Investment Insights

Autos: Concerns Overblown, or the Next Subprime Crisis?

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Highlights

- U.S. auto sales are slowing, and the cycle may be peaking, driven by a combination of structural and cyclical supply/demand factors.
- In the auto financing market, signs of weakness have appeared; however, there are mitigating factors, including healthy consumer balance sheets, prudent exposure to the auto market at U.S. banks, and the market's relatively small contribution to the overall economy.
- We expect the broader economic impact of an auto market slowdown to be limited, and we address how these trends affect some of Bessemer's portfolio holdings.

A decade after the onset of the subprime housing crisis, the term "subprime lending" still sends a shiver down many a spine. The subprime lending market is once again back in focus but this time in relation to the automobile market. In this *Investment Insights*, we survey the state of automobiles and determine that it may be peaking but that spillover to the broader economy is likely to remain contained.

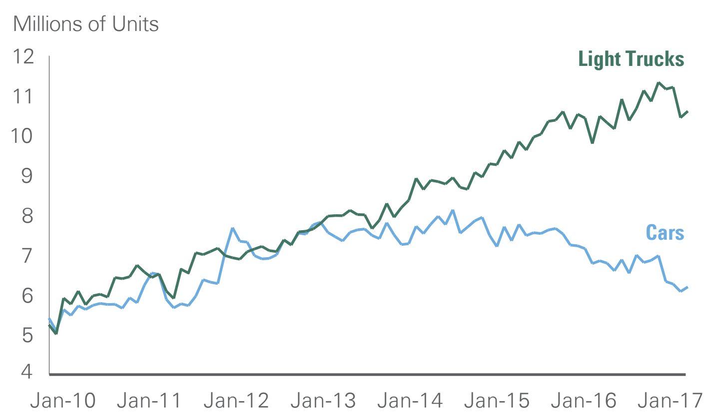
State of the U.S. Auto Market

Sales of new automobiles in the U.S. dropped from a peak of 18 million on a seasonally adjusted basis at the end of 2016 to around 16.8 million in April, according to WARD's Automotive Group. Though sales of new trucks have been more resilient than cars (Exhibit 1), due in part to lower gasoline prices motivating a shift in consumer preferences, auto sales have been elevated for some time. Several supply- and demand-related forces at play lead us to the conclusion that the auto market is likely peaking.

Supply

Inventories of new and used cars are at multiyear highs (Exhibit 2), putting pressure on car prices. The supply overhang within the used car market is of particular concern as weak used car pricing can quickly spill over into the new car market. Leasing has become increasingly popular since the financial crisis. Leases allow consumers to make smaller monthly payments for higher-tier cars. They also keep customers on a three- to five-year upgrade cycle, which is appealing to auto dealers and manufacturers. As a result, the number of used, off-lease cars on the market has risen with the increase in new lease originations, albeit with a lag. As we know from Economics 101, rising supply and steady demand equal lower prices, ceteris paribus. The resulting weaker used car prices have led to negative equity on trade-ins. This pressures lessors to raise residual values, making future lease originations less affordable.

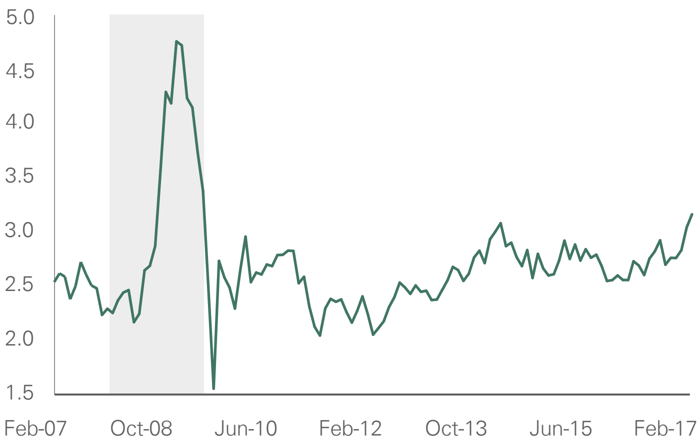
Exhibit 1: U.S. Auto Sales Softening



As of March 31, 2017. The Light Trucks category includes vans, pickups, and sport utility vehicles.

