



Accelerate *Your Business*

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## SUMMARY

**High new vehicle inventory and a poor mix relative to consumer demand increased competitive pricing within the new vehicle arena and pressured used vehicle values in September. The fundamentals of the economy and the retail used vehicle market remain solid, however, and there are several indicators that promise stable—albeit modest—growth ahead.**

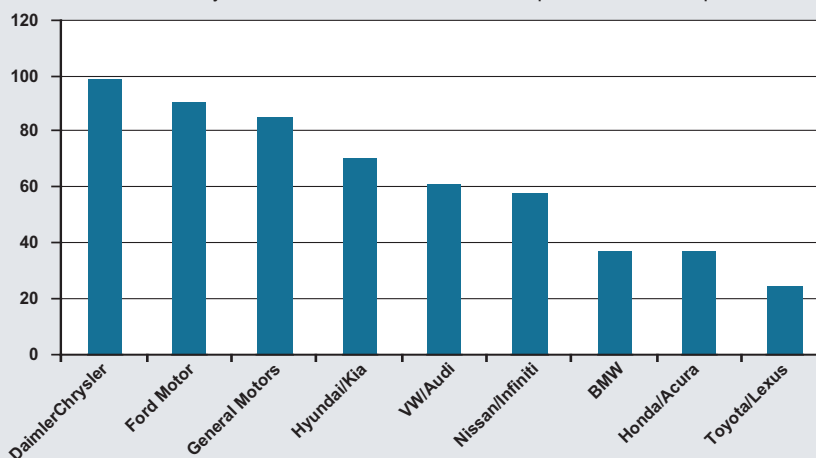
## MODEL YEAR CLOSEOUT INCREASES PRICING PRESSURES

Despite respectable new vehicle sales (16.6 million SAAR) in September, dealers received little relief from their new vehicle inventory burden. Unit counts remained high and the product mix continued to be weighted towards the slow selling segments. Add in competitive pricing on new '07 models, and it is easy to see why dealers needed to sacrifice used vehicle sales and margins in order to clear out the '06 carryover stock. New vehicle incentives, especially reduced-rate, long-term financing (even for subprime borrowers), depressed late-model used vehicle values even further.

When new vehicles remain on the lot for over 90 days (as has been the case for domestic franchises), the dealer's number one task is to get those units sold—his focus, ad dollars and internal spiff monies all shift from used to new.

### Not-So-New New Inventory Depresses Domestic Pricing

Number of days that new vehicles sat on the lot prior to sale in September



Source: Power Information Network



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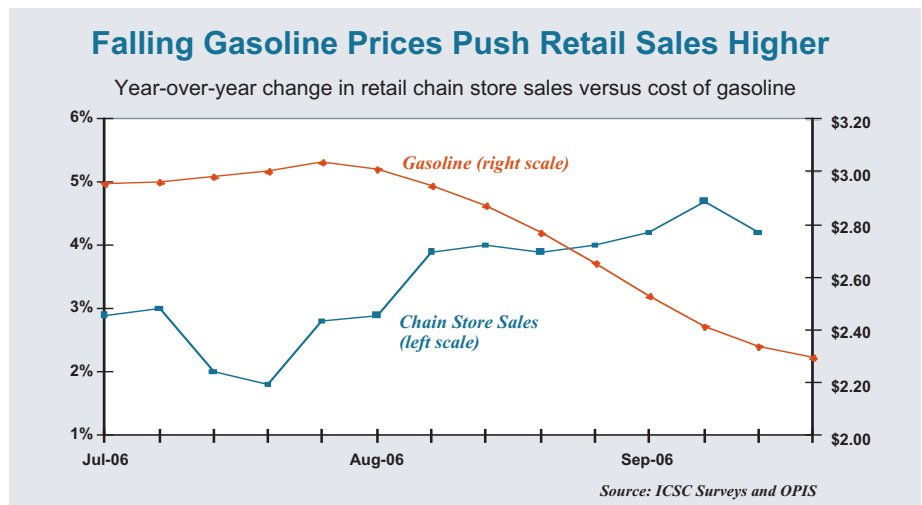
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**Production cuts should ease inventory overhang.** Domestic manufacturers have scheduled production cuts for the fourth quarter ranging from 21% at Ford to 14% at GM. Thus, if new vehicle sales remain in the 16.5+ million SAAR range, inventories should be back to normal by year-end, which will set the stage for a healthier used vehicle pricing environment.

## ECONOMIC OUTLOOK: SLOWDOWN; NOT RECESSION

Maintaining new vehicle sales at a level that reduces dealer inventory and keeping retail used vehicle activity at a pace that supports wholesale prices will require an economy that avoids recession. The signs, of late, have been promising, although the consensus forecast still pegs real GDP over the next 12 months to be a below-potential 2.5% versus a growth rate in excess of 3.5% over the past three years.

