GordonTLong.com

THE COMING AUTO ABYSS

MACRO INSIGHTS

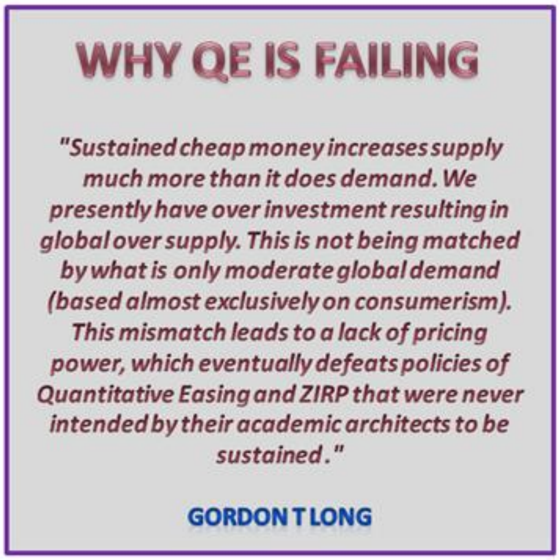
Gordon T Long
11/10/2015

THE COMING AUTO ABYSS

Too Much Supply & Too Many Brands Combining with Too Much Credit

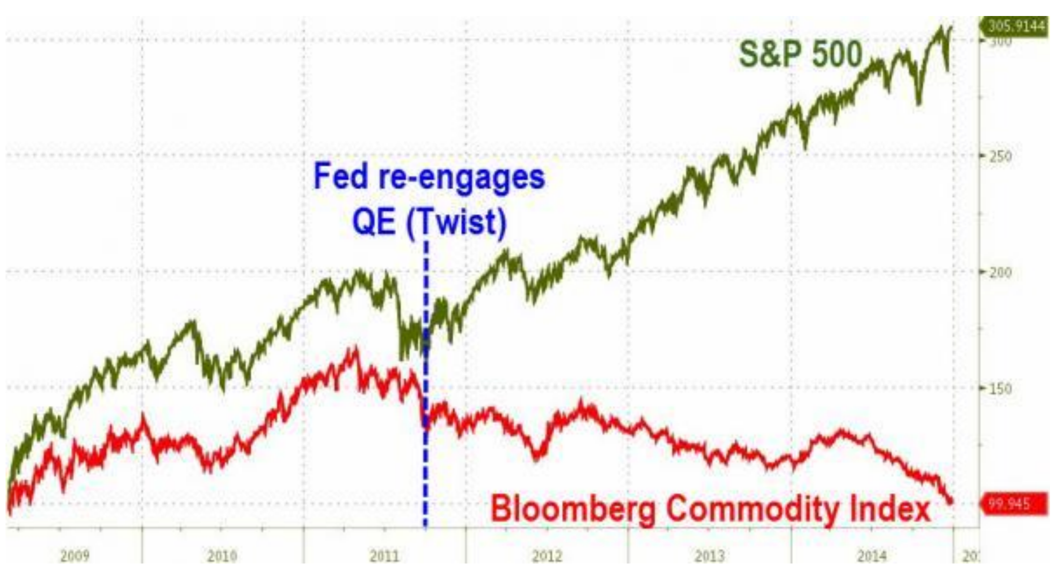
Over Supply & Excess Capacity

In previous reports I have laid out that easy credit, quantitative easing and ZIRP have brought demand forward. More importantly, excess credit has fostered a massive global oversupply.



Obvious If You Care to Look

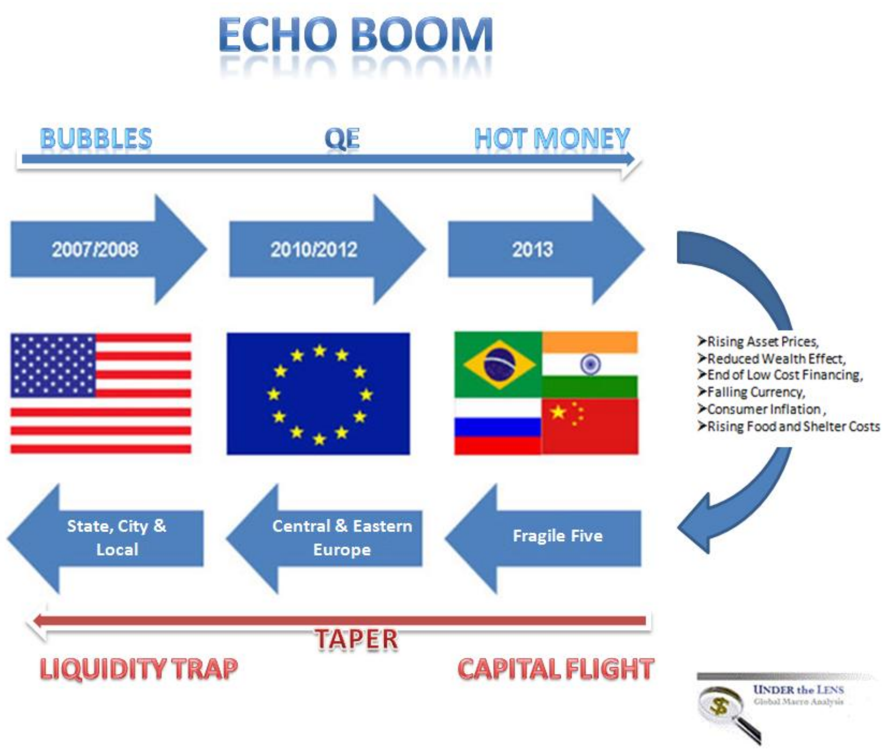
This over supply is now becoming evident as industrial capacity doesn't need the commodities it is so dependent on and has been scaling back orders. Commodity based countries primarily in the emerging markets are feeling the pain.



2014 Thesis: The Globalization Trap

We are now on the bottom side of this Echo Boom chart from the Globalization Trap. We can see here we expect problems in the Central and European countries to be next as well increasing problems at the State, City and Local level within the US.

The resulting policy responses here will eventually lead to hyperinflation and that last leg up in US equity markets shown in our last month's "M" top discussion.



A lot of problems are just below the surface and becoming very visible! None as you will see is is more serious than the coming Global Auto Industry problem.

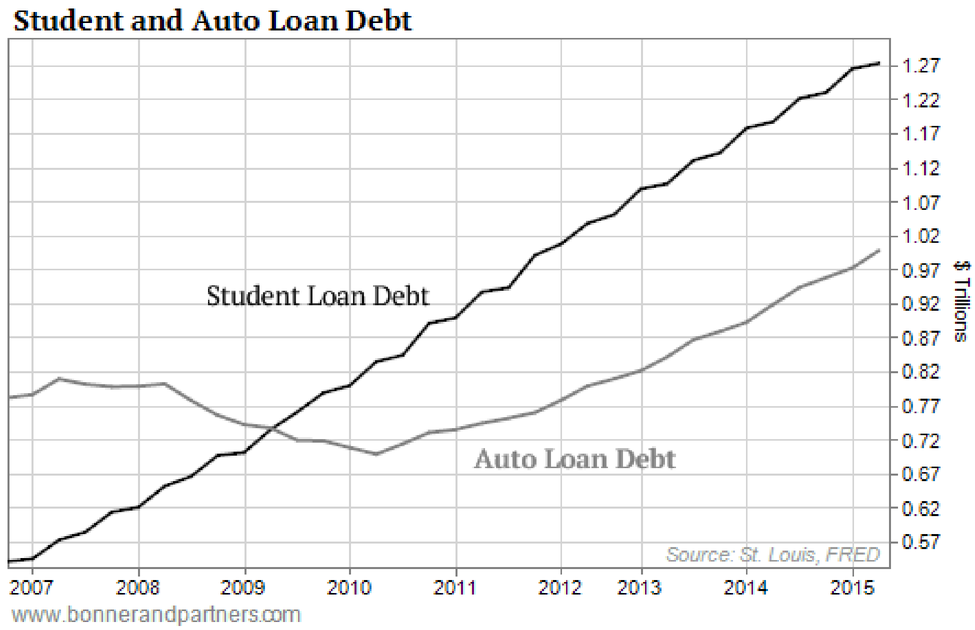
PERFECTLY PREDICTABLE - Saw *It Coming*

Student & Auto Loan Debt

Credit based spending has been in full effect with auto loans and student debt since not long after the 2008 financial crisis. With so many creditworthy Americans deep in debt, the temptation has been to go to subprime loans, which have accelerated dramatically.

