

ECONOMIC UPDATE



National Automobile Dealers Association, Industry Analysis Division

Joblessness or Missing Home Equity: Which Concern Dominates the New Car Buyer's Mindset?

By Paul Taylor, NADA Chief Economist

As Election Day draws near, unemployment is a key indicator for elected officials, because the unemployed vote in elections. Unemployed people seldom cast dollar ballots for really big-ticket purchases like a new car. So dwindling home equity is a key variable for new car sales forecasting, but unemployment is less important. You have to be employed to cast dollar votes for a new car, and a long stint of unemployment will put that customer in the used car market or the service and parts department for at least a few years.

Jobless recovery is upon us, with job growth well under the pace of other recoveries that characterized previous recessions during the last fifty years. In order to return to the peak level of employment reached prior to the 2009 recession (which ended in the second quarter of 2009) the current rate of job creation will take nearly four times as long as the average of other recent recessions prior to 1999. That would be nearly 4 years. There is a Presidential election in two years. Compared to the 2001 recession, which featured a slow recovery of the job market but left our industry only slightly affected, this recovery will take twice as long to return to peak pre-recession employment levels.

This recession compares closely to the 1981-82 recession in the number of dealerships closed and given the fact that it also was a credit-driven recession. In the 1981-82 recession there was a shortage of credit for housing that led to a huge pent up demand for housing in the recovery that started in 1982. Current recovery measured in jobs is taking twice as long as during the 1990-1992 recession.

From this experience, the trend of the last 30 years has been increasingly slower job recovery from recessions, in part because inflation is lower, and the slowdown in the housing market was progressively less, affected by

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credit interruptions in more recent times. The impact for new car dealers? In the past you missed a few used car sales in the short term, and welcomed the newly employed back into the new car market in the longer scheme of time. The current credit and real estate driven sluggishness is taking much longer to heal.

With the credit crisis that followed the bursting real estate bubble we were completely missing the surge in real estate that normally follows the lower interest rates that typically follow the onset of recession. Among companies listed on stock exchanges, the desire to show large profits in recovery has curtailed hiring even after economic growth returns. Inflation was missing in the last two recessions, and thus, pent up demand for real estate crowded out by high nominal interest rates needed to conquer inflation. There was no slowdown in housing or light vehicle purchase in the 2001 recession, and that contributed to the bursting real estate bubble as easy credit and casual real estate loan underwriting ended.

If a typical suburban cul-de-sac contains 10 houses, that yields approximately 22 people in the permanent work force. That includes some stay-at-home Moms and some stay-at-home 20 to 30-year old children still living with their parents. Normal five percent unemployment would leave just one person from the work-force out of work. Nine to ten percent unemployment, as we have currently, would have two people normally in the work force out of work.

The remaining 20 people in the cul-de-sac stayed employed, but worried somewhat about unemployment as the recession set in. With jobs slowly

coming back, these folks may well think that they have dodged the unemployment bullet. For the other two, after a stint of unemployment, you might sell them a used car, but it is unlikely that they will quickly come back to the new car market. The hearts and minds of those 20 employed people are what the new car dealer must focus attention on.

Therefore, consumer confidence and expectations about the future are a key element for the employed portion of the dealership's customer base. What stands in the way of confidence to buy a new car includes their household nest egg, the home equity they have built up, often over many years. Therefore, while unemployment motivates some voters, among likely new car buyers, who all have remained employed, there are a myriad of concerns currently holding them up from purchase. If they are not worried about a second recession, they are at least mourning the loss of home equity that is very slow to return in some areas of the country.

The current foreclosure debacle will simply prolong the recovery of the housing market and the return of a significant amount of home equity for consumers. While the immediate impact of delayed foreclosures is to reduce the supply of housing on the local market, that inventory of existing housing will eventually come to market, and provide a shadow supply of housing that overhangs the market. As a result, the foreclosure debacle is one more factor that extends the real estate crisis in some communities and restrains the recovery of the overall new car market.

Given the suburban setting of typical new car buyers, home ownership is ubiquitous, and that is the other large factor currently affecting typical consumer's confidence and willingness to buy a car. How this plays out in the November elections will be interesting. We know the currently unemployed will be motivated single-issue voters on November 2, but homeowners who remain employed are still concerned about the economy and the lack of resolution in real estate finance and housing values that will continue to impact family finances.

The window of time for elected officials to motivate the banks and banking regulators to make serious

progress on the issue of work-outs, write downs, continued foreclosures and depressed housing values prior to election day has come and gone. Softness in some commercial property values also impedes small businesses in many communities, because lines of credit based on owned commercial real estate as collateral have been drastically curtailed for many businesses. That means that even where opportunities for business expansion exist, often they cannot obtain the loans to expand. The foreclosure debacle has stopped sales of some foreclosed homes, a process that was already agonizingly slow, which has further depressed real estate market activity in many locations. States that rely on vacation and second home properties as part of the tax base are particularly hard hit. Nevada, Idaho and Florida are three states that are examples.

