

More Headwinds for the Auto Sector as Financial Conditions Tighten in Canada

- The outlook for Canadian auto sales has weakened substantially in the face of the COVID-19 outbreak and policy responses.
- Tightened financial conditions are adding to pressures for the sector as lower policy rates are not yet feeding through to financial markets.
- This should ease over time as the Bank of Canada launches an unprecedented arsenal of tools to correct market dysfunction so that market-driven price and risk determination can resume effectively as intended.

Canadian auto sales are expected to face a tough year in 2020. With a near shutdown in business activity and strict social distancing measures in place across most of the country, Scotiabank Economics anticipates the Canadian economy will contract by 4.1% this year, followed by a rebound of 5.1% in 2021. This is based on the assumption that activity starts to normalize in the third quarter of the year. Should the outbreak persist as long as six months, the contraction in GDP could be even larger than 6%. Needless to say, auto sales are expected to contract sharply in 2020 by around 25% y/y in a three-month scenario and over 40% if the situation endures beyond that.

Auto sales and the sector more generally face a variety of headwinds.

Consumers are largely housebound and many dealerships are closing temporarily as policy measures and precautionary behaviours take hold in the near term. Many households face income instability as layoffs ensue, with the federal government anticipating an additional 4 mn Canadians will apply for new employment insurance benefits on top of the reported 1 mn new applicants last week alone. This will further erode auto demand. In addition to a lower sales outlook, auto dealers and automakers face funding pressures as financial conditions tighten.

Policy rate cuts by the Bank of Canada have only partially fed through to financial markets as they otherwise would in normal times. The Bank has dropped its overnight lending rate by 150 basis points in March over three successive cuts outside of its scheduled rate decisions, including one today that brings the policy rate to the effective lower bound. In calmer times, policy rate cuts spur growth by making credit cheaper, thus encouraging investment and borrowing by households and businesses. But this has so far not alleviated a stark uptick in market-driven premiums in lending activity since the onset of the present crisis. Similar developments were observed during the Eurozone debt crisis, the Global Financial Crisis, and prior shocks.

Uncertainty around the duration and depth of the recession is heightening credit risk. This uncertainty is induced not only by the COVID-19 outbreak, but also by the OPEC+ shock with no clear horizon for resolution on either front. The impact on the finances of households, corporations, and government is yet unknown. Delinquencies in auto loans, in particular, typically spike higher—and from elevated levels—relative to other lending products during economic slowdowns (chart 1). Consequently, this has impaired market appetite to lend across these sectors, as well as to hold securities backed by such loans, as long as such uncertainty persists.

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Chart 1

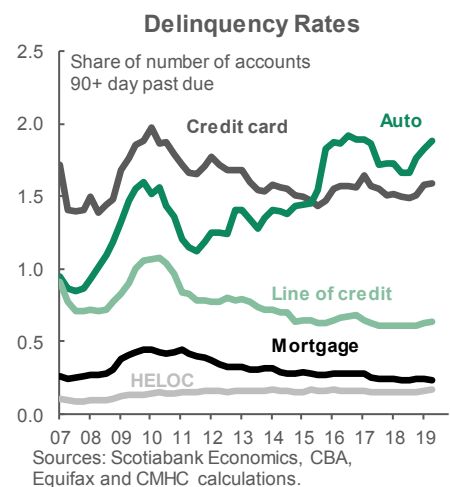
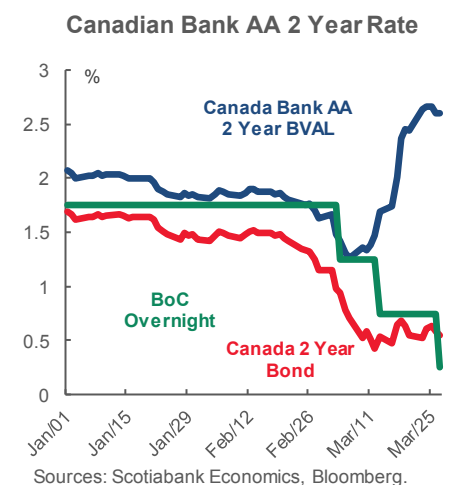


Chart 2



Infrequent trading of these securities has driven up liquidity premiums. Market-determined costs of borrowing have consequently been pushed higher for virtually all market participants compared to where it would be otherwise. For example, Bloomberg AA-rated Canadian bond indices (which are used in the rate setting process for subvented loan programs) have spiked recently, well-above “risk-free” Government bond yields that otherwise track closely in stable times as the heightened risks from the present crisis are priced in (chart 2). Bankers Acceptance rates—an important short-term debt instrument for auto dealers—also started ticking up, deviating from the policy rate path (chart 3), while yields on auto-related securitization products have spiked (chart 4). Equity financing availability typically tapped by auto dealers has also plummeted (chart 5). Similar patterns were observed during the Global Financial Crisis.

