

This Time is Different: U.S. Automakers Positioned for Slowing Economy

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The large ticket, financing-dependent, deeply cyclical auto industry is a tricky spot to invest amidst slowing economic growth, let alone during an actual recession.

As the U.S. economy exhibits signs of moderating activity and an underlying shift in consumer spending from durables and pandemic beneficiaries toward leisure activities and services, bloated retailer inventories have captured headlines. And while general goods, apparel, and housewares retailers grapple with price discounts and margin erosion to move unwanted product, U.S. automakers find themselves in almost the exact opposite position (Figure 1).

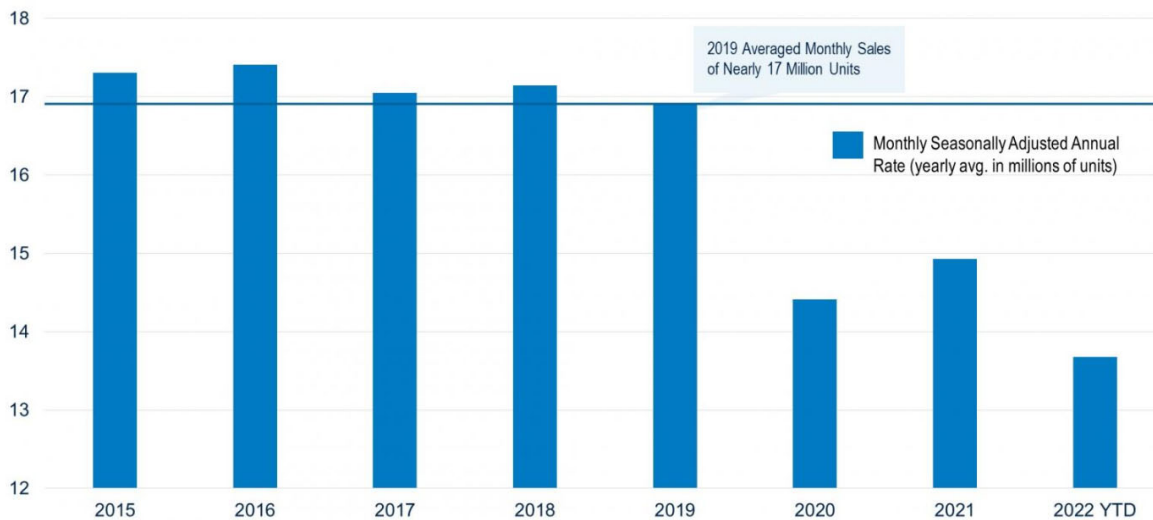
FIGURE 1: Auto Inventories Decoupled from Broader Retail During the Pandemic



Source: Census Bureau and Haver Analytics. Indexed at 100 as of February 2020.

During the past several years, semiconductor chip shortages and broad-based global supply chain disruptions have constrained U.S. auto production to levels more typically associated with below trend economic growth or economic contraction, leaving automakers unable to satisfy otherwise healthy end-demand from customers. Using average U.S. annual auto sales during the past five years as a rough proxy for normalized demand, we approximate the shortfall in retail auto sales may total upwards of 5 million units since the start of the pandemic, creating a large store of pent-up replacement demand (Figure 2). The shortfall includes not only unfulfilled consumer retail demand, but also fleet sales, including car rental companies that have been unable to source enough vehicles to satisfy recovering leisure travel demand.

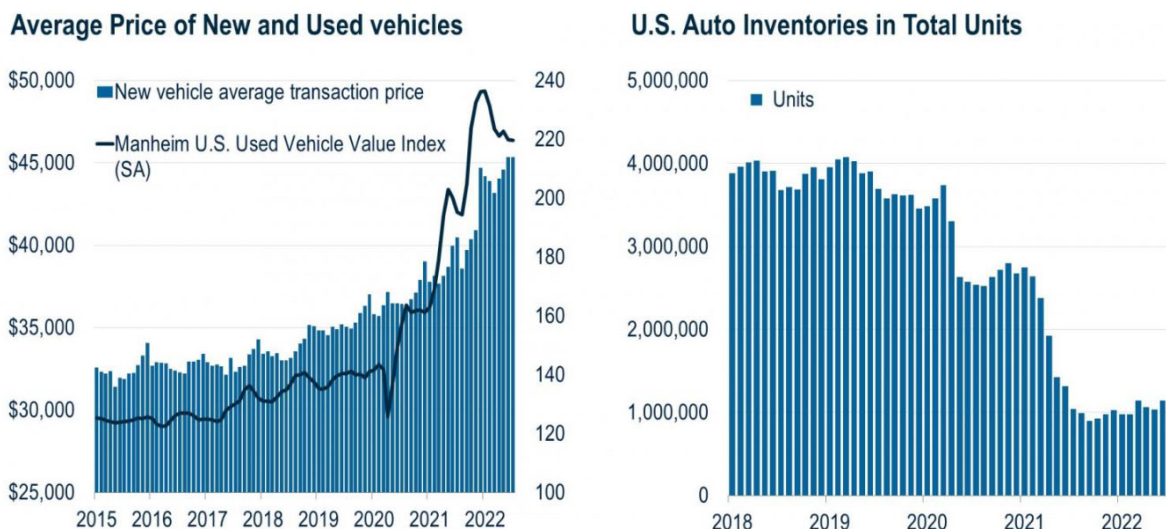
FIGURE 2: Vehicle Sales Fell Below Trend During the Pandemic



Source: Ward’s Index via Bloomberg as of July 31, 2022.