Source: Bureau of Economic Analysis

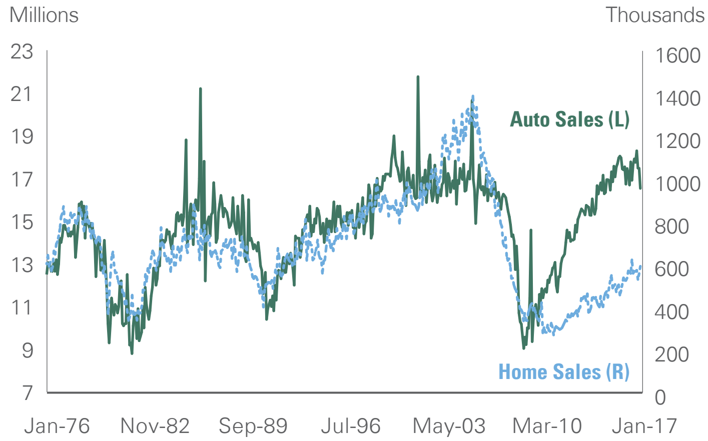
Exhibit 2: U.S. Auto Inventory-to-Sales Ratio Highest Since 2009



As of March 31, 2017.

Source: Bureau of Economic Analysis

Exhibit 3: Growth of Auto Sales Has Outpaced New Homes



As of March 31, 2017 for new autos and February 28, 2017 for homes.

Source: Bloomberg, U.S. Census Bureau, WARD's Automotive Group

Consumers are also keeping their cars longer, contributing to supply overhang. This may be due to the slow economic recovery and improvements in production, allowing cars to last longer than they used to. Vehicle scrappage rates have dropped from 12 to 14 million per year before 2013 to around 11 million per year over the last four years. More cars are remaining on the road, and they are older than ever, averaging 11.6 years according to IHS Markit (though with improved technology and lighter frames, 11.6 may be "the new 8.6," making this comparison over time more complicated).

All else equal, not only will the increased volume of off-lease and used cars at auction put pressure on prices, but the used car inventory will be older, with more miles, and possibly reflecting stale demand trends — which all put pressure on the used car market and, by extension, new cars.