Subprime auto debt is running rampant. Student debt is now the most delinquent debt class in America. Subprime debt is once again super charging the debt fueled market. **Subprime debt is back in a big way.**

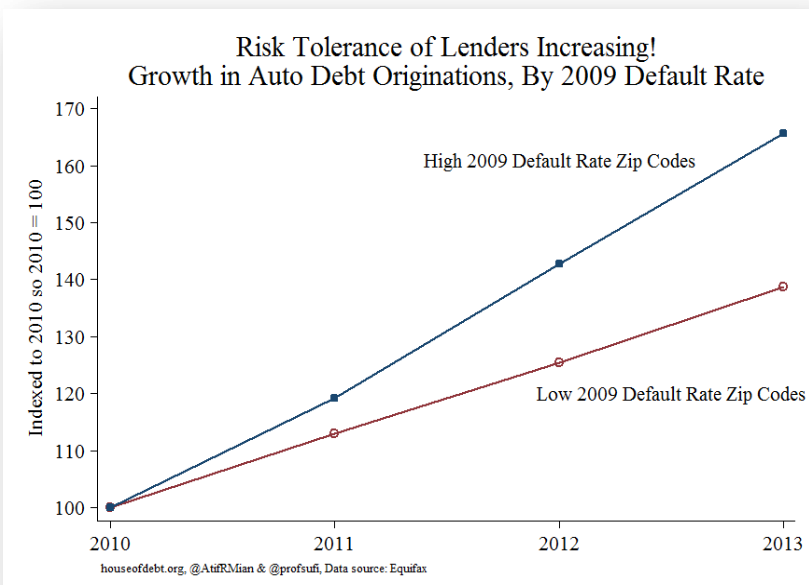
Over the last seven years courtesy of the Fed's low rate policies, auto and student debt has surged in dramatic fashion. While the shrinking middle class is unable to purchase homes with inflated values, many are still chasing the dream by going into debt for cars and college. The debt growth in these markets can be seen to be nothing short of fantastic.



A Sub-Prime Economy

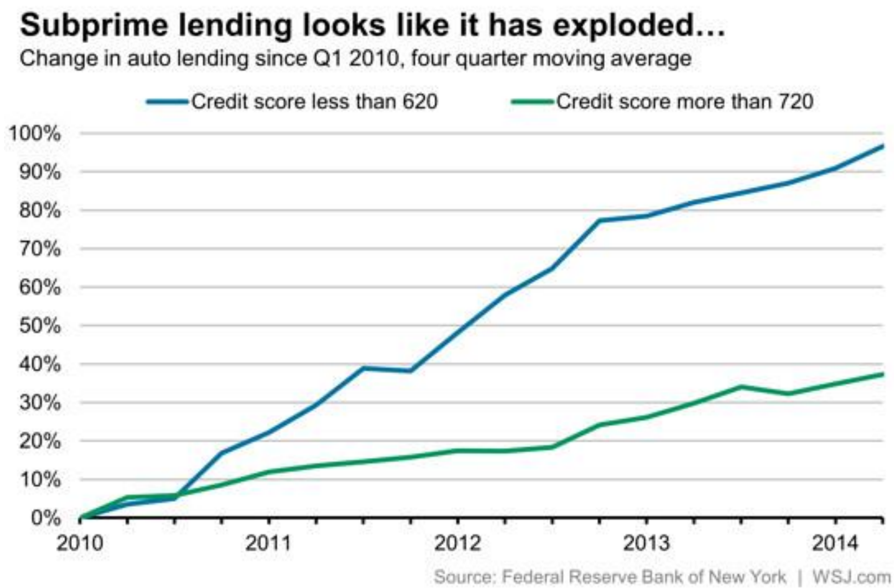
This is obviously the direct result of low interest rates and resulting consumer spending. We've essentially allowed Americans to buy cars on borrowed money and go to college on big debt while making it tougher for them to purchase homes based on the last crisis. Like wars, we always fight the last war with weapons that are obsolete in facing the new war.

What is scarier about this sudden growth is that much of the debt is being made to people that are having a difficult time paying it back. Take a look at subprime auto debt shown here.



Deep Sub-Prime

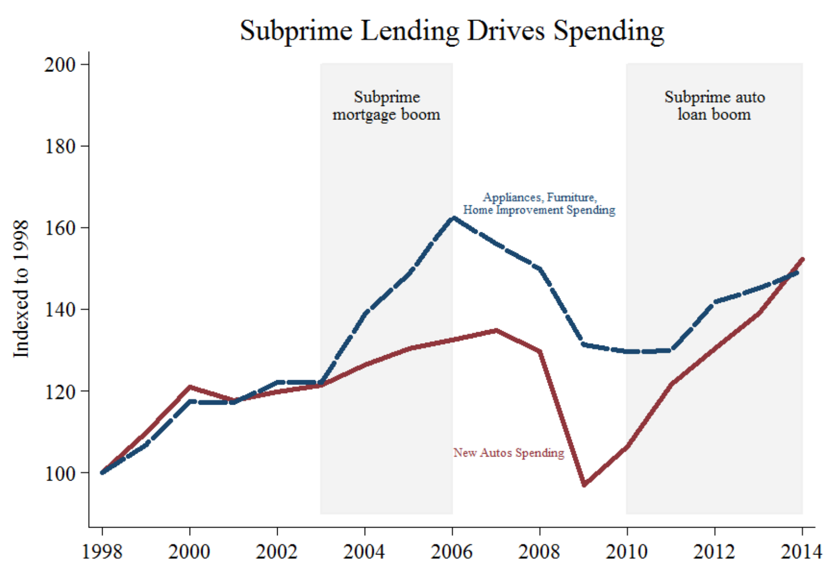
For auto loans since 2010 the growth in lending has come to consumers with credit scores of 620 or less. Those with higher credit scores of 720 have seen modest growth. Those with lower scores have seen nearly a 100 percent increase in loans while those with better scores have seen less than a 40 percent increase. In other words, the bulk of new cars are being bought with financing with those having trouble managing their current debt.



With cars costing $30,000 and higher, this is no small price tag. Any tiny little hiccup in the economy and this is enough to send their auto purchase into repossession. Do people remember the cash for clunkers and auto industry bailouts? These things did not happen too long ago. It appears that we are setting ourselves up perfectly for another kind of these scenarios.

The results of prolonged artificially low rates is that the market is now fully addicted to this environment.

The Fed is backed into a corner and they really have very little ammo left. Speculative lending is already dominating the market. You can see the subprime booms very clearly.