Healthy auto demand and constrained production have combined to push inventory to historically low levels. To boot, at the end of July, U.S. auto inventories totaled just 1.1 million units, a mere quarter of the inventory levels typically held by the industry prior to the pandemic. With dealer inventories depleted and demand currently healthy, it’s not surprising that new car prices are hovering near record highs of \$45,000 per unit, roughly 30% higher than pre-COVID averages, and used car prices are as much as 60% above pre-pandemic levels, pushing automakers toward record profitability despite reduced sales volume (Figure 3).

FIGURE 3: New and Used Vehicle Prices Surge as Inventories Run at One Quarter of Pre-COVID Levels



Source: Inventories from Autodata Corp. and new auto prices from TrueCar and used from Manheim Index as of July 31, 2022.

While we expect auto production will begin to normalize in the second half of 2022 and 2023 as chip and supply constraints ease, facilitating a gradual replenishment of inventories and likely creating downward pressure on new and used vehicle prices just as the economy slows, the magnitude of the inventory replenishment opportunity should act as a healthy revenue and profitability offset to price/mix headwinds as well as potentially weaker demand. Lean dealer inventories should also govern the typical management impulse to ratchet-up marketing incentives to move product, preserving some of the industry pricing captured during the past two years. In the event chip shortages and supply chain disruptions persist, automakers will continue to enjoy the outsized profitability associated with constrained availability of product. Central to either scenario is that U.S. auto production is already operating near levels associated with economic contraction and that

industry inventory levels are heavily depleted, leaving auto maker profitability comparatively less sensitive to end-demand relative to the historical experience.

In addition to lower expected drawdowns in profitability during a potential recession, automaker balance sheets start from a position of strength, as cash balances remain well in excess of gross debt levels, providing a sizeable liquidity cushion in the event of a weaker operating backdrop. Streamlined product portfolios, reduced pension burdens, and enhanced cost structure flexibility underscore sharply lower unit break-evens and greater financial flexibility relative to prior downturns. Industry resilience has been impressive in recent years, as the industry has navigated a series of industry shocks, including trade wars, a UAW work stoppage, and the early pandemic plant shutdowns. For manufacturers, such as Ford and GM, the profits windfall and expected counter-cyclical inventory and replacement demand tailwinds could not have come at a better time, supporting accelerated capital deployment into the ongoing industry transition toward electric vehicles.

To be clear, we are not relitigating the cyclical nature of autos (the industry is highly cyclical) or suggesting the industry is counter-cyclical (it's not). We simply expect that the current fundamental industry set-up means the sector will behave differently than the historical precedent. Most notably, heavily depressed inventory levels will catalyze a shallower industry downturn and once in a downturn, pent-up replacement demand will drive a steeper slope of exit velocity.

Definitionally, a slower economy or recession will negatively impact end demand for large ticket items, including cars. In a typical downcycle, automakers slash production in response to lower demand. Higher incentives are employed to help move dealer inventories. Automaker fundamentals suffer in response to lower production and higher incentives/weaker net pricing. In this cycle, the industry response will be atypical in that car makers won't have to slash production by many millions of units; production is already running near recessionary levels.

The resultant production cuts required to balance supply and demand will be of a materially smaller magnitude and will allow for less severe, and potentially far less severe, drawdowns in profitability and cash flow than historically experienced. Of course, there will also be impacts from raw material fluctuations, product mix, and the absolute level of interest rates and general availability of credit, among a number of other variables. But in our view, the tailwind from lower drawdowns in production owing to inventory levels will prove the largest single determinant of automaker profitability and industry health. Further, in the potential recession case, once end-demand troughs and begins to pick-up, the industry will benefit from a pent-up replacement demand accelerant that will quicken automaker recovery. As postulated earlier, the industry may have underproduced demand by as many as 5 million units during the past 2.5 years and ultimately, this demand will be unlocked.

The auto industry certainly won't be immune to the aftershocks of an economic downdraft, particularly if one were to prove lengthy or deep. However, anemic industry inventory levels, considerable pent-up replacement demand, and healthy starting balance sheets will combine to both mitigate the severity of any economic softness and to support a quicker acceleration of the auto industry out of any potential economic contraction. While it's certainly a tired cliché, this time may truly be different for U.S. automakers.

Portfolio Perspective

With auto sales having materially undershot demand since the start of the pandemic and auto inventories sitting at extreme lows, the auto sector will behave much differently than it has in previous periods of slower growth or recession. Our portfolio positioning approach will capitalize tactically on auto sector dislocations relative to the broader market and other cyclicals. Gyration in market valuations may facilitate the implementation of overweights in uniquely positioned automakers and suppliers despite their pro-cyclical characteristics. While sector and broad market drawdowns will provide opportunities, we may also look to reduce exposure if the risk/reward dynamic skews asymmetrically negative. Top of mind is that we are heading into a prolonged period in which active management will be crucial to meeting investment objectives across credit markets.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of August 18, 2022.

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