



Can Auto Stocks Continue Their Meteoric Rise?

Description

According to IHS Automotive, global vehicle production will surpass 100 million vehicles by 2018. In 2013, vehicle production was 82.8 million, so this represents an increase of more than 20%. North American auto companies are operating at close to capacity, and we may be hearing talk of capacity constraints if demand continues to accelerate and automakers and suppliers do not adjust quickly enough.

With stock prices having experienced very strong returns in the last two years, and considering that the automotive industry is a cyclical one, it is useful for investors to consider where we are in the cycle and where stock prices are in terms of reflecting the good times.

Two-year stock price performance

First off, let's review the stock performance of some of the auto companies in the last two years. As seen below, performance has been stellar.

General Motors (TSX: GMM.U)([NYSE: GM](#)): +65%

Ford ([NYSE: F](#)): +60%

Toyota ([NYSE: TM](#)): +50%

Linamar ([TSX: LNR](#)): +211%

Magna International ([TSX: MG](#))([NYSE: MG](#)): +187%

Martinrea ([TSX: MRE](#)): +39%

What is driving the auto industry's strong fundamentals?

In the United States, the housing and economic recovery has given consumers the financial ability to replace their old cars. Given that the average age of vehicles on the road is 11.4 years old, it's easy to understand why there is motivation to do so. In other parts of the world, such as China, India, and South America, the emerging middle class in these countries is fueling big demand increases.

May auto sales numbers are strong

The May sales numbers for the big automakers were once again very strong. Ford's sales were expected to decline, but instead surprised analysts and increased 3%. Ford's sales in India increased 105% and were up 32% in China, Chrysler's sales increased 17%, GM's sales increased 13%, **Nissan's** sales increased 18.8%, and Toyota's sales increased 17%. Light trucks and SUVs are still seeing strong sales, which is a sign that consumers have adjusted to the higher cost of gas, and low rates continue to support auto purchases.

But are there signs of a slowdown?

One data point that is considered to be a red flag is the factory orders that were recently released. More specifically, new automobile orders show a decline of 14%, which is a sign that the current pace will slow. Looking further into the future, with improved technology, cars now have a much longer life expectancy, so as consumers replace their old cars, the replacement cycle will be longer.

What does all this mean for stock prices?

Ford has unquestionably had a great turnaround over the last few years. The company is on the road to healthy earnings growth, and its results in India and China are particularly encouraging, as the emerging middle class in these economies should continue to drive strong auto demand. The stock currently has a dividend yield of almost 3% and trades at a P/E ratio of less than 11 times.

We are seeing one of the risks of owning auto manufacturers, or OEMs, in the current events at General Motors. The company's recalls have resulted in a stock price decline from over \$40 at the beginning of the year to lows of \$32 in April, yet the stock still trades at a P/E of 20 times. As an alternative, investors can look to a lower-risk way invest in the automotive industry, and suppliers to the OEMs offer this.

Being a supplier to many different OEMs, Magna has exposure to the auto industry as a whole, but it is less sensitive to a specific brand or class of car, which helps to mitigate the risk. Even in good times, investors should always be on the lookout to minimize the risk that they are taking. Considering that GM and Ford are two of Magna's biggest customers, the strong sales numbers that they have seen as of late will translate to Magna's sales numbers. Magna trades at a P/E of just over 15 times.

The bottom line

The automotive industry and auto stocks are experiencing very positive fundamentals. Investors can reasonably expect this to continue but must remember that this is a cyclical industry and big gains have been made, so a close eye must be kept on new orders, inventory levels, and interest rate levels.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:F (Ford Motor Company)
2. NYSE:GM (General Motors Company)
3. NYSE:TM (Toyota Motor Corporation)
4. TSX:LNR (Linamar Corporation)

5. TSX:MG (Magna International Inc.)
6. TSX:MRE (Martinrea International Inc.)

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