THE EFFECTS OF TARIFFS ON VEHICLE REFINANCING

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Current Tariff Situation Explained

What Is A Trade Tariff?

Tariffs have routinely been used by almost every nation to address the following economic issues: a) trade-deficit between countries, b) to protect local manufacturers, and c) for national security purposes. Open market proponents frown upon tariffs as these lead to the creation of "imperfect markets." Those who want the government to protect local jobs and economies generally support policies like these.

The 2018 Tariffs

- **25% tariff on the import of steel into the USA**
- **10% tariff on the import of aluminum into the USA**
- **Retaliatory tariffs imposed on American steel by European countries, China, Mexico and Canada**
- **China imposes 25% tariffs on the import of American automobiles (recently cut to 15%)[1]**
- **A plan for the US to impose up to 20% tariff on the import of automobile from the European Union[2]**
- **A possible retaliatory tariff by the European Union on US manufactured cars entering the region[3]**

The rationale for the new tariffs is the imbalance between the tariff rates imposed for products imported into the US and those that US exporters face when they sell in other countries. For instance, when a car manufactured in Germany enters the United States, a 2.5% tariff is applied, whereas when an American car is imported into Germany, the corresponding tariff rate is 10%. The tariff applied on American cars exported to China is 25%. Similar imbalances exist in cross-border auto trade between the United States and other countries.

Tariffs, such as the ones being discussed here, are temporary measures and cause an economy to move away from its current state. The amount of movement, and whether it qualifies to be termed a disruption, depends on the level of the tariffs imposed as well as the absolute dollar value of goods and services on which such tariffs have been applied.

Why Are Tariffs Specifically Important Right Now?

The US has imposed tariffs on a wide range of products and services. China, Mexico, Canada and the European Union have countered with their own tariffs on the United States in response. The automobile manufacturer as well as the buyer is caught in this tariff crossfire, unsure of what the effect of these tariffs could eventually mean. An increase in the input costs will drive up the cost of manufacturing. The cost increases will likely be global because of the quid-pro-quo of the tariff 'war'.

How Will Auto Manufacturers React?

The tariff structure incentivizes manufacturers to produce locally and not have their products cross international borders. This has complex ramifications. Manufacturers based in the US who export to other countries, for example to China and the European Union, will explore moving manufacturing outside of the United States. Tesla, BMW[4], Harley Davidson and Polaris[5] are a few who have already taken steps in that direction. Those companies who manufacture cars in Mexico, Canada and the EU for the American consumer might elect to just pass the extra cost to the consumer or could even contemplate manufacturing them in the US.

Tariff Impact on Dealer Costs, Pricing

Manufacturing and Consumer Costs

The tariffs will impact the automotive sector in two direct ways. First, the cost of steel and aluminum will increase, leading directly to an increase in the cost of manufacturing. Second, the cost of importing cars to the US (and elsewhere if retaliatory tariffs come into play) will increase. Either situation is likely to lead to consumers seeing an increase in the prices of new automobiles both in the US and abroad.

Substitution Effect

If the price of a good increases, people will switch to other comparable goods that are relatively cheaper.

If the price of that good gets even more expensive, people will switch to less expensive, inferior, but similar goods.

One estimate suggests that the price of a $32,000 car could go up by as much as $5,000[6]. This increase is in addition to new car price increases that were already hitting the automotive market prior to the tariffs. Increases in prices should lead to a decrease in new car demand. Price increases in new cars are likely to cause some prospective new car buyers to purchase used cars instead due to the 'Substitution Effect'.

Used Cars Get More Valuable

Due to the increase in pricing, more potential new car buyers will either purchase a used vehicle or keep their current vehicles for longer than they had originally planned. An increase in used car demand as well as a potential shortfall in inventory (from the cars that don't hit the resale market) will cause used car prices to rise. An increase in used car pricing, in turn, leads to reduced demand for used car sales. A rise in used car pricing provides an interesting benefit for the consumer: their vehicles are suddenly worth more - a potentially significant benefit when refinancing a vehicle. We are starting to see the beginning of this effect become reality as evidenced by the Manheim Used Vehicle Value Index, which, in July, is at its highest point since 1995 (and 5.1% higher than last July)[7].