The Federal Reserve System appears committed to further stimulus of several hundreds of billions of dollars worth of bond purchases, a much smaller stimulus effort than the almost \$2 trillion of purchases made as the financial crisis unfolded. This is what has been labeled a second "quantitative easing" and dubbed QE II. Unlike the ship dubbed QE II, the second effort of quantitative easing will not be nearly as big as the original. This effort will likely lower the yield of the Ten Year U.S. Treasury Note slightly, the source of pricing direction for mortgage lending rates. Other long-term interest rates will fall somewhat, helping business investment, but only if the banks lend money at these lower rates.

The Fed cannot make the banks, thrifts and finance companies write mortgage loans, particularly the FDIC regulated banks. That would be a job for the executive branch of government, which oversees the bank regulators, and which has had little success so far in keeping Americans in their homes if purchased in the 2006-2008 boom period. NADA Industry Analysis continues to believe that a double dip, (or officially, a start of a second recession given that the first one is officially over) will be avoided. However, if recession were to occur, a major cause would be the failure to come to grips with the huge loss of wealth that the lingering residential real estate recession created. The foreclosure difficulties are simply additional evidence that regulators have failed to come to grips with the crippled residential real estate market.

As a result, many swing voters in the suburbs are motivated voters this year, and that should not be a surprise. Shortly, some elected legislators will be out of office because of the failure to put housing values on a firmer footing. In the meantime, the uncertainty of the mid-term elections simply add to the sour mood and lack of confidence of consumers, who are not cheering up as quickly as even the current slow rate of positive growth in the economy. Better slow growth than no growth. To homeowners, however, financial confidence is not back, home equity has recovered only slightly on average, and new car and truck sales are lower than they should be in this recovery, as a direct result.

Consumers will have to stop worrying about home equity and unemployment before new car sales come back strongly. The good news is that October new car sales are improving slowly. Consumer confidence should start improving on November 3.

Some Practical Drivers Help October Car Sales

While real estate foreclosure and uncertain economic and political concerns continue to hamper the new car market, mileage continues to pile up on your customers current vehicles. The value of all those potential trade-ins remains high, even with too much mileage, due to lack of used car supply derived from recent years of slow new car sales. Add to that enhanced incentives and historically low interest rates, and some buyers are bound to respond. October sales numbers should be encouraging to new car dealers. With used car prices elevated, and likely to stay at historically high levels compared to effective new car prices, sales should finish the last months of the year at a faster pace. It is not back to 2005 or 2006 levels, but at least the market is clawing its way back toward the numbers posted in the good old days of the last decade.

Expect October sales to come in at or near 12 million units as a seasonally adjusted annual rate for the month. Not great, but much better than the 11.3 million units that we have averaged so far this year. The last three months of the year will pull the sales average up as we look forward to some pent up demand for cars to be unleashed after the election. Consumer confidence is likely

to bounce upward when the current electoral uncertainty is relieved. The extension of current tax rates set to expire in 55 days would be an important step in further reducing economic uncertainty in the economy. That action by the Congress might unlock some business buying of vehicles.

Going for Broke: Weak Dollar Raises Questions as Treasury Secretary Lectures Other Developed Countries on Exchange Rate Policy

U.S. Treasury Secretary Timothy Geithner has enjoyed an easier time in the job compared to some recent occupants of that job, despite the tough economy. That may have ended this past weekend as other Finance heads of the developed countries react with incredulousness to a letter Secretary Geithner sent requesting the G20 "commit to refrain from exchange rate policies designed to achieve competitive advantage by either weakening their currency or preventing appreciation of undervalued currency."

Advising top elected officials of foreign countries to avoid their countries' self-interests is ignored just as it is by individuals in the private marketplace. Long term, however, debasing the purchasing power of the currency is not in the self-interest of any country, and particularly not in the interest of the United States, which gains from its status as the provider of the key international currency used in world exchanges. In the long-term, debasing the currency simply makes a country poorer, and the consumption baskets of consumers increasingly contain foreign goods.

The Treasury Secretary will have to lead by example if he wishes to lead at all on exchange rate policy. In addition, if the U.S. Congress does not stop over-spending, it will be hard to run a coherent strong dollar policy at home.

The Impact of Exchange Rates on Vehicle Sales Mattered for Europe When the Dollar Was Strong. Now That the Dollar is Weaker, It Affects Choice of Production Areas for German Manufacturers

When Ronald Reagan was President, the problem for Europeans was a strong value for U.S. dollars

compared to the then European currencies. Too many American tourists in Paris in those days, and too high a cost structure to produce cars in the U.S. To obtain a reasonable length of comparison on major German-based brands, NADA Industry Analysis used a Deutsche Mark to Dollar comparison that began before the Euro was introduced.

What NADA found was that in Germany, arguably a higher cost of production area than the United States, and particularly higher cost than the right-to-work states where the transplant auto plants have tended to locate, was very sensitive to the strength of the dollar, losing market share when the dollar decreased in value.