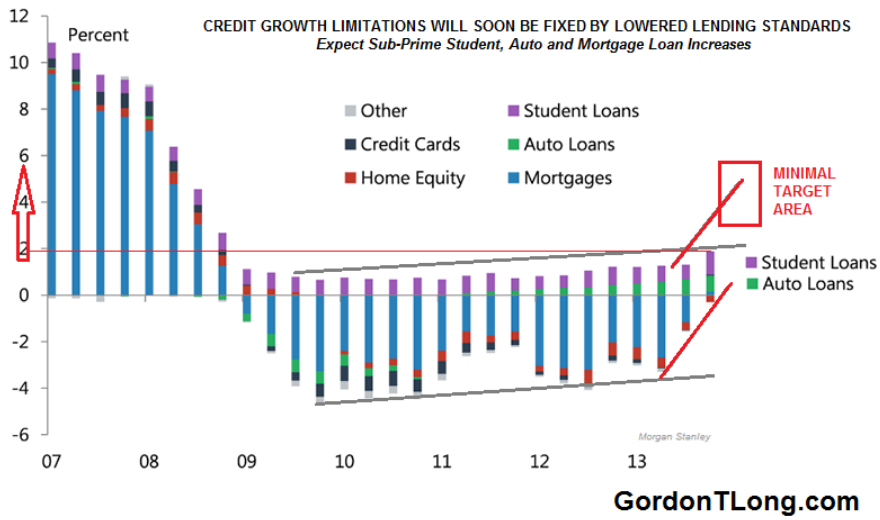
Addicted to Sub-Prime

The economy is clearly slowing down. Recessions happen. And once again we have saddled a large enough group of Americans with debt where the pain will be deeply felt when the correction hits again.

A Required Strategy

I showed this chart a couple of years ago and argued that the government and its regulators had little choice following the 2008 financial crisis but to force growth by any means in both the student loans and auto industries.

It has succeeded, but at what cost and systemic risk?

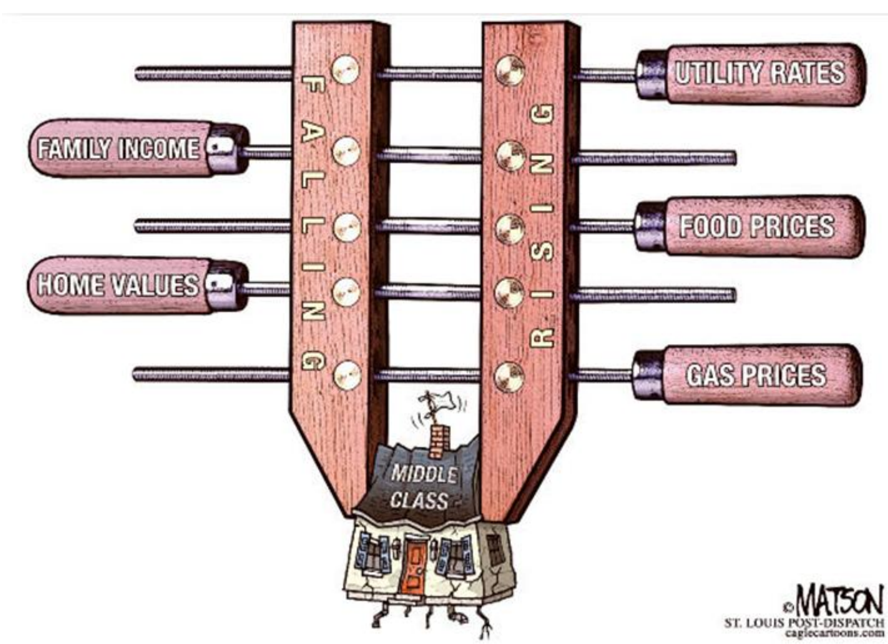


Only the Acronyms Have Changed

Both are dependent on the Shadow Banking system for their survival and growth. In the case of the auto industry for ABS (Asset Backed Securities) and in the case of student loans for Sallie Mae and it's financing through the shadow banking industry. It was MBS (Mortgage Backed Securities) that was the central problem in the 2008 crisis. The only thing that has changed is the vehicles and acronyms which justify them. We have talked about this before.

Addicted to Sub-Prime - Little Choice But To Fish Where the Fish Are!

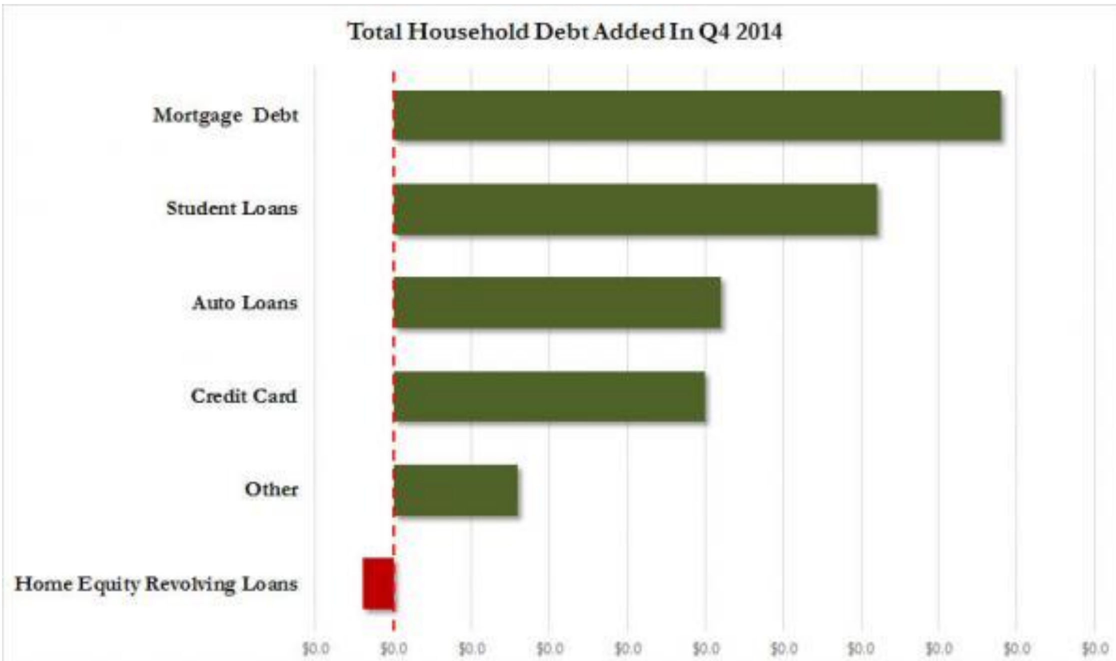
A huge difference between now and 2008 is that the US consumer is tapped out, the US middle class not making a "living wage" with debt being the only way for them to survive. Debt they have almost no ability to pay off! Credit has become a charade to postpone the inevitable.



EXCESS SUPPLY – Every Country an Exporter?

