




The Auto Recovery and \$4 Gas

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A few days into the third month of 2011, the auto makers look to be revving up their engines. Indeed, traffic continues to build at showrooms across the United States, as the industry's sales recovery appears to be picking up steam. So far, surging oil prices have not kept drivers off the lots. How long this success lasts against this backdrop, however, remains to be seen.

After a strong start to the year, the Automotive Industry sustained momentum through February, with sales of new vehicles climbing 27% in the United States. As a result, the adjusted annualized sales rate reached 13.4 million in the month, its highest level since the Cash-for-Clunkers-fueled summer a few years back. This performance was refreshing enough on its own, considering sales in 2009 and 2010 represented the two lowest annual totals this millennium. Making it more impressive, however, was the fact that much of the higher showroom traffic came despite the fact that violence and political unrest in the Middle East and North Africa propelled gas prices significantly higher.

The demand for fuel efficiency was already surging heading into this year, and the rising oil prices did nothing but spur this sentiment along further. In fact, small-car sales increased 24% in February. Some of the more notable showroom numbers included a 70% year-to-year increase for **Toyota Motor's** (TM) *Prius* and an advance of about half that for **General Motors'** (GM) *Chevy Cruze* over the model it replaced.

That said, despite rising gas prices, it was not the small cars that made the most noise last month. Instead, Americans continued to buy trucks and SUVs, a vast turnaround from the last time per-gallon gas prices headed up toward \$4. Sales of pickups and SUVs both advanced in the mid-30% range from the 2010 totals. Granted, the comparisons were relatively easy, while the companies continue to pile on the incentives. Still, to see such a recovery in more gas-hungry vehicles is a positive sign for the industry. GM and Chrysler both notched significant year-to-year increases in pickups, while sales of **Ford Motor's** (F) *Explorer* more than doubled.

With the volatile global political environment still on very shaky ground, the question is now what can we expect for March and beyond. The car companies, on the whole, seem confident that slow and steady price increases at the pump will not have a dramatic impact on demand, though some acknowledge that volatile spikes may be a different story. Still, it seems the car makers must stay focused and manage their expectations. Inventories remain at healthy levels, rather than the bloated levels of the recent difficult years. Ford has announced plans to increase production by 9% in the second quarter. This largely stems from the fact that some dealers were having trouble getting their hands on the remodeled *Explorer*, of which there was clearly the demand.

Auto sales seem almost certain to be headed for a healthy improvement this year, as drivers are finally replacing old and used vehicles, a task many had put off during the recession. SUVs and pickups appear well in the midst of a replacement cycle, but, it is hard to believe a sustained increase in the cost of filling up these bigger tanks won't slow down the pace of this group's rebound.

Fuel efficiency is going to remain on the front burner, whether gas prices break the \$4-a-gallon barrier or not. And this trend should further engulf the truck space, where more crossovers and hybrids continue to roll out. For example, about one-third of the trucks sold by Ford have six-cylinder engines, which are not as gas guzzling as the standard eight-cylinder models.

All the production aside, it is likely going to become a game of perception in the months ahead, as fuel efficiency now sits at the top of drivers' list of demands. Frankly, the Big Three have their work cut out for them. Sales of the *Cruze* and *Fiesta* are certainly strong, but the Japanese brands have built solid reputations, especially in recent years behind the likes of the *Prius* and **Honda Motor's** (HMC) popular *Civic* and mid-size *Accord*. Though, that is not to say the task is impossible, considering the Ford *Fusion* bested the *Accord* in February.

This looks to be a very active year on the new-vehicle front, as all the car makers appear to have dusted themselves off and now look to recapture market share or build on recent gains.

For investors, results so far this year have been mixed. The American names have pulled back since the start of the year, as fourth-quarter earnings results disappointed the Street. Meantime, shares of the Japanese trio, Toyota, Honda, and **Nissan Motor** (NSANY) have all advanced in that same time frame.

For now, though, these shares are all likely at the mercy of oil, North Africa, and the Middle East. The closer drivers come to filling up at \$4 a gallon, the rockier the near-term road ought to become for the auto group and its 2011 recovery.