Higher vehicle values helps consumers who want to refinance by lowering the LTV through increasing the value while holding the remaining loan amount steady. A lower LTV makes it more likely that the refinance will be successful (with a potentially better interest rate as well). Additionally, the vehicle is now worth more if the consumer decides to resell it.

What is an LTV Ratio?

LTV (loan-to-value ratio) is the amount owed on the loan as a percentage of the value of the asset.

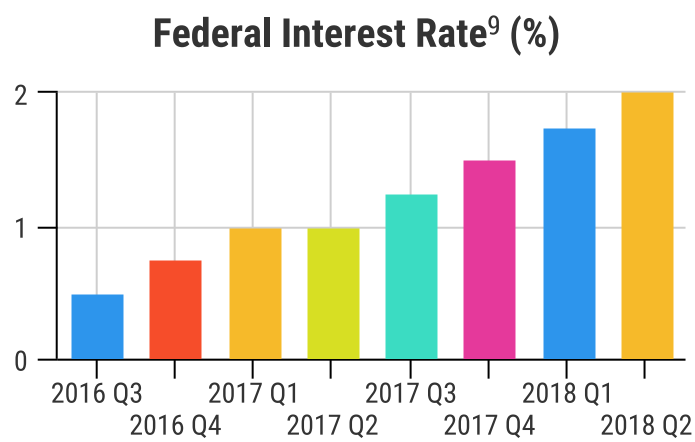
Why is LTV important?

LTV often affects the terms a lender will give for a loan – or if they will approve the loan at all. Generally, the lower your LTV, the lower the interest rate the lender is willing to provide.

Finally, some portion of the roughly 14%[8] who are 'upside-down' on their loans (they owe more than the vehicle is worth) might be able to refinance as the LTV of their used vehicle potentially improves.

Other Economic Factors: Interest Rates, Inflation & Gas Prices

Interest Rates Are Steadily Climbing



Interest rates have been going up steadily for more than two years. This includes the Federal Reserve raising interest rates three times already this year (one quarter of a percentage point each time). The Fed has also indicated that one additional increase is on the way before the end of 2018[10].

In the US, an estimated 85% of the new cars and 53% of the used cars are financed through loans. Higher interest rates combined with an increased cost for the purchase of a new (or used) car creates an 'exponential' effect on the monthly payments for financing vehicles, pushing many of those people to keep their current vehicles. In fact, according to Edmunds.com, auto loan interest rates hit 5.75% in May, 2018, a nine-year high[11].

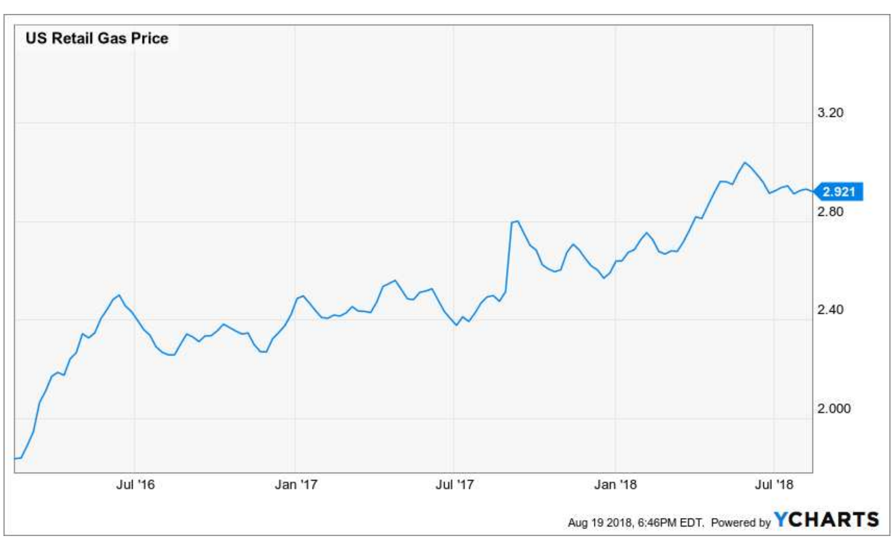
As mentioned previously, demand for used cars and ultimately, the prices of used cars are also likely to increase because of the substitution effect. Monthly payments on used car loans would go up as well due to both the increase in price and the rising interest rates.