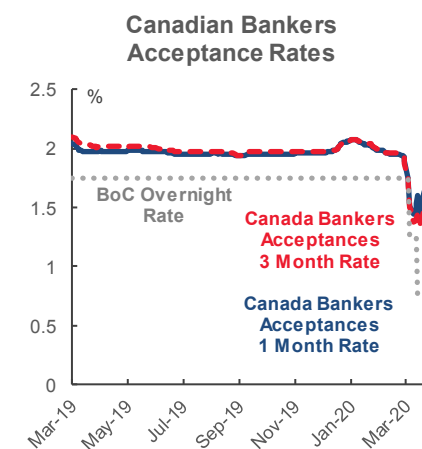
Perceived counterparty risk in the financial sector has also risen. This is raising the premium global lenders attach to dealing with one another. As a consequence, bank funding costs are higher than implied by central bank policy rates with interbank lending spreads high and widened (chart 6).

Central banks and governments are rolling out a massive array of programs to address such dysfunction. This includes buying these securities directly or extending loans and guarantees. The Bank of Canada has already introduced close to a [dozen](#) different targeted measures aimed at improving financial market functioning that build on lessons from the GFC. For example, the Bank has quickly ramped up its Banker’s Acceptance Purchase Facility with the aim to guide rates back towards normal levels that would ease funding costs for auto dealers. It has also established a new Standing Term Liquidity Facility (STLF) to help banks better manage their liquidity risks and continue to provide their customers with access to credit. Today, it announced its intention to purchase commercial paper that should also alleviate strain in commercial credit markets, while unprecedented and massive quantitative easing should improve system-wide credit and liquidity (see our take [here](#)).

It will take time for measures to have an impact. Canada has entered this most recent shock on soft footing. Growth was stalling and the output gap was opening already in late 2019. Scotiabank was the first bank calling for policy rate cuts well-before the pandemic on an insurance basis to underpin Canada’s growth and inflation outlook. As the transmission of policy rate cuts to the real economy takes a quarter or more in the best of times, it will take some time before impacts are felt. And these are no longer insurance cuts so the transmission will be muted.

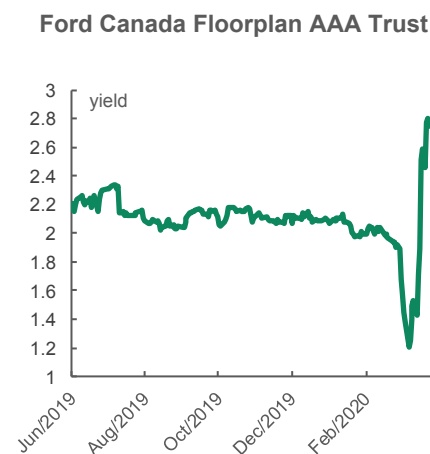
Complementary measures by the Bank are equally important to correct dysfunction in financial markets so that market-driven price and risk determination can play out as intended. The Bank of Canada continues to calibrate its toolkit as needs emerge in this regard, and to size its response accordingly. We do expect these measures will gradually succeed by ensuring that the financial system functions as well as possible throughout the severe economic shock. In the Bank’s own words, its actions are intended to “lay the foundation for the economy’s return to normalcy”. This will take time.

Chart 3



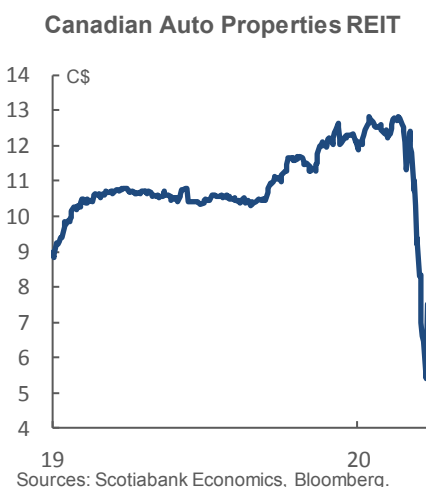
Sources: Scotiabank Economics, Bloomberg.

Chart 4



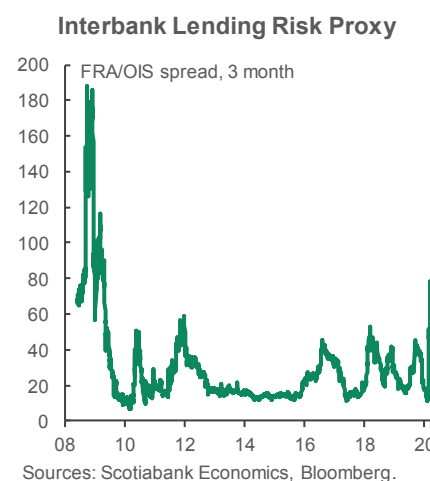
Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Chart 6



Sources: Scotiabank Economics, Bloomberg.

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