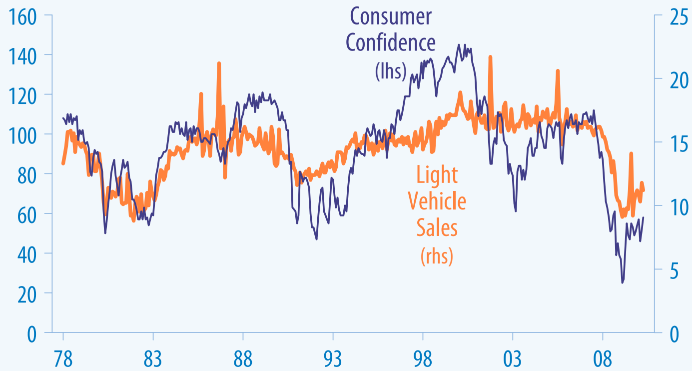
CHART 1
AS CONFIDENCE GOES, SO DO SALES
United States



Consumer Confidence = (1985 = 100) Vehicle Sales = (mlns : s.a.a.r.)

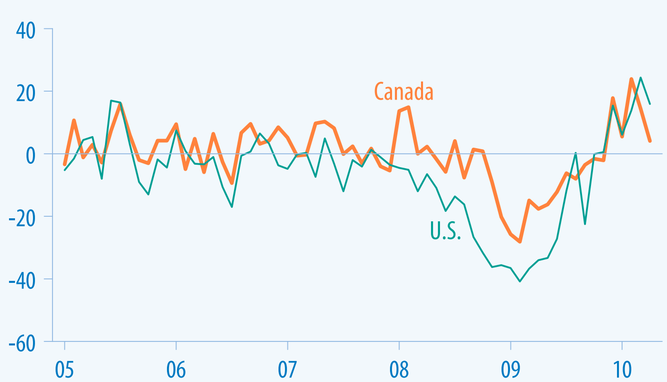
CHART 2
SOARING INVENTORIES SPARK PRODUCTION CUTS
United States (s.a.)

Domestic Auto Inventory-Sales Ratio

Source: Bureau of Economic Analysis

CHART 3
AUTO SALES EMERGE FROM THE DOLDRUMS
(y/y % chng)

Auto Sales



Many Miles Traveled, More Miles to Go

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Just one short year ago, the North American auto market was in the proverbial tank. Demand had collapsed amid recession, financial turmoil, wealth destruction, and unprecedented job loss. As a result, consumer confidence plummeted, dealing a severe blow to U.S. vehicle sales, which were then running at their lowest yearly rates since the early 1980s—just over 9 million units (*Chart 1*).

Inventories, which had soared relative to sales (*Chart 2*), pushed automakers to slash production, close plants and shrink their workforces. With auto production plunging more than sales as manufacturers sought to rebalance the market, parts producers saw their output tumble in lockstep, sparking further factory closings and layoffs. Given the Canadian industry's reliance on the U.S. market, production and exports of autos and parts in Canada fell.

With their ability to generate cash from sales limited and without access to capital markets, the ensuing liquidity problems raised the likelihood of bankruptcies among automakers and suppliers with elevated cost structures. As the spectre of financial failure loomed, it came as no surprise that GM and Chrysler were shepherded into government-engineered bankruptcies in an effort to avoid an untidy market resolution and potentially grim wider economic consequences.

Today, the auto market is far healthier than it was a year ago. Auto sales began to turn the corner during the second quarter of last year and have since strengthened as the economy emerged from recession. Year-to-date through April, auto sales had risen roughly 15% in the United States and 12% in Canada. The sales improvement—bootstrapped in the United States by the "cash-for-clunkers" program—has exceeded expectations amid rising consumer confidence, healthier financial markets, rock-bottom interest rates and favourable pricing (*Chart 3*).