The Inflation Rate Is Getting Higher

The United States inflation rate is at its highest point in more than six years[12] and 70% higher than it was just a year ago[13]. An increase in inflation generally leads to an increase in interest rates and thus creates an incentive for the consumer to either purchase or refinance before rates go up.

Gas Prices Are Going Up As Well

Gas prices are up to $2.92/gal (for the week of August 13, 2018). That is an increase of 17% in the last year (from $2.49/gal) and a 49% increase from its low of $1.83/gal in February of 2016[14]. Since the use of gas is fairly inflexible, the increased cost of gas will force the average consumer to find savings in other parts of their monthly budget. This becomes more difficult with the current increase in inflation, as most purchases for that the average consumer are getting more expensive as well.



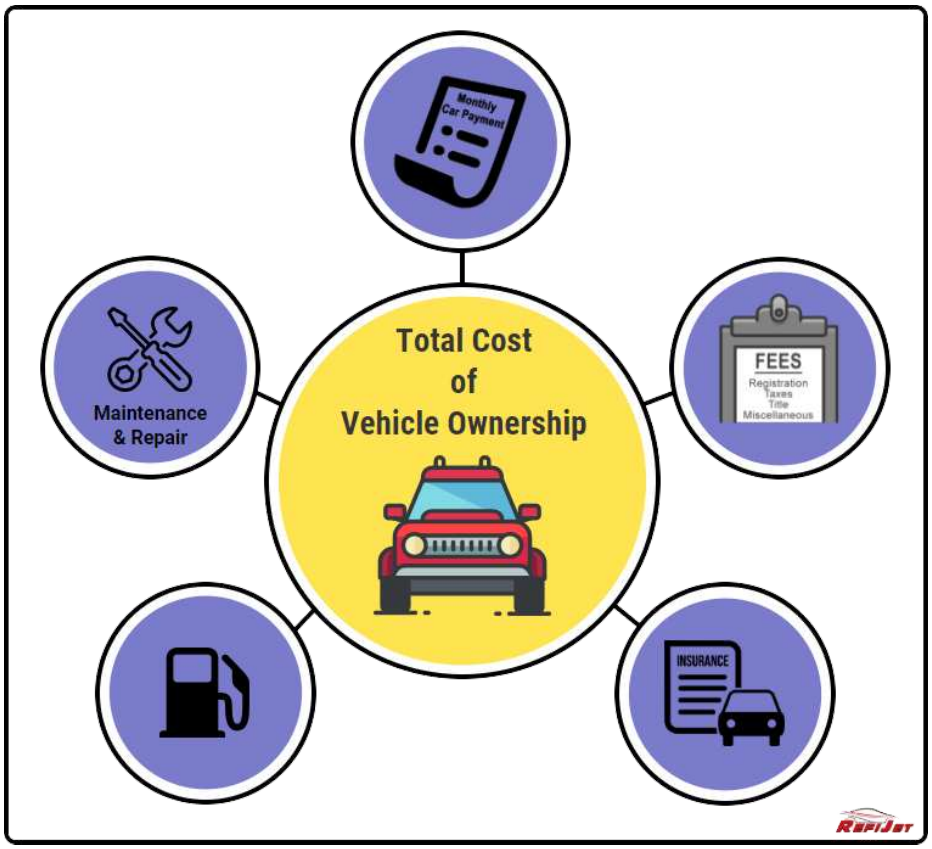
Total Cost of Vehicle Ownership

Total Cost of Vehicle Ownership is Going Up

- The cost of new and used vehicles is likely to keep rising
- Interest rates are rising and are expected to continue to increase
- Gas prices have gone up over the last year
- Inflation is increasing

When these effects are combined, it creates a perfect storm of economic variables driving up the total cost of ownership of vehicles at a time when consumers' budgets are already getting thinner due to three straight quarters of inflation outpacing wage growth. There are, however, ways to potentially mitigate these increased costs.

