower than a year ago. New vehicle prices have been in a deflation mode since September 1997.

A view from the Big Three

An economist from one of the companies formerly known as the Big Three presented their assessment of the vehicle industry. The fundamentals for continued good sales in the vehicle

1. Actual 1998 and median forecasts of GDP and related items

	1998 (Actual)	1999 (Forecast)	2000 (Forecast)
Real gross domestic product[a]	3.9	3.8	2.4
Real personal consumption expenditures[a]	4.9	4.5	2.7
Real fixed investment, nonresidential[a]	11.8	8.2	5.4
Real fixed investment, residential[a]	10.4	7.9	0.2
Change in business inventories[b]	57.4	55.6	46.8
Net exports of goods and services[b]	–238.2	–313.4	–325.0
Real government consumption expenditures and gross investments[a]	0.9	2.8	1.8
Industrial production[a]	3.7	2.0	2.2
Auto & light truck sales (millions of units)	15.5	15.6	15.3
Housing starts (millions of units)	1.62	1.63	1.50
Unemployment rate[c]	4.5	4.3	4.6
Inflation rate (Consumer Price Index)[a]	1.6	2.0	2.2
1-year Treasury rate (constant maturity)[c]	5.05	4.85	5.10
10-year Treasury rate (constant maturity)[c]	5.26	5.30	5.40
J. P. Morgan trade-weighted dollar index[a]	5.0	0.0	–0.0

[a]Percent change from previous year.
[b]Billions of chained (1992) dollars.
[c]Percent.
Note: Data as of May 28, 1999.

industry are still in place. Economic growth remains strong in the U.S. Consumer spending continues to look solid, with only some minor concerns.

There are several factors that have led to the acceleration in vehicle sales over the past nine months: 1) the still strong labor market outlook; 2) the increase in net wealth; 3) strong consumer confidence; 4) falling new vehicle prices; 5) strong mortgage refinancing in late 1998; and 6) low interest rates. There is no estimated pent-up demand remaining in the industry so the strong sales could be implying pull-ahead sales, which could lead to softer sales in the near future.

Consumer spending growth has been averaging 5% versus household income growth of 3%. This discrepancy might be cause for concern with savings balance growth being negative, but there has been a significant increase in household net wealth with double digit nominal gains annually since 1995. The wealth-to-income ratio has been increasing, while at the same time the savings rate has been decreasing. It appears that the wealth effect has been a significant driving force on consumer spending. This economist believes that the net wealth effect could have contributed as much as 28% to overall consumer spending growth during 1998. For the first quarter of 1999 it could have accounted for 2% of the 6% increase in consumer spending.

How long can this net wealth effect continue to fuel consumer spending? If one anticipates continued appreciation in the stock market, especially with very low inflation, the economist said it will continue to generate very strong growth conditions with the overall economy continuing to grow well above the 3% range.

Looking at world markets, the economist noted that Europe offers a lot of opportunities for the automotive business. Despite the recent economic slowdown there followed by interest rate cuts, essentially zero inflation, and the weakness of the euro, vehicle sales have remained quite good, and some countries have had record sales. Some lessons were drawn from the U.S. market. When there is intense competition among producers, there is essentially no inflation, so there is real consumer income growth and consumers will buy, even with a weak job market.

In Brazil, the IMF program likely helped stem a more significant downturn, although growth is anticipated to be down nearly 6% this year. Vehicle industry volumes have slipped sharply over the past several years. Significant vehicle price incentives are supporting sales, which are still expected to be down over 35% this year compared with last year. Only a modest increase in sales is forecast for next year.

Recent economic news looks better for Japan. The minicar market is very strong, industrial production is stabilizing, and retail sales, though still negative on a year over year basis, are not declining further. However, there is still very little industry and consumer demand and not much expectation of good economic performance in the near term.

Korea in contrast has had much better economic performance. The industrial sector has expanded by 10%. The overall economy is expected to be unchanged from year ago levels with some modest increase in the vehicle industry this year. This is well above what most analysts thought was likely when they were putting their forecasts together in early 1998. Korea has undertaken some very aggressive reforms, especially in the banking sector.

Dealers' perspective

A speaker representing the vehicle dealer viewpoint indicated that the vehicle market remains very positive. During 1998, many factors contributed to a strong year of dealer sales. Real economic growth was near 4%, employment growth was quite strong, and the stock market rose sharply. The National Automobile Dealers Association's dealer optimism index reached a five-year high in April of this year and dealers expect positive economic conditions to continue into 1999 and beyond. Consumer confidence reached a 30-year high last year as credit conditions were favorable and vehicle prices were flat. Consumer confidence remains high and many other areas of the economy remain robust. Households are in tremendous shape and spending accordingly, which is keeping light vehicle sales strong. Though warmer weather in certain parts of the country pulled some sales into the first quarter of 1999, the dealers' forecast for light vehicle sales in 1999 is still for slightly better sales than last year. Despite their high level of optimism, dealers have expressed concern about excess vehicle capacity, lower corporate profits, rising household debt, and the Asian crisis.