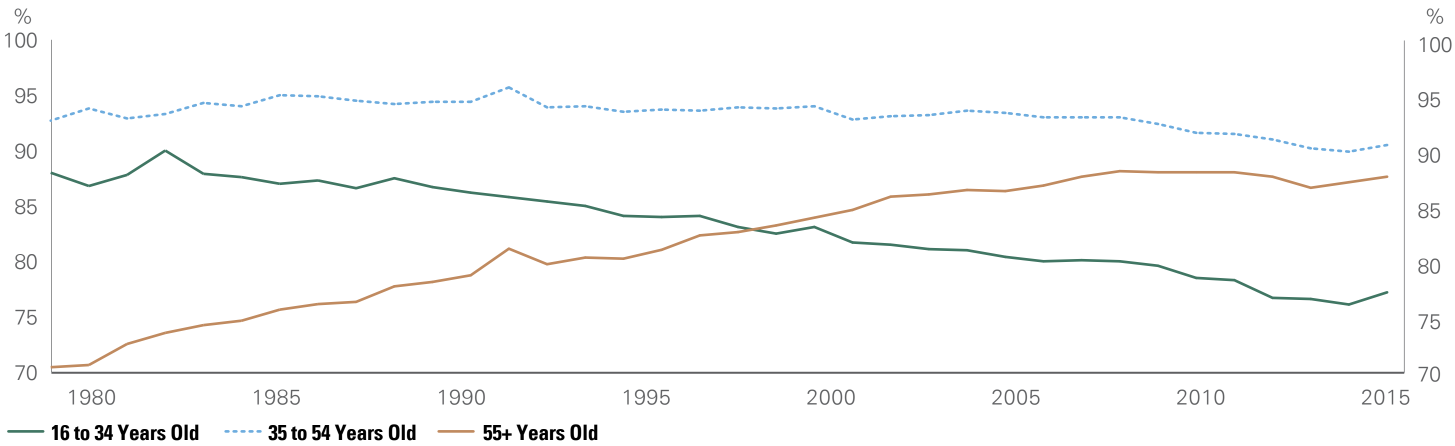
Demand

Looking ahead, cyclical and, we believe, structural forces are at play that should slow demand growth for new and used cars. For years, manufacturers and dealers have been sweetening deals for new cars and light trucks with incentives that amount to over $3,500 per car, at the top of the post-recession range and unlikely to meaningfully increase from here. Perhaps most importantly, from a cyclical perspective, sales of new autos and new homes have historically tracked each other. However, in this most recent recovery, there seems to be more of a substitution effect between the auto and housing markets, likely due to the excessive number of foreclosures and general severity of the housing crisis. The auto market has run quite a bit ahead of the housing market, suggesting the auto cycle may be closer to its peak than the rest of the economy (Exhibit 3).

We also highlight two structural factors that pose a risk to the auto market longer term. First, in terms of demographics, age groups 16 to 34 years and 35 to 54 years together make up around 65% of the driver-age population. However, both of these groups have seen a multidecade decline in the percentage of the population with a driver's license (Exhibit 4). This, along with a resurgence in city living and increased popularity of ride-sharing apps (roughly 35% annual growth in car-sharing members in the U.S.[1]), present long-term structural headwinds to the automobile industry.

[1] According to McKinsey & Company

Exhibit 4: Structural Decline in Share of Younger Population with Driver's Licenses



As of December 31, 2015.

Source: Department of Commerce, Department of Transportation, Goldman Sachs

Fault Lines in the Auto Loan Market

Often, the transmission mechanism for weakness in one industry, like autos, to the broader economy is through the lending market, and we are starting to see potential red flags within subprime auto lending. Subprime auto loans outstanding now total roughly $280 billion, while auto loan delinquency rates have gradually increased since 2014. Auto and personal loans as a percentage of income are back to pre-recession levels of around 11% (Exhibit 5).

In our view, these fault lines in the auto-lending market do not signal an imminent earthquake for the auto industry or broader economy. For one, the increased dollar value of subprime loans is a result of a rebound in overall lending; subprime as a percentage of outstanding auto loan balances has been steady at around 19% and below pre-crisis levels, though we are monitoring growth in the share of "deep subprime" loans (those with credit scores below 550).

It is also reasonable to expect underperformance of subprime auto loans at this point in this particular cycle. In the immediate aftermath of the last recession, many borrowers' credit scores were decimated as a result of a foreclosure or short sale on their homes. These borrowers otherwise had solid income and payment histories, but they were swept under the subprime umbrella. Today, many of these borrowers have improved their credit scores and moved up to the near-prime category, leaving a more typical subprime borrower profile within that bucket.

Relevance to Bessemer Portfolios

Bessemer's equity mandates hold very little direct exposure to the auto market — about 1% of Bessemer equities in auto producers or components versus 3.5% for the equity benchmark. However, Bessemer equity managers invest in some names with indirect exposure to autos, like specialty retail parts suppliers or even vehicle auction companies. Managers look for sound management and business models that are often tied more to volumes in the used car market than directly to used or new auto prices. A company that specializes in used or salvage vehicle auctions, for example, would stand to benefit from an increased number of off-lease vehicles in the market or even a higher accident frequency, as their revenues are driven by volume and fixed fees for each vehicle that goes to auction, making them relatively immune from weaker prices in the next auto downturn.

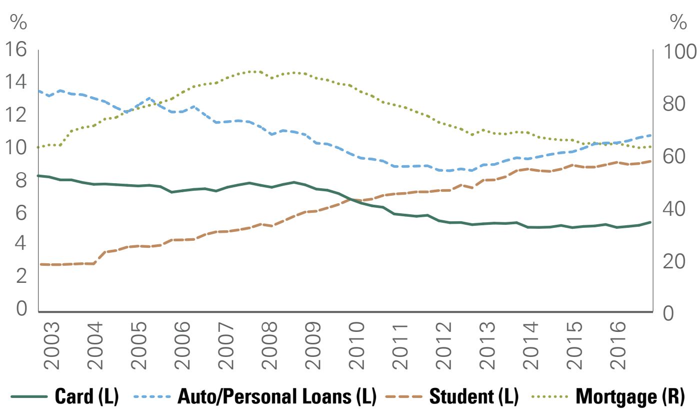
Exhibit 5: Auto Loan Delinquencies, Non-mortgage Consumer Debt Creeping Up

a. Auto Loans 90+ Days Delinquent

As of of December 31, 2016.

