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SHIFTING GEARS BACK TO FUNDAMENTALS

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Summary

Much to the dismay of securities markets, which have struggled to price risk in an uncertain environment, the auto market has been on a joy ride for the past few years. When reflecting on just how strange the market has been, several things come to mind: appreciation of new and used vehicles; a couple of ABS deals are positioned to incur losses on a few lower tranches; manufacturers' wide production of electric vehicles—and a sports car launched into outer space. Despite the strange environment leading into 2024, we are going to paint a picture of the next year using simple economics and a few publicly available charts. The next year, also known as the return to "normal," will depend on two things: supply and unemployment.

Supply in Domestic Auto Inventories

While vehicle supply has been on a downward trend since 1995, it reached rock bottom levels in 2021 due to COVID-19. The overall trend is a result of manufacturers focusing on lean production and targeting profitable luxury car segments. It makes sense that COVID-19 exacerbated this trend: If you have a limited number of cars you can produce, you should focus on the most expensive ones, especially when consumers are flush with cash and the demand is high. This worked out great for car manufacturers, which is evident in the record profits they gleaned during the heights of the pandemic. However, the pendulum of supply has begun its swing back towards equilibrium, as represented by the tail end of the 'Domestic Auto Inventories' line in Figure 1. This normalization of supply will be the primary driver of downward pressure on high car prices. As inventories bounce back to stable levels, we will see price competitiveness for combustion engines follow a path similar to the ones seen in the pricing wars in the Electric Vehicle market. There is likely some level of inflation baked into ongoing car prices, as manufacturers will be slower to shift their production lines to more reasonably priced vehicles. Despite this, it is in our opinion that car prices will moderate this year. How quickly that happens brings us to the second topic for 2024: unemployment.

Figure 1. FRED Auto Inventories and New and Used Vehicles CPI

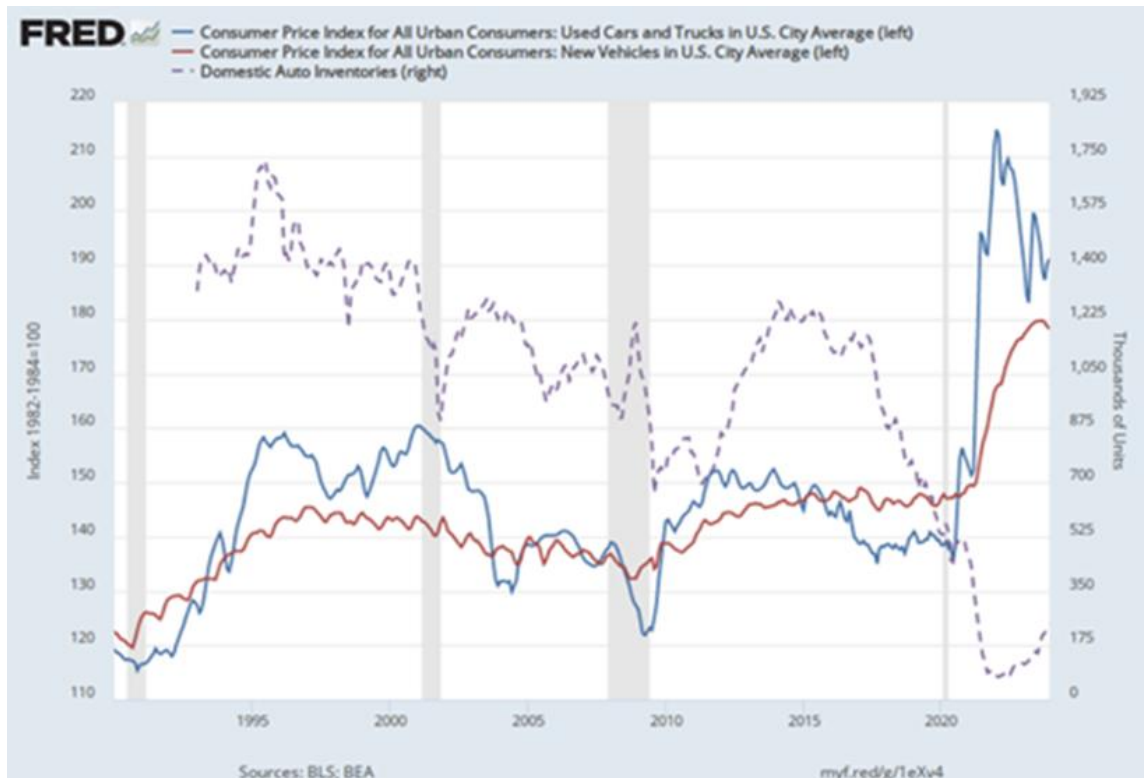

Figure 1: There is a clear downtrend in inventory which started around 1995, as noted by the “Domestic Auto Inventories (dashed purple)” line. COVID’s lower inventories are likely here to stay as manufacturers and dealerships are choosing to stay lean on inventory and focusing on luxury segments.

Unemployment

Unemployment has traditionally been the primary driver of defaults for autos. Despite the drastic swings created by economic shutdowns and subsequent massive stimulus packages, we expect this to hold moving forward. As the residual effects of inflation exhaust consumers’ excess savings and consumers’ debt burdens continue to grow, unemployment will once again be the primary driver of defaults. That said, unemployment has refused to yield to the Federal Reserve’s campaign against inflation—whether that will continue through 2024 remains to be seen. In the scenario where unemployment does increase to levels around 4.5% and above, deals consisting of loans originated in 2021–2023 will be at risk for higher severities, due to the peak in car prices around that time. This will be especially true since delinquencies have already surpassed pre-pandemic levels, as seen in Figure 2. Higher unemployment will fuel increasing delinquencies, add additional downward pressure on car prices, and potentially pinch manufacturers who have been focusing on luxury segments.

Supply and unemployment will drive the narrative for autos in 2024; however, the effects of student loan payment resumption could also exacerbate things for consumers. People typically prioritize their auto payments over student loans, and we expect this trend to continue. Nonetheless, the increase in repayment obligations could act as an additional weight on consumers who are rapidly burning through excess savings accrued during the stimulus period. This effect likely won’t have an impact until the “on-ramp” period of student loan resumption expires in September 2024.

Figure 2. Delinquencies by Type of Debt, 2006-2023

Conclusion

Considering the factors above, it looks as if the auto market's long road trip out of crazy town is coming to an end. As supply and unemployment approach their long-term trends, car prices will follow. Delinquencies have already surpassed their pre-pandemic levels and may continue to increase over 2024, depending on unemployment. This scenario may be difficult for manufacturers, as demand for expensive vehicles will wane significantly, while price competitiveness increases. The health of the consumer has remained robust, and we will be monitoring it closely over the next year.

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