With inventories down sharply, the recovery in sales provided a major fillip to the production of autos and parts. Auto production, which has been trending upward

CHART 4
SALES RECOVERY LIFTS PRODUCTION
(y/y % chng)

Auto Production

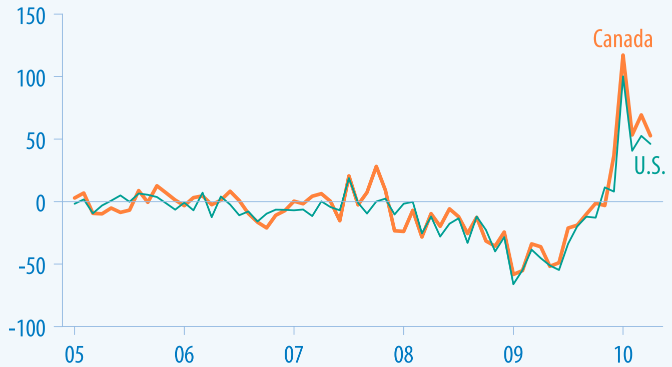
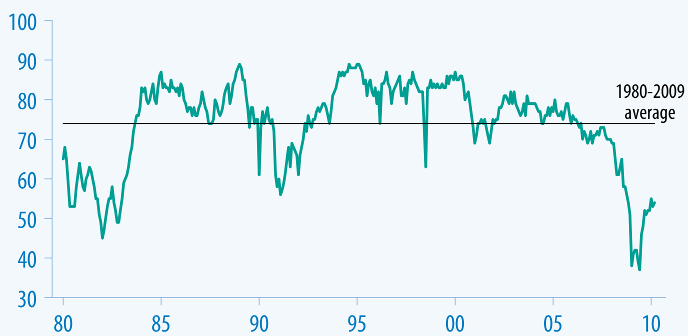


CHART 5
ACTIVITY LEVELS REMAIN WEAK
United States (%)

Capacity Utilization Rate: Motor Vehicles & Parts



Source: Federal Reserve Board

since early 2009 in both Canada and the United States, was about 70% and 60% higher (*Chart 4*), respectively, over the first four months of this year. The brisker pace of activity has lifted Canadian automotive exports.

Thanks to healthier sales, higher prices, increased production and lower cost structures due to industry rationalization, financial performance among automakers and parts producers is improving, with some of the major players reporting profits. Better financial prospects, along with the need to boost production to meet growing demand is encouraging automakers and suppliers to increase investment and add to their workforces.

The improvement over the past year is a welcome development for an industry that was recently caught in the worst business climate in more than 25 years. Still, there is a long way to go before the industry returns to pre-recession activity levels. New vehicle sales are still occurring at rates well below what was typical during the five years ending in 2007. While the Canadian market has largely returned to pre-recession levels (in view of healthier household finances and greater credit availability), U.S. sales have run below replacement levels—in the 12-13 million unit range—as U.S. consumers remain cautious amid a still-weak job market and banks are guarded in their lending. Overall, while business conditions have clearly improved, the industry is currently operating far below normal capacity utilization rates (*Chart 5*).

The auto market should continue to firm in line with economic recovery. Combined U.S. and Canadian sales are slated to rise to roughly 13 million units this year and 15 million in 2011. While up notably from 11.8 million units in 2009, these levels would remain well below the 18-plus million unit average from 2003 to 2007. However, with below-replacement-rate sales fostering pent-up demand, some 2 million new individuals added to the U.S. driver population each year, and excess capacity helping to keep pricing favourable, there is potential for market outcomes to exceed current expectations. A smaller, competitive market would continue to challenge weaker players in assembly and the supply base and promote further industry restructuring. Further out, new vehicle sales should continue to strengthen, facilitated by a return to more normal rates of scrappage and additions to the driver population. Little support is likely to come from increased ownership rates, given a saturated U.S. market. Though unlikely to return to typical pre-recession levels, given expectations of greater consumer frugality and more cautious bank lending, sales will likely move to the 16-17 million unit range over the medium term.