Source: Bloomberg, Federal Reserve

b. Consumer Debt to Income Levels by Type



As of of December 31, 2016.

Source: Bloomberg, Deutsche Bank, Federal Reserve

Peak Housing Market and the Broader Economy

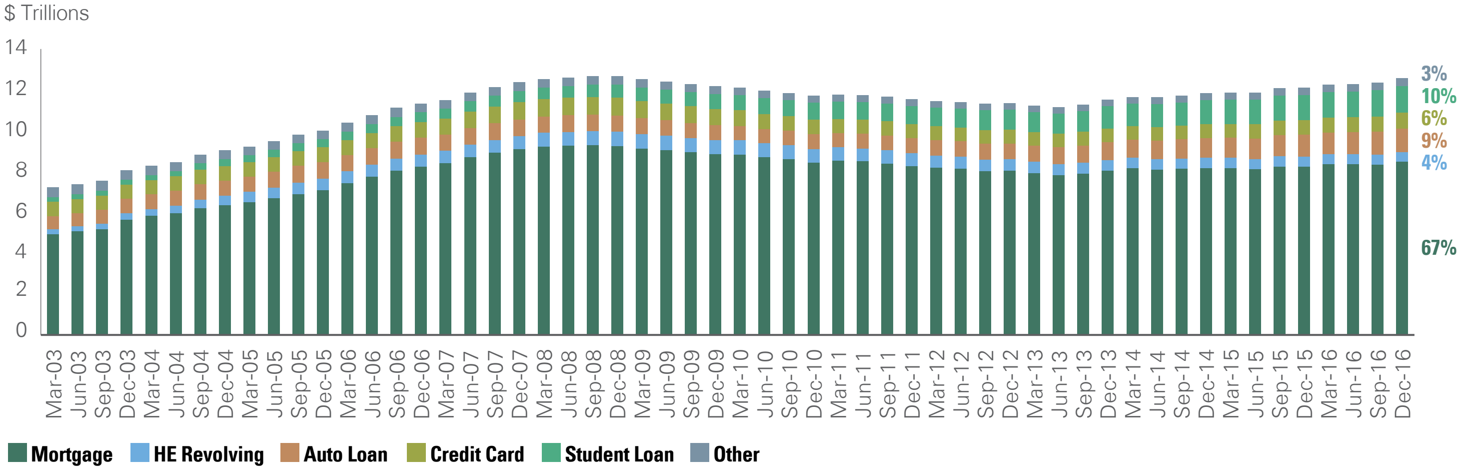
Could weakness in the auto market and subprime auto lending be the straw that breaks this recovery's back? In our view, it is a possibility that bears monitoring but is not our base case. Consider three factors that give us reassurance that a slowdown in the auto industry will not derail the broader economy:

Relevance to Bessemer Portfolios

Certain Bessemer fixed income and credit mandates have and may continue to hold some direct exposure to the auto industry through a mix of corporate debt and asset-backed securities (ABS) secured by AAA-rated auto-related assets like prime auto loans, new car leases, or even rental car fleets. On the former, corporate debt issued by the finance arms of large automakers like Toyota, Honda, and Ford usually trade at yields in excess of standard corporate debt while having support agreements in place with the parent company. ABS generally offer higher risk-adjusted returns than corporate debt, due in part to loss coverage for the AAA tranche that exceeds 20 times the estimated losses on the underlying collateral.