Medium and heavy-duty truck market

An economist from a research company that analyzes the medium and heavy-duty truck industry presented the forecast for this market segment. The economic outlook for trucks calls for continuation of current positive trends. This economist believes that strong consumer confidence, moderate inflation and interest rates, healthy construction and housing markets, and improved productivity—adding to a noninflationary environment—are all pushing economic growth. A strong growth economy translates into increased freight shipments. It continues to be a very special time in the truck industry. Net orders for trucks continue to be at high levels, even though they have been slowing somewhat recently. Backlogs are extremely high across the board, ranging from six to nine months. Inventories appear high, but are in line with sales. Production and sales should set records in 1999 and the industry should start the year 2000 on a strong footing.

It is anticipated that new orders over the next two or three years will set records. The future continues to be seen as one of a growing economy, with increases in the already high levels of freight shipments. The shipment industry is now moving to 'guaranteed' delivery times as competition remains intense among trucking firms. Railroads were brought up as possible competition, but this was immediately dismissed by the speaker, due to the fact that on time performance for the railroad deliveries are only about 80%–85%.

European import perspective

An economist from a European vehicle manufacturer focused on the microeconomics of a vehicle manufacturer. This economist spoke of visionary automobile designs that have supported the success and longevity of particular models. Brand management is a key strategy of this firm, as is understanding the customer emotions and rationale involved in making a vehicle purchase. This company realizes that it is in a niche market and has limited resources, but it will continue to focus on brand management and production capabilities. Signals of success seen by this company are the economic and demographic robustness of its customer base. Management feels that the company's production capabilities are at the desired level, given that the industry may be at the top of the business cycle, and sees downstream activities for dealers, financial issues, and brand concerns becoming a much greater concentration in the future.

World overcapacity of vehicle production

One economist from a research firm looked at the issue of excess capacity in the world vehicle market. Two key issues the speaker addressed were 1) boosting profits in an environment of global overcapacity and 2) the need to broaden market bases and diversify risks. The excess capacity currently in the global market—due largely to building ahead of local market demand in many emerging markets—has constrained global profitability. The Asian economic crisis has compounded the problem.

The significant excess capacity has led to downward pressure on prices in markets approaching record level of sales. Firms are cutting costs, yet finding that they are not able to improve profitability because consumers are driving prices down.

The speaker said that North America, which is categorized as a very mature market with little growth potential, is probably the strongest market right now. Europe has been experiencing faltering growth, but as in the U.S., consumers in Europe are propping up the auto market. Unless European economies weaken significantly, the vehicle industry should continue to do well in Europe, at least in the near term. Japan is best characterized as an economy with a flat tire and a very weak pump. This is an economy that may be going into a double dip recession.

2. Vehicle sales growth rates by region (%)

Region	Boom years 1986–96	Crisis years 1996–98	Recovery years 1998–2008
North America	–5.6	6.5	13.3
South America	81.3	–6.9	81.5
Western Europe	9.9	13.9	9.8
Japan and Korea	45.0	–24.1	42.4
Other Asia	102.7	–20.0	116.7
Other	16.7	12.2	56.5

Emerging markets, which probably have a year to go before they get back on their feet, introduce a degree of instability to the entire global market. Emerging markets are considered the large growth markets of the future. The U.S. and Europe are pretty much saturated and can not grow much beyond the limit of population growth. But in the emerging markets as per capita income increases, people move away from bicycles and motorcycles and upgrade to cars, and this opens up a tremendous new market. The past ten years illustrate this potential for growth. South America and Asia, excluding Japan and Korea, well out-distanced growth in the mature markets of the world. Figure 2 shows the impact of the economic crisis on these emerging markets. This analyst's projection is that the growth potential is still there. As these countries recover, they will experience disproportionate growth. The enthusiasm and excitement are still there; the risks are high, but so is the potential.

In the U.S. there are approximately eight vehicles for every ten people; in Europe the number is between five and six cars for every ten people; worldwide, there is only one car for every ten people; and in very densely populated countries like China and India there are fewer than ten cars for every 1,000 people. This represents a lot of potential in the emerging markets once per capita GDP increases. Even small increases in per capita GDP can significantly increase the vehicle market.

However, where the potential demand is, is not where current capacity is concentrated; about 75% of vehicle production is in the mature markets (although, due to the recession in Asia, over 90% of current excess capacity is in the emerging markets and Japan). Based on estimates of production in 2008, with no new capacity added in the world, the only region that would still have excess capacity would be Japan, with a great shortage of capacity in emerging Asian countries.

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The speaker asked whether vehicle makers can solve their profitability problems through mergers. Most mergers have not directly addressed the excess capacity issue. The analyst discussed the potential mergers of several vehicle companies that have been rumored to be candidates for consolidation. Even in an environment with a lot of opportunities, it is not easy for even the strongest companies to find successful partners. Companies want to keep their products, markets, and geographic locations well balanced. A successful partnership often requires a lot of financial resources to bolster one of the partners, at least through the short term, and commitment and cooperation to overcome cultural differences.

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