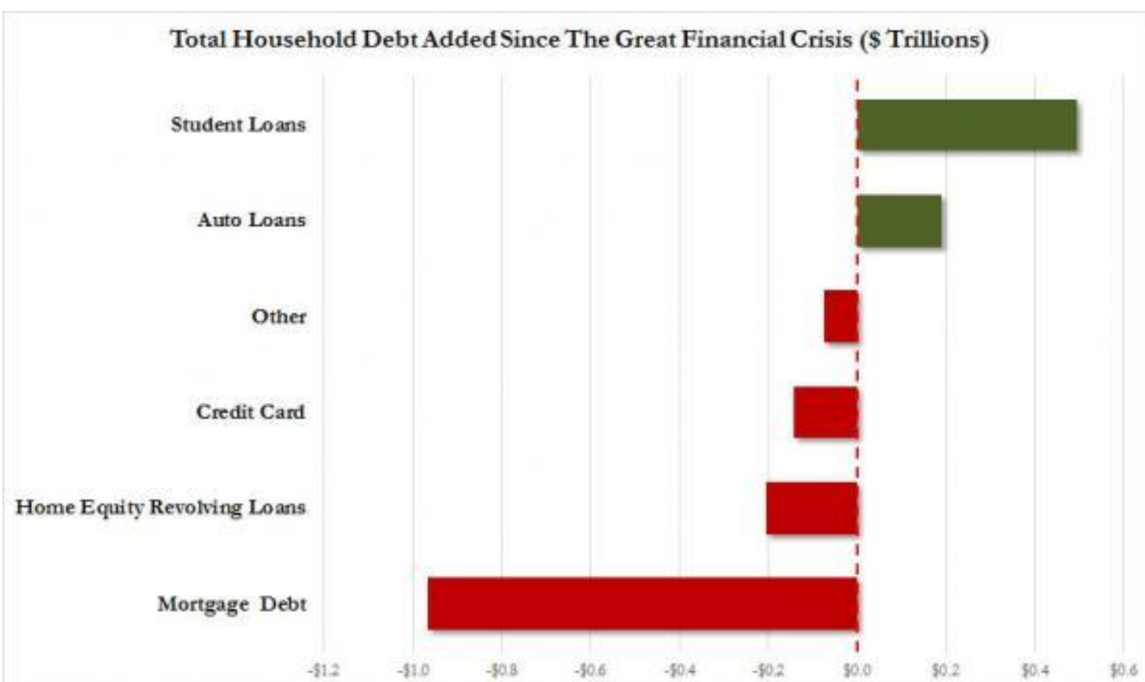
Total Household Debt Added

Total household debt has continued to grow!



Little Choice Buying and Debt Acceptance

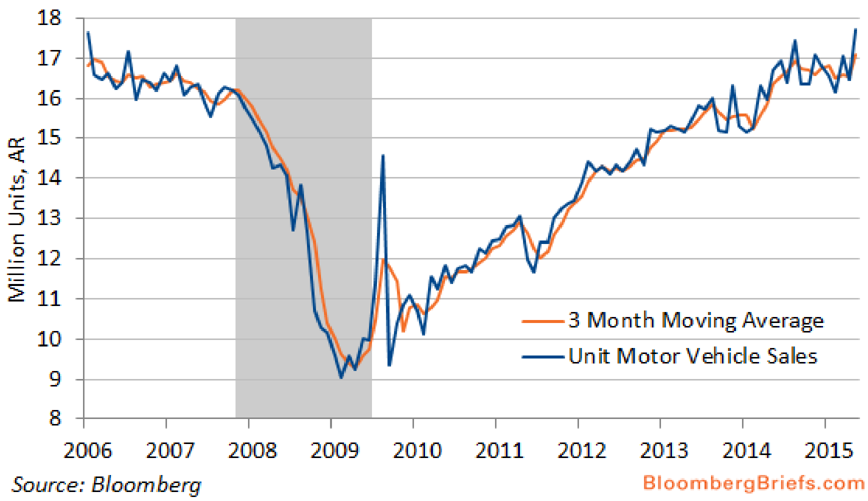
Total household debt added since the great financial crisis has been primarily in student loans and auto loans.



A Strong Dollar is creating a False Demand Illusion

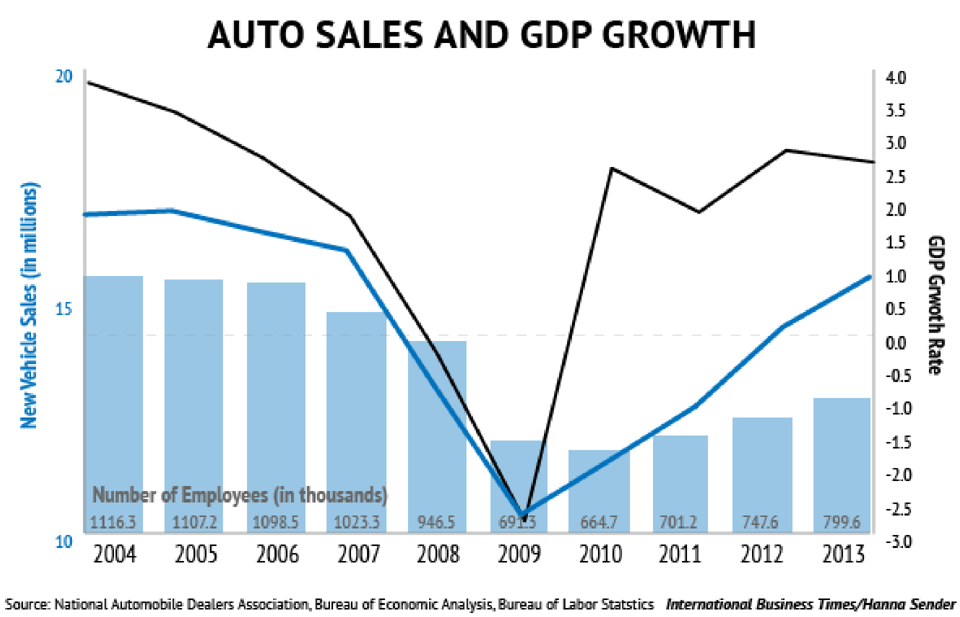
What has happened is that a strong US dollar has allowed auto prices to stay lower than they might have been. It has also allowed credit to be there at extremely low rates and to be made available to those who cannot afford the items (like autos) which they have been clamoring to buy.

In the northeast it seems that everyone is driving a new or relatively new car, suv or truck. It is rare to see a late model vehicle on the road anymore.



Economic Driver

There can be little doubt that this auto buying binge has helped an economy that can only be described as temporarily on "life support".



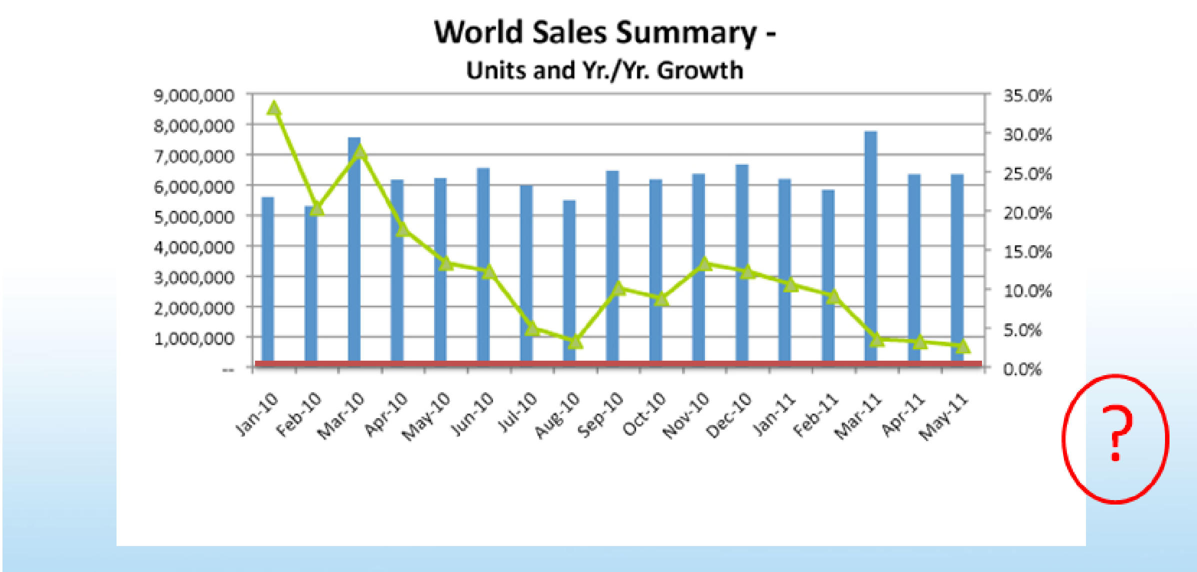
88.6M New Cars in 2015

As I said earlier global supply has ramped up and is expecting to sell 88.6 million new cars in 2015. This is a further increase of 2.4% Y-o-Y.

However the rate of increase is falling and sales appear to be topping.

How Many New Cars Can we absorb?