- **Consumer balance sheets are healthy and not overexposed to the auto market.** Despite growth of more than 5% per year, auto loans still represent a modest share of total consumer debt (Exhibits 5, 6). The bulk of consumer debt, on a total and per capita basis, remains tied to housing. Growth in home sales, mortgages, and home prices has been more muted than the auto market during this recovery, leaving the housing market less vulnerable. Also, default rates on auto loans during the crisis were much lower than the rate of defaults on mortgages: net losses for auto ABS peaked at 3.6% in 2009 (1.8% for prime and 9.8% for subprime), compared to peak delinquencies for single-family residential mortgages of 11.5% in 2010. The repossession market is more liquid and faster than the foreclosure market, and a car is usually necessary to get to a job, motivating borrowers to prioritize their car payments over their mortgages.
- **The auto market is important but remains a relatively small contributor to overall economic growth.** As a rough estimate, auto sales represent around $500 billion per year (16.5 million car sales times median car price of around $30,000). A similar calculation for the housing market yields a value three times that. While spillover risks can be difficult to predict, the impact of housing market trends on consumer balance sheets and economic growth remains much larger than that of the auto market.

Exhibit 6: The Vast Majority of Consumer Debt Is Tied to the Housing Market



As of December 31, 2015.

Source: Federal Reserve Board of New York

- **The leasing cycle may actually help stabilize the market, at the margin.** A key contributor to the increase in used car inventories is the leasing cycle, but the higher number of leases could end up forcing consumers into a new vehicle during a weak economy, when they would otherwise delay the replacement cycle. Leasing could also continue to elevate the quality of used cars going to auction (since off-lease vehicles tend to be newer with fewer miles than the rest of the used car market), thereby slightly offsetting headwinds to demand and pricing in the used car market.
- **Systemic risk to the financial system from the auto market is much less than from housing, for two reasons.** 1) Auto loans have a shorter duration than mortgages, even after accounting for principal prepayments on mortgages. This means auto loans take less time to recover, making their collateral losses less damaging in most cases. 2) The outstanding balance of loans and securitized products tied to the housing market is significantly greater than auto loans and auto-related ABS. For example, there is roughly $8.5 trillion in outstanding home loans in the U.S., compared to only $1.2 trillion in auto loans. In the securities market, the balance of auto-related ABS outstanding is $196 billion, of which only $41 billion is subprime. By comparison, before the crisis, non-agency subprime mortgage-backed securities (MBS) totaled around $800 billion, and that does not include the significant number of subprime loans issued through government agencies like Ginnie Mae, Fannie Mae, or Freddie Mac.

As investors, we believe it is important to possess a healthy amount of skepticism in our outlook, which leads us to constantly question where we could be wrong. For example, while consumers on average retain a healthy amount of debt, excluding the top 5% income bracket shows a much higher debt-to-income ratio, suggesting high-income earners may be masking underlying weakness. We are also monitoring growth in deep subprime lending and defaults, as well as tightening credit standards, as an acceleration in any of these may hasten a recession, all else equal.

Staying the Course

In our view, the U.S. auto market is exhibiting signs of peaking, and we could see a slowdown in growth of auto sales and production, likely weighing primarily on auto manufacturers or dealers. However, we do not believe the spillover to the broader economy or lending market will provide a sufficient catalyst for an immediate U.S. recession. The labor market and wages continue to grow, the Federal Reserve is proceeding along a path of gradually raising rates, and it is still our base case that the U.S. economy will receive fiscal stimulus from tax cuts or infrastructure spending. Growth in the auto market is also not only reliant on the U.S. economy, and much of the anticipated growth in auto sales over the medium term is likely to come from emerging markets, where economic growth has been stable of late.

We remain steady in our neutral positioning to equities versus the benchmark, with a Balanced Growth 70/30 stock/bond risk profile holding roughly 70% stocks. This should allow us to participate in what we expect to be further equity gains as the broader economic recovery continues into the late innings. Client portfolios also hold some defensive assets, including high-quality fixed income (though underweight versus our benchmark) and lower-volatility equity strategies. These defensive assets should dampen portfolio volatility and limit losses should some of these risks turn out to be more serious than anticipated.

With special thanks to Michael Morrisroe, portfolio manager, and Alex Tang, credit research analyst, for their contributions.

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