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Driving Forward: A Case for Autos in 2012

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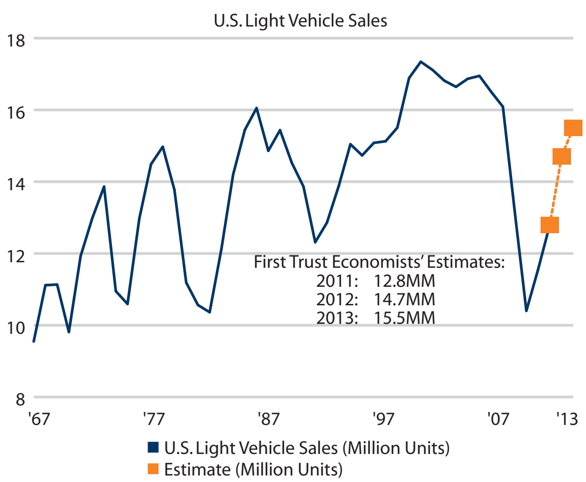
The fallout from the credit crisis and subsequent bear market in equities from 2008 through Q1'09 cut deep, but few industries faced challenges as profound as the auto manufacturers. Frightened consumers simply stopped buying cars. Banks implemented stricter lending standards for those still interested in purchasing a vehicle. These were unchartered waters to be sure. But the worst appears to be behind us.

There are signs of life for the global auto industry. In the US, auto sales are trending higher, driven by pent-up demand and more liberal lending standards within the banking industry. Concurrently, the focus of the automobile industry is expanding beyond the established markets of Europe and North America, to a whole new group of consumers in China and other developing markets.

Pent-up demand for new cars

2009 was the worst year for US auto sales since 1982, topping out at 10.4 million units. The fact that sales stayed above 10 million units can largely be attributed to the "Cash-for-Clunkers" program which created a short-term surge in demand during the month of August. During the intervening 26 years between these two nadirs, sales trended higher, averaging 15.2 million units (Chart 1).

Chart 1



Source: Bloomberg

While many would-be buyers refrained from splurging on new cars in the midst of economic turmoil, US auto sales are rebounding. The seasonally adjusted annual rate (SAAR) of auto sales increased to 13.6 million units in November of 2011, the best rate since June of 2008, excluding the "Cash-for-Clunkers"-induced surge in August of 2009 (14.2 million SAAR). This was followed by a better-than-expected SAAR of 13.5 million units in December. As pent-up demand is unleashed, our forecasts call for US auto sales to reach 14.7 million units in 2012, and 15.5 million units in 2013. Of course, there is no assurance that these projections will be realized.

New cars cheap relative to used cars

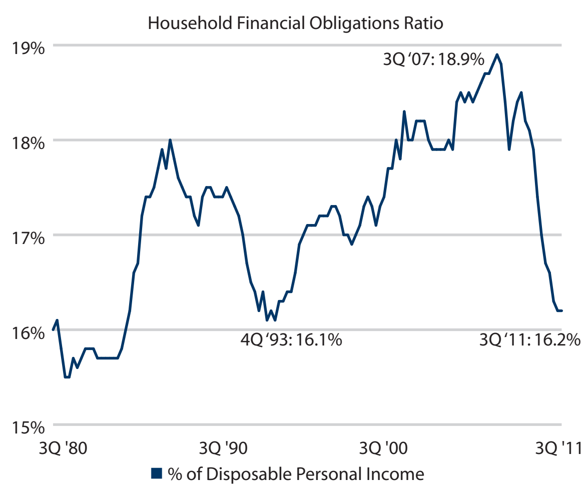
One important input that helps drive consumers' decisions to buy new cars is the relative cost of used cars. In December, the Manheim US Used Vehicle Index, which captures pricing trends of used vehicles sold at auctions, reached a level of 125.1, which is about 11% higher than the 15-year average.

There are a few simple factors that likely account for much of today's elevated used car prices. Perhaps the most obvious of these is the fact that consumers' avoidance of new cars has created more demand for used cars. But another important factor to consider is the secondary impact of the "Cash-for-Clunkers" program, which abruptly removed 680,000 used vehicles from the marketplace. Also, traditional auto fleets, which bought fewer new cars in the downturn, are contributing less to used car inventories. Consequently, not only is there more demand for used cars, there is less supply. Whatever the cause, the implication of high used car prices is that the economic incentive to "trade down" to used cars is diminishing, potentially providing yet another tailwind to new car sales volumes.

Consumers have means

Relative cost comparisons are really only relevant if consumers can afford to spend money on vehicles. One useful measurement of consumer leverage is the "Household Financial Obligations Ratio", which measures the proportion of disposable income required to pay mortgages, rent, car loans/leases, and other debt service. While this ratio climbed steadily from 16.1% in 1993 to 18.9% at its peak in 2007, it has since dropped back down to 16.2%, as consumers have taken advantage of historically low interest rates to refinance mortgages, while also paying down other debts (Chart 2).

Chart 2



Source: Federal Reserve Board

Additionally, according to Haver Analytics, over the last 12 quarters, consumers spent about 3%, on average, of their disposable income on vehicles, compared to approximately 4.4% over the past 20 years. As consumer debt burdens continue to decrease, spending on autos may return to more historically normal levels.