**Retail sales sizzle in September.** Aided no doubt by falling gasoline prices, past wage gains and a cool spell that boosted apparel spending, retailers across the board (with the very notable exception of Wal-Mart) had strong September sales. As discussed in this month's Q&A, we are willing to discount—for now—Wal-Mart's weak performance in September. Instead, concern should be directed to the slowdown in hiring of new employees by all retailers and their pre-buying of new merchandise. Both suggest that retailers have rather muted expectations for holiday sales.



**Labor market stronger than the weak job growth numbers suggest.** Non-farm payrolls grew by a measly 51,000 in September, but the continued decline in initial jobless claims, stable overtime hours, reasonable wage gains and a low unemployment rate (4.6%) all suggest a labor market that will support a healthy retail used vehicle market. Likewise, we would note that Fed policymakers seem more concerned with wage inflation than any slowdown in job growth.

**Spillover from the housing slowdown might be contained.** One of the keys to preventing the economic slowdown from becoming a recession will be the ability to limit the negative repercussions flowing from the correction in the housing market. The not-so-soft landing in housing (as discussed in last month's *Auto Industry Brief*) will not be prevented, but the reduction in mortgage rates, as well as rising income levels, may keep adverse economic effects limited to local markets and even to a small segment of households within those markets.

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## METRICS THAT MATTER

*This is an ongoing series designed to discuss the economic variables, surveys and company statistics that we follow to better understand, and anticipate shifts in, the used vehicle marketplace. In last month's Auto Industry Brief, we reviewed Initial Jobless Claims and Wal-Mart Same-Store Sales. This month we look at Consumer Confidence and Wage & Salary Income.*

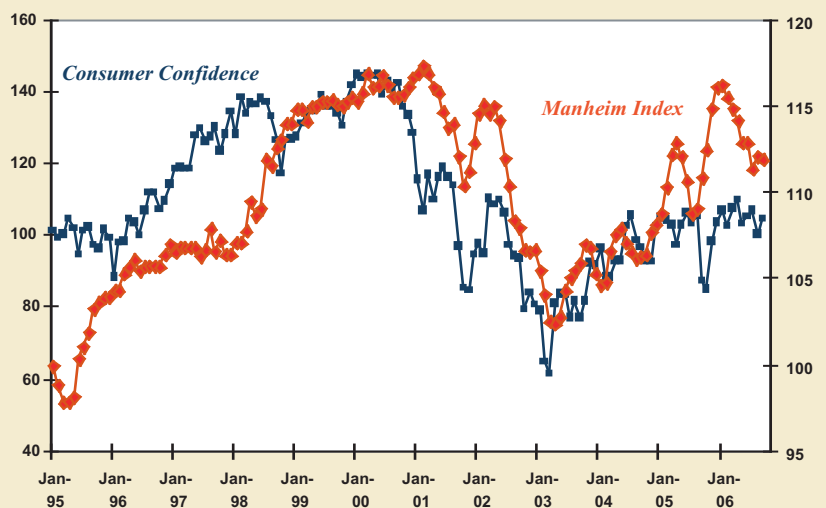
### Consumer Confidence

**Closely followed, but little understood.** Both the Conference Board's and the University of Michigan's Consumer Confidence measures are based on household surveys — at the core of which there are five questions (two pertaining to current conditions and three focused on expectations). Conference Board numbers are released on the last Tuesday of every month and the University of Michigan results are released on the second and fourth Friday.

**Why it is important.** Consumer spending accounts for over two-thirds of the economy, and, as the nation has become wealthier, a greater portion of that spending has become discretionary. Thus, if you can divine the population's propensity to spend, you are a long way to correctly forecasting the overall economy, not to mention corporate profits.

**Relationship to used vehicle sales and prices.** In practice, consumer confidence measures offer little, if any, forecasting insights. Indeed, it is often joked that the confidence measures are only good at "predicting" current conditions. But that is an insight not to be dismissed. In fact, we follow consumer confidence to gain a better understanding of the past movement in wholesale prices. For example, in the accompanying graph, note that the two series track one another closely. So when they diverge (like they did post-Katrina), it is an indication that wholesale values are being driven more by industry-specific factors (in that instance, the increased demand for replacement vehicles) than by national spending patterns. Right now, consumer confidence levels and wholesale values are in balance; in other words, no underlying headwind or tailwind to used vehicle pricing.

**Consumer Confidence Tracks  
Manheim Used Vehicle Value Index**



Source: Conference Board & Manheim

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## METRICS THAT MATTER

### Wage & Salary Income

**Means to an end.** Regardless of their confidence, consumers' spending will inevitably be tethered by their budget. Hence, the need to monitor available spending power.