By comparison, the Dollar/Yen exchange rate had little impact on the market share of Asian manufacturers, who continued to gain market share of U.S. sales through periods of strong dollar and weak dollar in relation to the Japanese Yen. Many of the top Asian brands already had significant production capacity in the United States, and now have more. (See Graphics on the last page)

As might be expected, German-headquartered manufacturers have invested more in U.S. plants since the Regan years, and have gained market share as a result. Volkswagen is back in the U.S., in Tennessee, after failing to produce successfully in Pennsylvania during the Reagan years. Tennessee is a Right to Work state that offers lower overall labor costs than Pennsylvania. Currently, small Volkswagens sold in Australia are produced in China, so it remains to be seen where future expansion of Volkswagen production will take place. Volkswagen already has a large footprint in Mexico, and dominates the Taxi market in China.

Audi recently postponed an exploration to produce cars in the United States as the dollar strengthened, even as Audi sales improved among all European luxury brands. Now the dollar is falling against the Euro. Efficiency gains in production are a key to the future performance of European luxury brands as they face luxury brands from the U.S. and Asia. Exchange rates in this weak dollar period are key variables in production location decisions, but U.S. customers are not yet faced with the higher vehicle prices

they will eventually have to pay if U.S. budget deficits continue and the dollar were to continue to weaken. Voters appear to feel more strongly about continued accelerating budget deficits.



**National Automobile
Dealers Association**

8400 Westpark Dr.
McLean, VA 22102

Phone:

(703) 821-7010

Fax:

(703) 749-2372

E-Mail:

industryrelations@nada.org

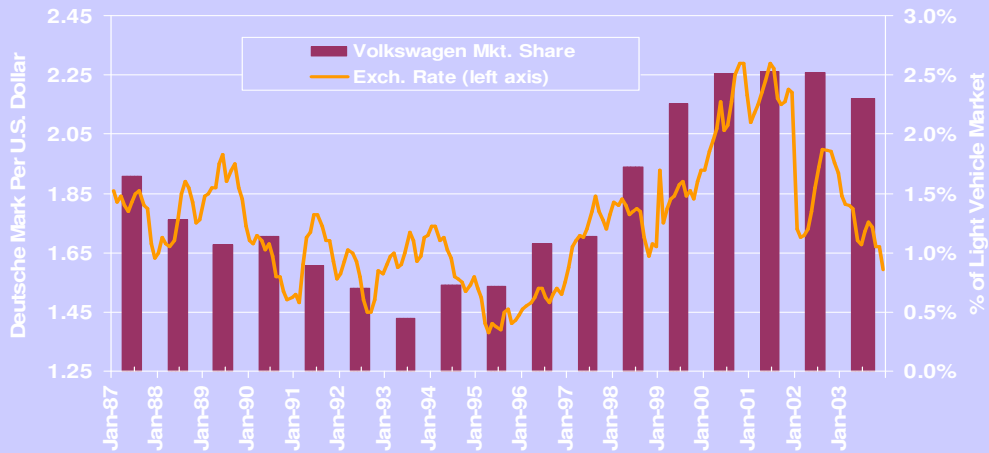
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Exchange Rates & Market Share: Europe

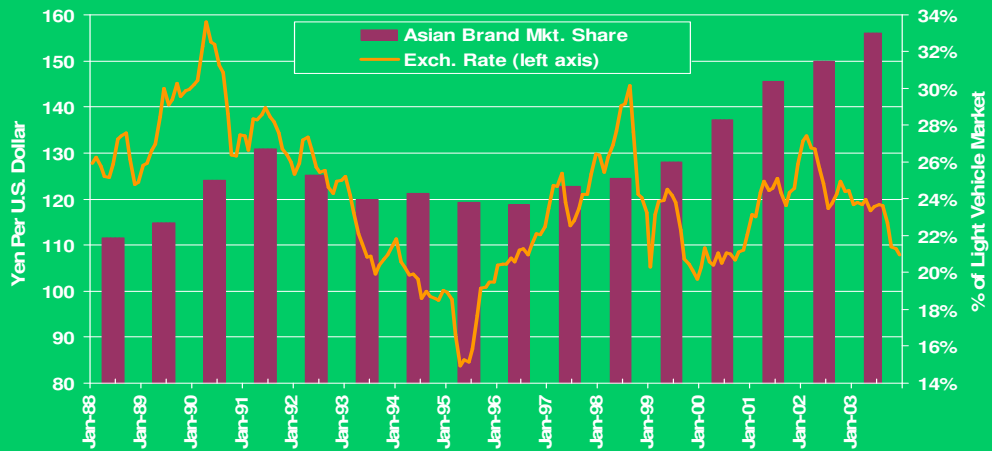
Strong Euro Mutes Euro-Badge Sales Growth, 1987-2004



Source: Federal Reserve, Wards Automotive

Exchange Rates & Market Share: Asia Brands

Strong Dollar Unrelated to Asian-Brand Share? (1987-2004)



Source: Federal Reserve, Wards Automotive