Reduce the monthly car payment
Depending on the interest rate being paid on a car loan, it might be possible to refinance the vehicle at a lower interest rate, thus creating a smaller total of payments. Depending on individual needs, the term of the loan could also be extended to reduce the monthly payments even more.



GAP and ESC plans
Guaranteed Asset Protection (GAP) minimizes financial risk if the vehicle is in an accident or stolen, covering the difference between what is owed on the vehicle and what it is worth. Extended Service Contract (ESC) takes care of unexpected repairs or maintenance. Bundling these products into a loan could be a good reason to refinance as they are easily added during the refinance process.

Keep the car longer
A car is generally a depreciating asset, meaning its value goes down over time. An average car will lose approximately 20%[15] of its value in the first year and another 15% of its original value over years two and three. Since the car is worth less, insurance costs generally go down as the vehicle ages since the insurer is only insuring the value of the vehicle. Many states also base their annual registration fees and taxes on the value of the car, thus giving the consumer another cost benefit to keeping their car.

The Projected Impact on Consumers

Immediate Consumer Impact

The consumer opportunities are likely to be the greatest in the immediate term. If consumers are thinking about buying a car, new or used, they are likely better off making their decision now. The cost of waiting to make a decision could be high; both with higher vehicle pricing and higher interest rates on whatever amount that they finance. Putting off the decision ultimately could lead to significantly higher monthly payments for the same vehicle.

If the consumer is considering refinancing their current vehicle, it would make sense to refinance before interest rates go up again (as mentioned earlier, the Fed has indicated that it is looking at one more interest rate hike in 2018). More importantly, as an individual's refinancing situation becomes better (credit score goes up, LTV of the vehicle goes down, etc.), there is always the option to for the consumer to refinance again in the future.

Short-Term Consumer Impact

For consumers considering refinancing, the risk of interest rates going up is high, but the likelihood that their car may have a higher LTV is also stronger. Again, with the knowledge that one could refinance again if the market conditions improve, it would be better to lock in a refinance (assuming it improves the consumer's situation), than wait.

Because of some uncertainty around the timing and scale of the tariffs, the short term could have opportunities for consumers considering a new car purchase. There is the potential for “end-of-year sales” to be stronger than in years past, particularly if the rising costs (as well as the other factors previously mentioned) come to pass. This could leave dealerships with more inventory than they would prefer as the year starts coming to a close, providing extra motivation to move the vehicles. If the inventory was acquired by the dealerships before the price increases kicked in, the dealerships might have the ability to offer very aggressive pricing in order to hit end of year sales goals.

Long-Term Consumer Impact

The long-term looks to be the least attractive to the consumer. If the higher costs of manufacturing persist, interest rates continue on their upward trend and inflation keeps rising faster than wages, consumers are going to be facing an increasingly more difficult market – one where the costs of purchasing a new or used vehicle are going up significantly quicker than their income. This fundamentally impacts all players (manufacturers, dealers, insurers, lenders and, most importantly, consumers) in the automotive ecosystem the same (negative) way – fewer cars being sold/purchased. There could still be advantageous refinancing options in the long term, but waiting for that possibility could be risky.

Endnotes

[1]https://www.nytimes.com/2018/05/22/business/china-cuts-auto-tariffs.html
[2]https://money.cnn.com/2018/05/24/news/car-auto-tariffs-us-germany-japan-toyota-volkswagen/index.html
[3]https://www.reuters.com/article/us-trump-autos-eu/eu-to-respond-to-any-u-s-auto-tariff-move-report-idUSKBN1JJ0DL
[4]https://www.usatoday.com/story/money/2018/07/03/car-prices-trump-auto-tariffs/745342002/
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[8]https://cars.usnews.com/cars-trucks/how-to-finance-a-car
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