How many cars can the global economy absorb? World sales are trending the wrong way and actually look like a contraction is a real possibility.



Something has to give!

TOO MANY BRANDS – Too Much Choice Means Lost Purchasing Power

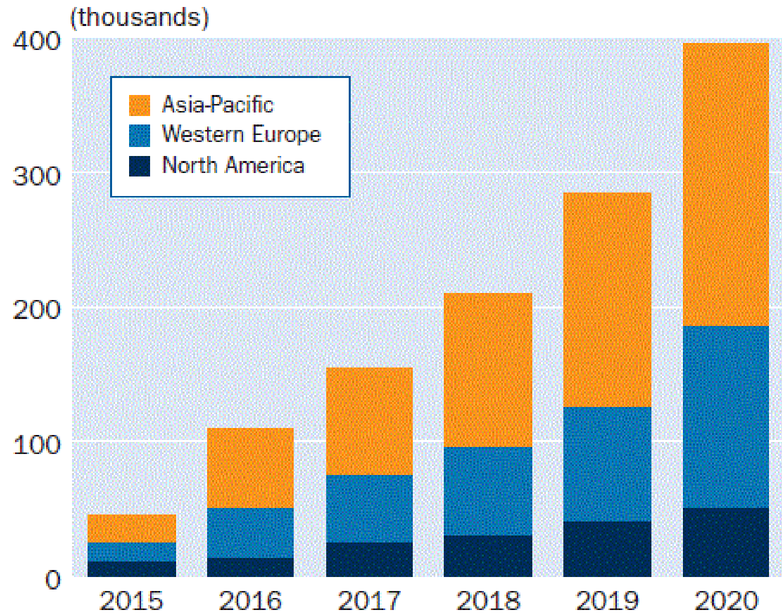
Unsustainable for Many Reasons

With the currencies of Emerging Markets continuing to fall it is now harder for many of what were global auto expansion areas to buy autos

But IHT Says Differently

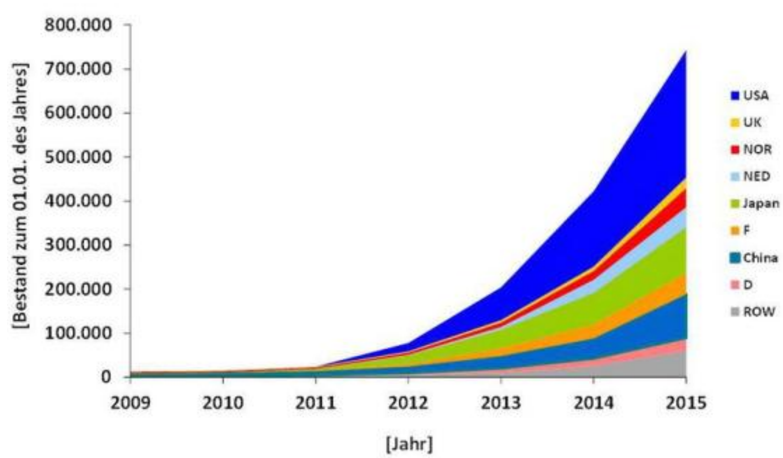
IHT Automotive says that emerging market sales are falling and the only growth is in the developed economies where credit is still flowing.

The predictions no longer make sense which IHT is subtly alluding to.



Looks like Most “Peaking” Charts

Charts like these always end badly, especially when they are based on cheap credit and historically low and artificial interest rates.



It seems that every major G10 country in the world is a major exporter of autos! They include: US, Japan, China, Korea, Germany, Italy, France, UK, Canada, and others. Let’s talk Germany for just a moment to fully appreciate what this house of cards the auto industry has become based on easy credit.

The German Volkswagen Example

It is no secret that with the rest of the US economy, and especially housing, sputtering the one bright spot for US production and manufacturing has been the automotive sector. Whether the recent strength has been a function of money-losing leases, extremely generous terms on auto loans including a new rise in subprime debt issuance is up for debate, but whatever the reason carmakers have had a few years of relative stability.

But if in the US automakers have been the solitary silver lining to an economy that is once again rolling over (as the Fed lack of a rate hike just confirmed), in Europe carmakers are absolutely critical, while for export powerhouse Germany, one can say the local auto industry is nothing short of systemic.

Here are the latest facts on Germany's automotive industry from GTAI.de

- German automobile manufacturers produced almost 13 million vehicles in 2013 – equivalent to more than 17 percent of total global production. Twenty-one of the world's 100 top automotive suppliers are German companies.
- **The automotive industry is the largest industry sector in Germany.** In 2014, the auto sector listed a turnover of EUR 384 billion, **around 20 percent of total German industry revenue**. Source: VDA 2015
- The auto industry is the largest industrial sector in Germany, contributing about 2.7% to gross domestic product.
- **Some 20% of Germany's exports are made up of vehicles and parts.**
- **Germany is Europe's number one automotive market**; accounting for over 30 percent of all passenger cars manufactured (5.6 million) and almost 20 percent of all new car registrations (3.04 million). Source: ACEA 2015
- **Germany is home to 43 automobile assembly and engine production plants with a capacity of over one third of total automobile production in Europe.** Source: ACEA 2015
- **One in every five cars worldwide carries a German brand.** Source: VDA 2015
- **In 2014, automotive industry R&D expenditure reached EUR 17.6 billion, equivalent to one third of Germany's total R&D expenditure.** Source: VDA 2015
- **21 of the world's top 100 automotive suppliers are German companies**. Source: PWC 2013
- **Around 77 percent of cars produced in Germany in 2014 were ultimately destined for international markets – a new record.** Source: VDA 2015
- **R&D personnel within the German automobile industry reached a level of just over 93,000 in 2014. Around 775,000 are employed in the industry as a whole.** Source: VDA 2015

Then there is the value-chain, i.e., the suppliers and the providers of R&D for Germany's automotive industry.

- Germany boasts 21 of the world's top 100 automotive OEM suppliers. Of these 21 companies, 18 belong to the top 50 automotive suppliers in Europe. Breaking the figures down further still, six belong to the top 25 global suppliers by size.
- Exports account for almost 37 percent of 2013 revenue generated by German OEM suppliers

As for why Volkswagen is the benchmark? Because not only is the Volkswagen Group the largest automaker in Germany, it is also the largest German company by revenue according to Forbes (Daimler is #3, BMW is #7). Some other facts:

- The Volkswagen group accounts for roughly one in 10 vehicles sold globally.
- Most German auto sales came from the Volkswagen group, which reported just over 202 billion euros in revenue in 2014.
- Roughly 70% of Volkswagen vehicles are sold outside German borders.
- Volkswagen employs nearly 600,000 people around the world, and more than a third of the 775,000 people who work in the auto industry in Germany.

In short, while banking may be the most important sector to the hyper-financialized US economy, for the export-driven German economy - whose exports account for over 40% of GDP - it is all about the car companies and their massive supply chains.

THE FINANCING GAME – The Mounting Residuals Problem

The Automotive Industry Financing Game

In my recent Financial Survival Interview I discussed some of these issues with Kerry Lutz, who as a former credit attorney said:

> *"The car companies have done exactly the same thing as the mortgage market – they have backend loaded leases. By over-stating the value of what the car is really going to be worth at the end of the lease they have effectively backend loaded all these leases. This is a game car company's play to get rid of cars when the market is tight, or when the economy is tight to get people into cars that they wouldn't otherwise be able to afford!* ***NOW IT IS BLOWING UP IN THEIR FACES****"* Listen to podcast


Gordon T Long
Market Research & Analytics

Gordon T. Long – Subprime Auto Bubble Is Popping
from Financial Survival Network As usual the numbers don't lie. Gordon T. Long and I predicted over... [more]

Gordon T. Long – Subprime Auto Bubble Is Popping

from Financial Survival Network

As usual the numbers don't lie. Gordon T. Long and I predicted over a year ago that the Great News coming out of Detroit was more about easy credit than about solid fundamentals. Fast forward a year and now the truth is beginning to become obvious. Auto leasing is way up and the supply of cars about to come off-lease is going sky high, thus driving used and new car prices down. Around the globe auto makers are going to take a major hit. From China, to Germany, to Mexico, to the good old USofA, the story is the same. Markets artificially goosed up by easy credit. But the day of reckoning is getting closer.