**A better measure of used vehicle buyer budgets than personal income.**

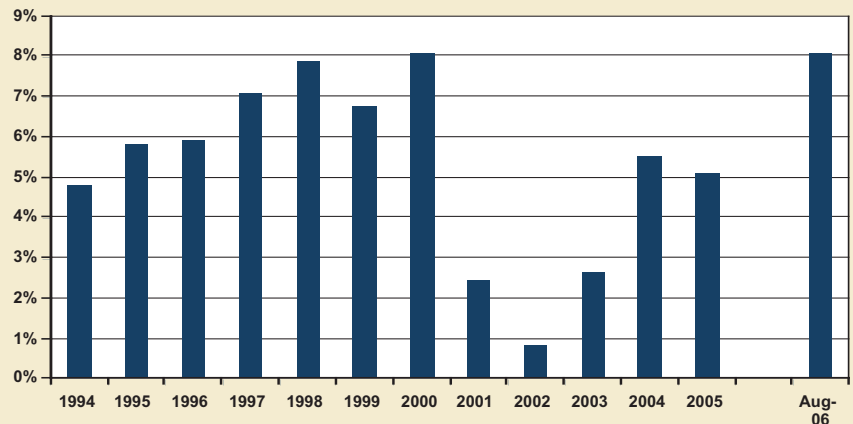
Wages and salaries are a component of the broader, more publicized, personal income series that also includes proprietor, rental, and dividend and interest income. Since these other forms of income are relatively small for the typical used vehicle buyer, we find wage and salary income to be the preferable measure to follow.

**Recent wage growth is supportive to higher used vehicle sales and prices.**

Wage and salary growth, on a year-over-year basis, has been in excess of 8% for most of 2006. The quarterly growth rate has slowed to a more sustainable, but still healthy, 5.4%. Additionally, like the government payroll numbers, there is reasonable suspicion that the wage numbers are underestimated. In any event, the graph depicts how much the overall situation has improved since the recession.

#### Wage and Salary Growth Strengthens in 2006

Annual Increase in Wages and Salaries



Source: Bureau of Economic Analysis

## MANHEIM USED VEHICLE VALUE INDEX

**Prices slip in September.** Wholesale used vehicle prices (on a mix, mileage and seasonally adjusted basis) slipped modestly in September, erasing part of the gain posted in August. The Manheim Used Vehicle Value Index was 111.9 in September, representing a year-over-year gain of 0.9%.

Model year changeover is always a tumultuous time for pricing in the wholesale used vehicle market. Last year, employee pricing rapidly cleared out carryover stocks and the downward pressure on used vehicle pricing was swift and severe. This year the process has been smoother, but prolonged. As discussed earlier, clearing carryover models always confirms an old industry truism—"for a used car manager at a franchised dealership, the hardest competition is often his own new car department."

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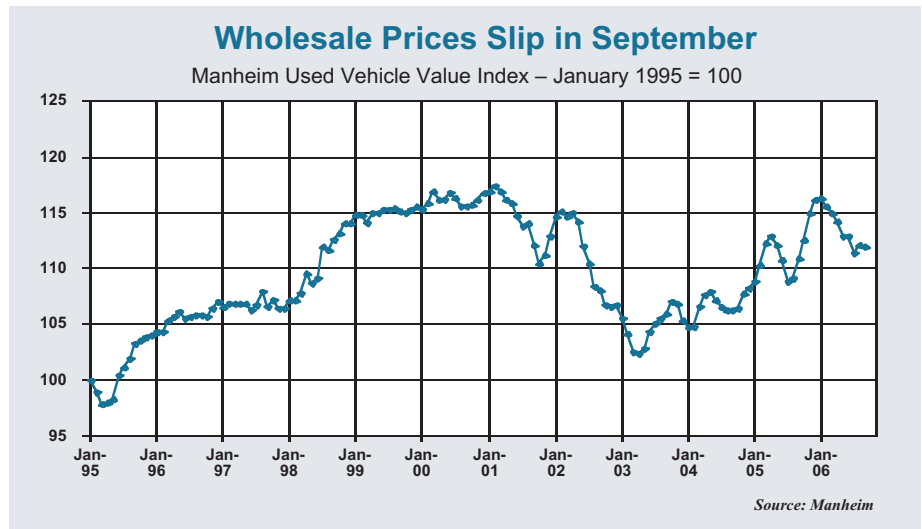
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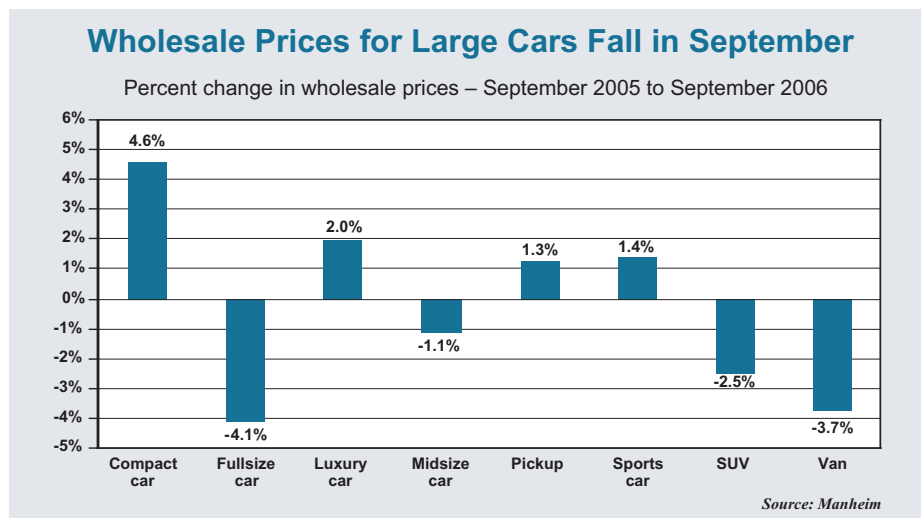
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Given this scenario, the weakest pricing in the wholesale market recently has been late-model vehicles (for example, off-rental and company cars). This, in spite of the fact that dealer retail sales of manufacturer CPO units continued at a record pace in September.