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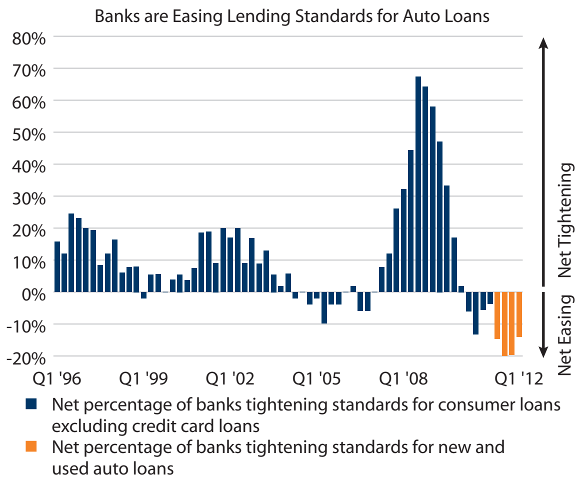
Banks ease lending standards for auto loans

In contrast to a few years ago, when banks were tightening lending standards, consumers may now have an easier time financing auto purchases, as banks have begun easing lending standards. The results of the latest "Federal Reserve Senior Loan Officer Opinion Survey" show a net 19.6% of banks indicated that they had eased lending standards for auto loans during the third quarter of 2011. This is a strong reversal from the severe tightening of lending standards between 2008 and 2009 (Chart 3).

Chart 3



Source: Federal Reserve Board

Global penetration is paramount

Worldwide economic distress has overshadowed an important trend that's taken shape in the global auto industry over the past 5 years. While vehicle sales in North America and Europe decreased from 35.7 million units in 2005 to 32.3 million in 2011 (-1.7% Compound Average Growth Rate, or "CAGR"), sales in Asia Pacific and Latin America increased from 19.2 million units in 2005 to 35.1 million units in 2011 (10.6% CAGR).[1] As a result of this geographical shift, North America and Europe, which accounted for 65% of global auto sales in 2005, represented less than half in 2011, while Asia Pacific and Latin America represented about 52%.[2]

Not surprisingly, the largest contributor to Asia Pacific growth during that time span was China, as rising wages fueled growth in passenger vehicle sales, which increased from 4 million units in 2005 to 14.5 million units in 2011 (23.9% CAGR).[3] We believe these increases (both in China and other developing economies) are especially significant because they do not generally come from consumers replacing used vehicles, but rather from a new, emerging class of consumers. Located in some of the most populated areas of the world, these developing auto markets represent an enormous secular growth opportunity for car manufacturers that was unavailable a decade ago.

Time to take another look at the autos

Certain risks remain for the global auto industry, both macro — such as the European debt crisis; and company-specific — such as underfunded pension liabilities. However, these potential risks may be outweighed by the long-term opportunity that exists for patient investors. The auto industry has shown throughout history that it can be extremely profitable in an environment of rising sales and adequate cost controls. From an industry perspective, we believe the auto companies have set themselves up for profitable years ahead if the global economy improves. The First Trust NASDAQ Global Auto Index Fund (CARZ) is an efficient way, in our opinion, for investors to capture exposure to the global auto industry. This exchange-traded fund invests in 36 auto manufacturers from around the world.

[1]Bloomberg.
[2]Bloomberg, sales data.
[3]Source: China Automotive Information Net.

RISKS

The fund's shares will change in value, and you could lose money by investing in the fund. One of the principal risks of investing in the fund is market risk. Market risk is the risk that a particular stock owned by the fund, fund shares or stocks in general may fall in value.

The fund's return may not match the return of the NASDAQ OMX Global Auto Index℠. The fund may not be fully invested at times. Securities held by the fund will generally not be bought or sold in response to market fluctuations.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

The fund invests in stocks of companies in the automotive industry and consumer discretionary sector. You should be aware that an investment in a portfolio which is concentrated in a particular industry involves additional risks, including limited diversification. The automotive industry can be highly cyclical, and companies in the industry may suffer periodic operating losses. The industry can be significantly affected by labor relations and fluctuating component prices. While most of the major manufacturers are large, financially strong companies, many others are small and can be non-diversified in both product line and customer base.

The fund invests in the stock of companies operating in Japan. Because Japan's economy and equity market share a strong correlation with the U.S. markets, the Japanese economy may be affected by economic problems in the U.S. Japan also has a growing economic relationship with China and other Southeast Asian countries, and thus Japan's economy may also be affected by economic, political or social instability in those countries. Japanese securities may also be subject to lack of liquidity; excessive taxation; government seizure of assets; different legal or accounting standards and less government supervision and regulation of exchanges than in the U.S. Furthermore, the natural disasters that have impacted Japan and the ongoing recovery efforts have had a negative affect on Japan's economy, and may continue to do so.

An investment in a fund containing equity securities of foreign issuers is subject to additional risks, including currency fluctuations, political risks, withholding, the lack of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be heightened for securities of companies located in, or with significant operations in, emerging market countries.

The fund is classified as "non-diversified." A non-diversified fund generally may invest a larger percentage of its assets in the securities of a smaller number of issuers. As a result, the fund may be more susceptible to the risks associated with these particular companies, or to a single economic, political or regulatory occurrence affecting these companies.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.