The Financial Black Hole

Let me show you some basic statistics.

Total Auto Loans:

2007 $781 billion

2015 Over $1 trillion. More 30% higher – Why?

LEASE:

The percentage of all new vehicles financed accounted for by leases was 31.46% — a record.

2008-2011 **7 million in the three years to 2011** set to **spark a massive surplus Of high-quality used cars.**

2012-2015 **13.4 million vehicles** *(leased over the past 3 years in The US)*

Three-year old, used premium luxury-car prices are down by nearly 7% from a year ago

BUY:

- Average loan term for new cars is now 67 months — a record.
- Average loan term for used cars is now 62 months — a record.
- Loans with terms from 74 to 84 months made up 30% of all new vehicle financing — a record.

- Loans with terms from 74 to 84 months made up 16% of all used vehicle financing — a record.
- The average amount financed for a new vehicle was $28,711 — a record.
- The average payment for new vehicles was $488 — a record.
-

The Financial Black Hole

- 73% Sub-Prime Vehicle loans bundled into securities – 73% now exceed 5 years
- Used-car prices fall, as leases expire and more used cars hit the market.
- DEEP Sub-Prime:
    - *Skopos Financial, a four-year-old auto finance company based in Irving, Tex., sold a $149 million bond deal consisting of car loans made to borrowers considered to be Deep Sub-Prime?*
    - ***Details from the prospectus show a whopping 20 percent of the loans bundled into the bond deal were made to borrowers with a credit score ranging from 351 to 500—the bottom 6 percent of U.S. borrowers, according to FICO.***
    - ***As a reminder, the cut-off for "prime" borrowers is generally considered to be a credit score of around 620. More than 14 percent of the loans in the Skopos deal were made to borrowers with no score at all.***
    - *That means the Skopos deal has a slightly higher percentage of no-score borrowers than the recent subprime auto securitization recently sold by Santander Consumer, which garnered plenty of attention for its dive into "deep subprime" territory.*

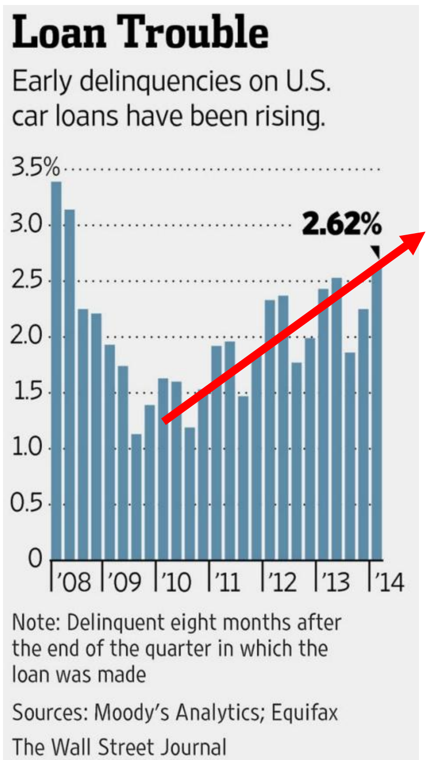
Wholesale Auctions – As Far As the Eye Can See

The result is we have a black hole between 3 years leases and long term bought cars that isn't going to be filled! Prices are going to fall for used cars and therefore lease residuals are exposed.


TROUBLES BREWING – Delinquencies

Loan Troubles

As you would expect early delinquencies on US car loans have been steadily rising.

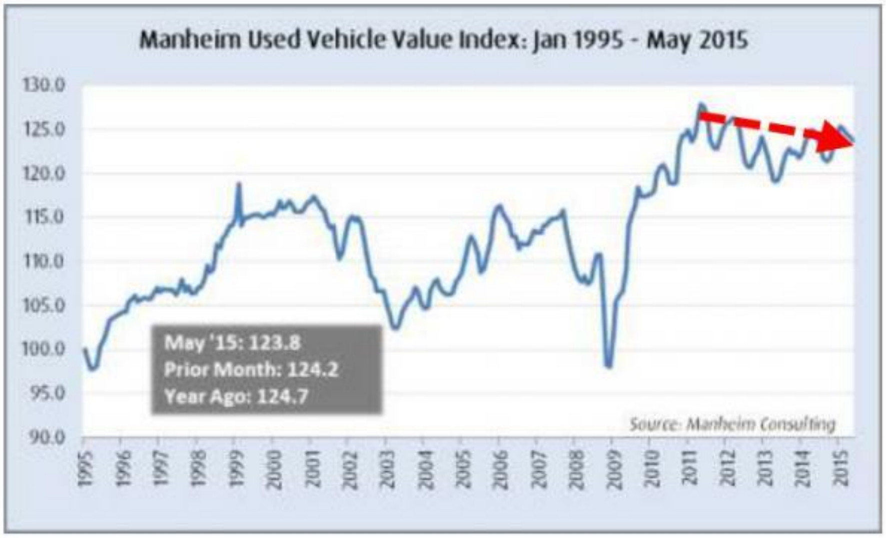


Repos on TV?

Have you noticed that tow trucks and companies are now all called "Towing and Recovery"! I go for an early morning run that involves turning around at a coffee shop. I sit there and watch truck after recovery truck coming through the drive-in as they get a coffee from being at it all night! It is a huge stealth industry that few are awake to see!

Falling Prices – Edmonds -7-8%

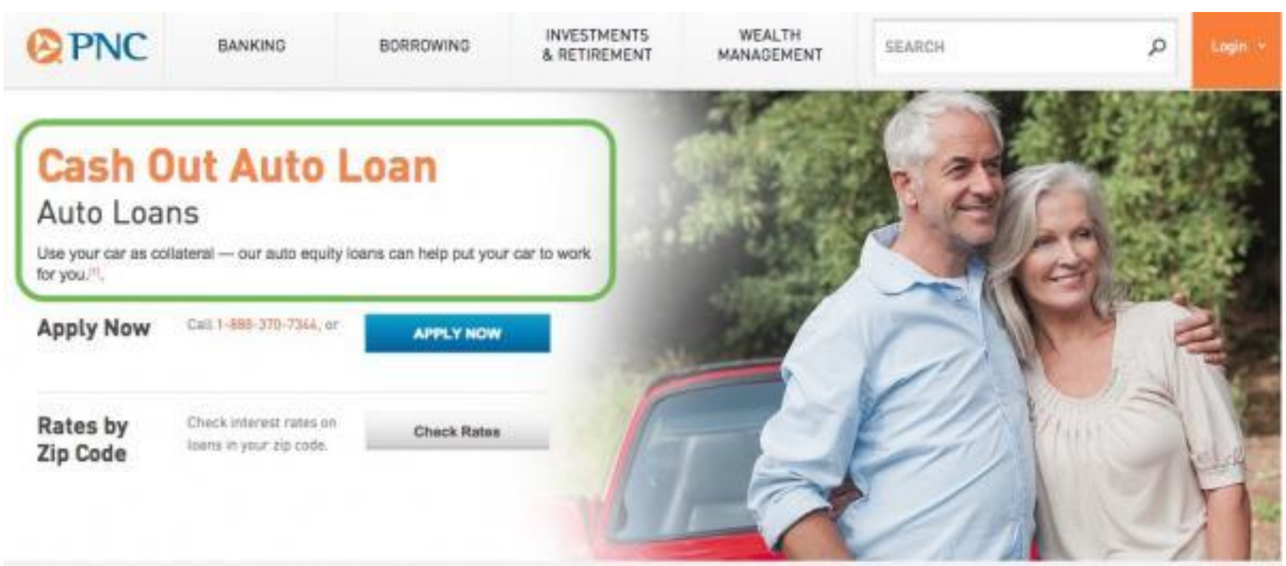
Used vehicle prices are falling and Edmunds recently showed that used US autos coming off lease are down 6-7%. Who is holding the back on those loses? Those Shadow Banking ABS holders such as pension funds and others who have been forced to chase nonexistent yield in desperation.