**Full-size cars, dominated by off-rental units, weaken in September.** Full-size cars slipped from a relatively flat year-over-year price performance in August to sharply negative in September, making it the weakest of the eight market classes. Full-size cars represent a relatively small portion of auction sales (less than 2.5% of the total) and their volume is often dominated by off-rental units. Last September, program rental cars were the hottest segment of the auction market as dealers snatched up those units to fill the role that carryover units (already depleted by employee pricing) normally play. Needless to say, dealers had no such driving need for program cars this year.

Within the SUV segment, luxury models now have the distinction of being down more than full-size models (-6.9% versus -4.1%). Mark it up as evidence that the weakness in the SUV segment is driven by a consumer preference shift that goes beyond just the cost of gas. Also note, the average luxury SUV sold at auction typically has 40% fewer miles than the full-size ones and, thus, they were more affected by rampant competitive pricing on the new vehicle side in September.



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**Q. Last month you noted how Wal-Mart same-store sales performance was indicative of the financial health and psyche of mainstream used vehicle buyers. In September, Wal-Mart had same-store sales growth of only 1.3%, whereas most other retailers had a stellar month. Is this an indication that lower-middle income households are facing a financial squeeze or are in a general funk?**

**A.** Not necessarily. As we noted, it is often risky to try to divine consumer behavior from the performance of one company, since it may be facing strategic issues specific to itself. Also, as we noted, comments from company executives can be just as, if not more, telling than the actual numbers. Wal-Mart executives have not altered their full year sales or profit guidance nor have they blamed their recent performance on any retrenchment in their customer base. That said, I would still be more confident of a rebounding used vehicle market if September retail sales had not been so dominated by stores selling high-end goods and teen fashions.

**Q. Our commercial fleet consignors are expecting sizable increases in their auction volumes over the next year. Is that typical of the industry? Will it have a negative impact on pricing?**

**A.** Commercial fleets will definitely be selling more units at auction in the months ahead. I expect no weakening in prices for these units. Being less susceptible to the pressure from new vehicle pricing, these units are already outperforming the overall market and that should continue. Intelligent remarketing on the part of major fleet management companies has definitely played a role in boosting residuals for their customers' cars—and that too should continue.

**Q. Last month you painted a very bleak picture as to the slowdown in housing and the negative impact it would have on the overall economy. Has there been any good news since then?**

**A.** As to the not-so-soft landing in housing, it continues on course. August housing starts fell to their lowest level in over three years, the inventory of unsold homes continued to increase, and prices softened further. It is, however, quite possible that we are closer to the trough in housing starts than the peak, so the question now becomes the duration of the downturn, rather than its depth.

The decline in mortgage rates is also a positive. As a result, mortgage applications are up some 20% from their low point. The increase, of course, is driven by refinancings and not new mortgages. And the refinancings have, in part, been forced on households facing interest rate resets. For example, "some \$2 trillion worth of adjustable rate mortgages is scheduled to reset at a steeper rate by the end of 2008," estimates Moody's Economy.com. The ability and ease of households in restructuring their mortgage obligations will play a major role in limiting the economic fallout. Additionally, the continued boom in commercial construction is offsetting some of the decline in the residential sector.

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