Residuals Too High

What does this sort of ad tell us?

It reminds of home mortgages becoming ATM for holidays, vacations and easy spending just before the US housing implosion!



SHADOW BANKING ABS – 2008 on a Global Basis

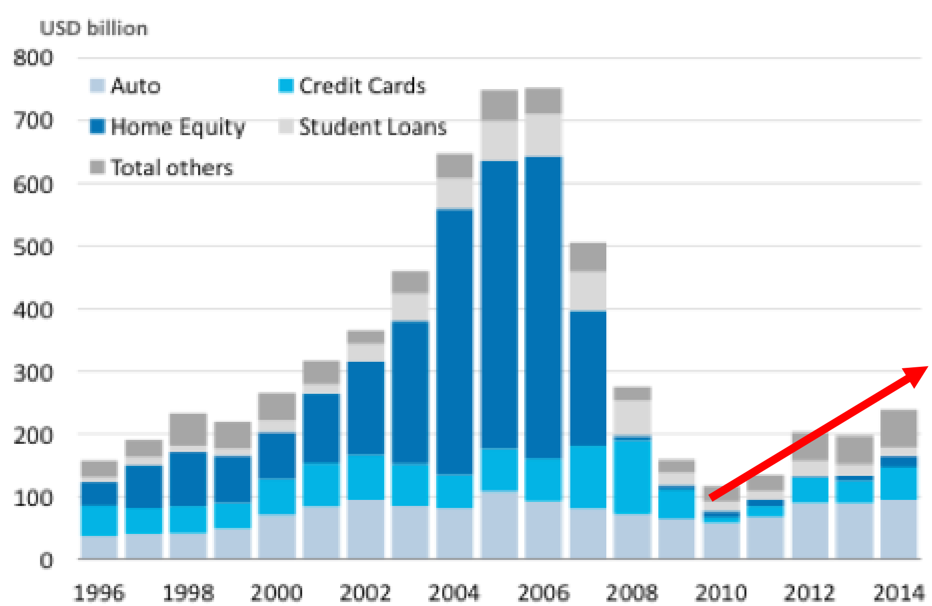
Borrowing Short to Lend Long

So what is happening in the Shadow Banking System?

ABS

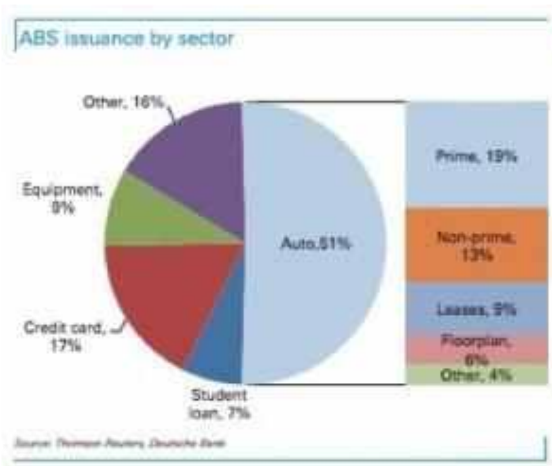
Asset backed securities sure aren't at the level they were previously but they may be a bigger bomb!

Figure 11: Issuances of Asset Backed Securities in the US



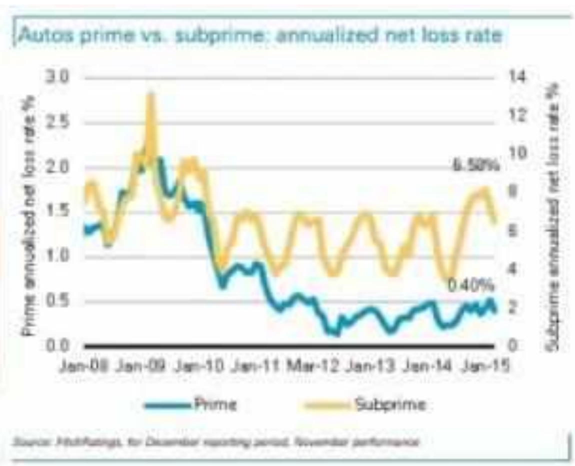
Source: Securities Industry and Financial Markets Association (SIFMA)

The problem is prime borrower growth is falling off and must be made up for in sub-prime or "deep sub-prime' areas.



ABS issuance by sector

Source: Thomson Reuters, Deutsche Bank



Autos prime vs. subprime: annualized net loss rate

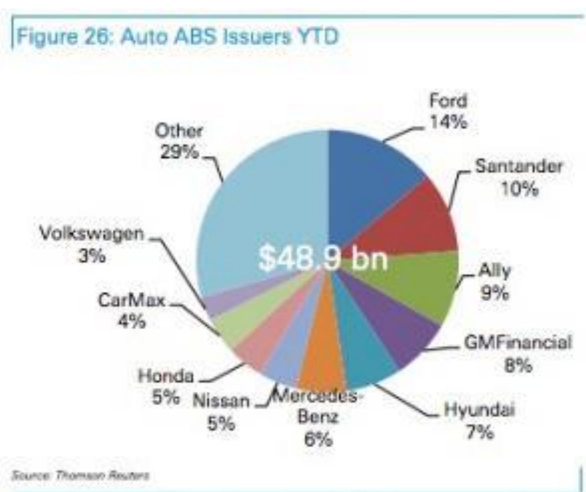


Figure 26: Auto ABS Issuers YTD

Source: Thomson Reuters

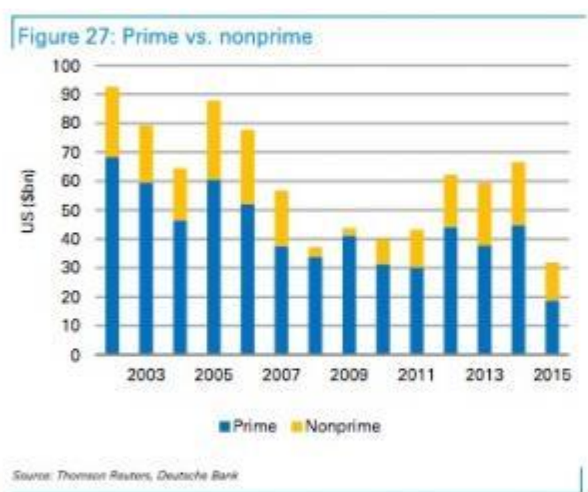
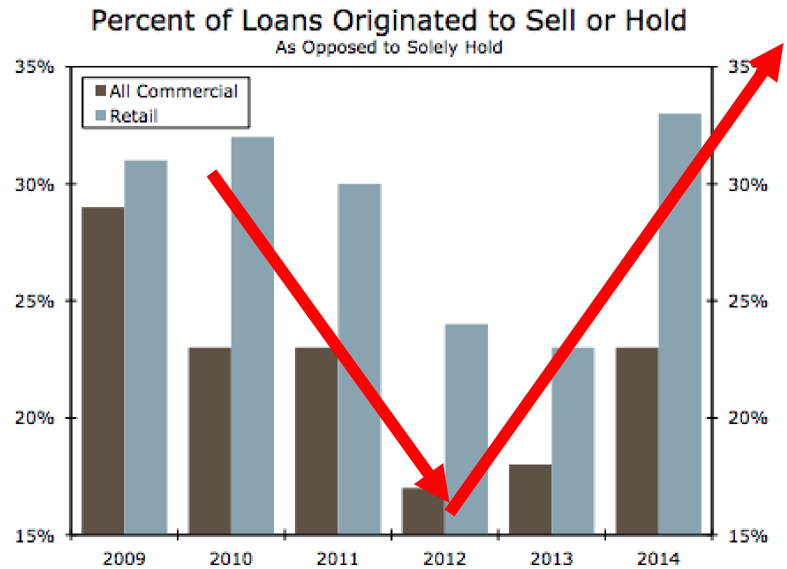


Figure 27: Prime vs. nonprime

Source: Thomson Reuters, Deutsche Bank

Loan Origination

.. and as usual questionable loans are being made simply to be sold to the unsuspecting

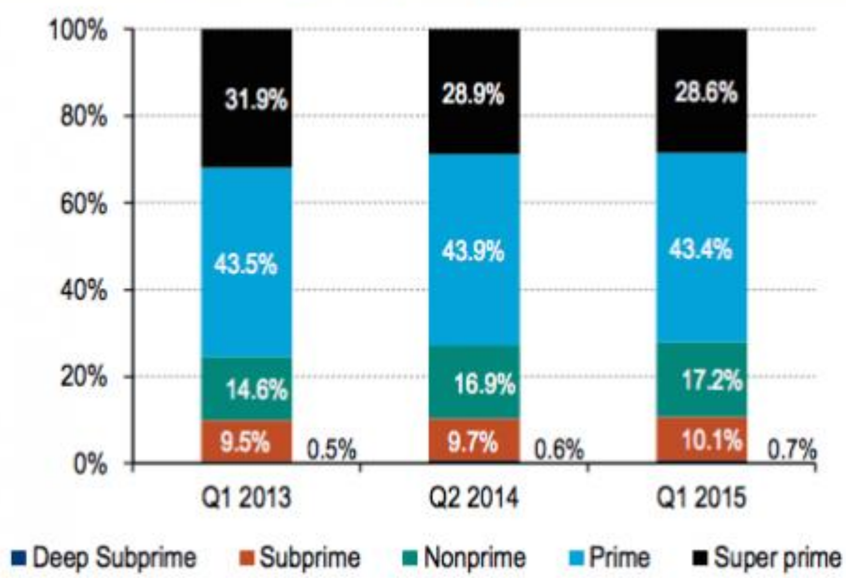


Source: Office of the Comptroller of the Currency, Federal Reserve Board and Wells Fargo Securities, LLC

Prime Losing Share

Most of today's loans are financing new vehicles made by prime borrowers, although as I pointed out earlier it is losing share.

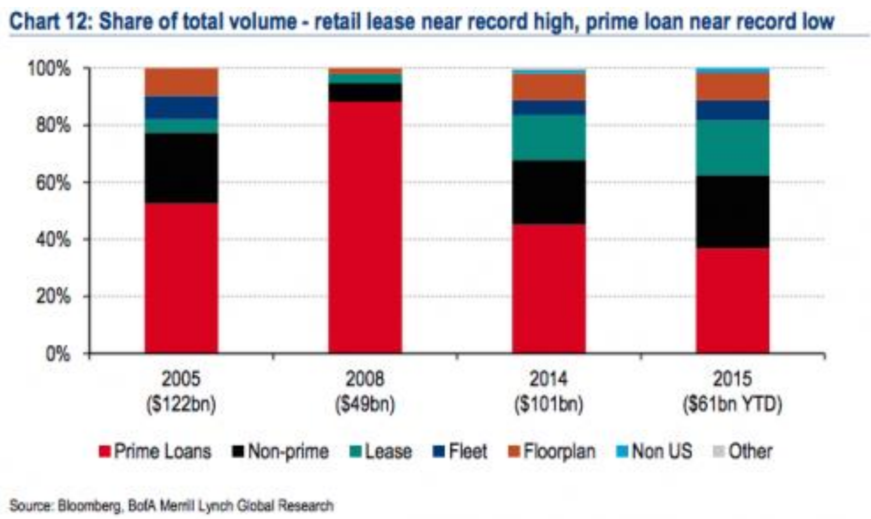
Chart 15: Most of today's loans financing new vehicles are made to prime borrowers, although the prime segments have lost share.



Source: Experian's State of the Automotive Finance Market First Quarter 2015

Prime Losing Share

Retail leases are near a record high but prime loans are near a record low.



Loan to Value Going Negative

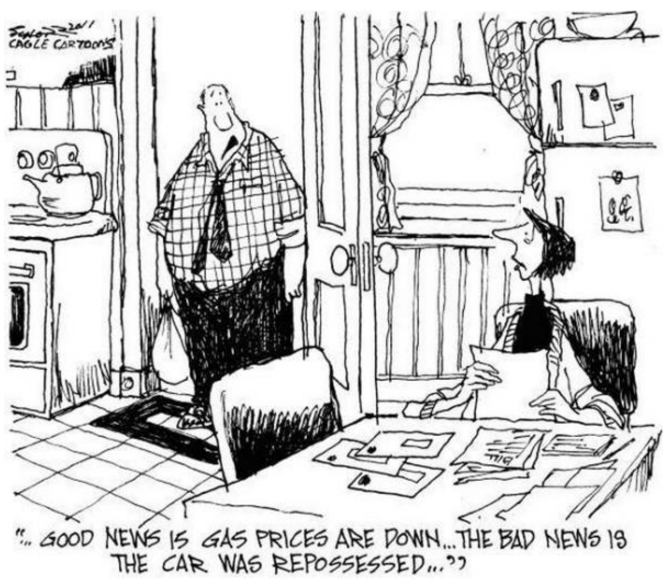
Many owners, like the post 2008 housing crisis are upside down on the value of their cars and are locked in with an inability to change.

7 X 1 Job Losses

As our German example showed for every automotive job in the economy there are 7 other jobs dependent on auto sales. A slowing auto industry is a major drag on any developed economy. Imagine the havoc a global slowdown could cause?

Tougher Economy Ahead

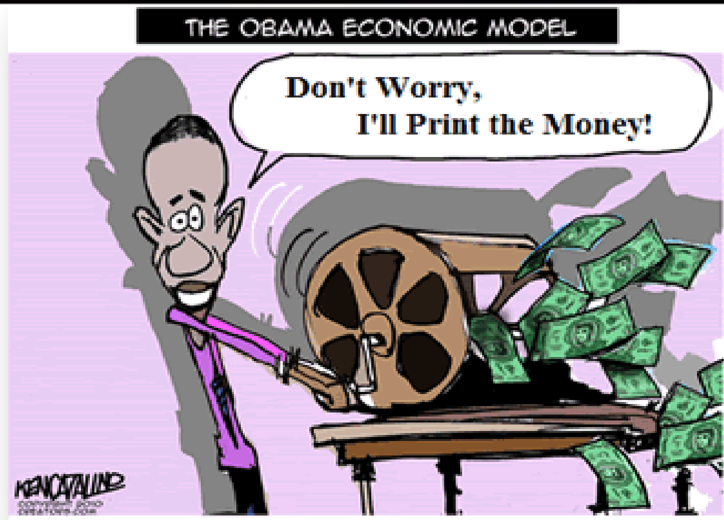
The global economy is slowing and a US recession is a real possibility. The central bankers have few real bullets left to stop it. The auto industry may be the tsunami they never saw coming!



PRINT THE MONEY

In summary let me remind you every month – don't worry because you know what the government will do.

"Never forget throughout this turmoil: "They will print the money!"



Until No one wants it or Trusts It!

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