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BLUE BOOK Market Report
MARCH 2011
Analysis from Kelley Blue Book's Analytic Insights Team
Annual Subscription Value: $500

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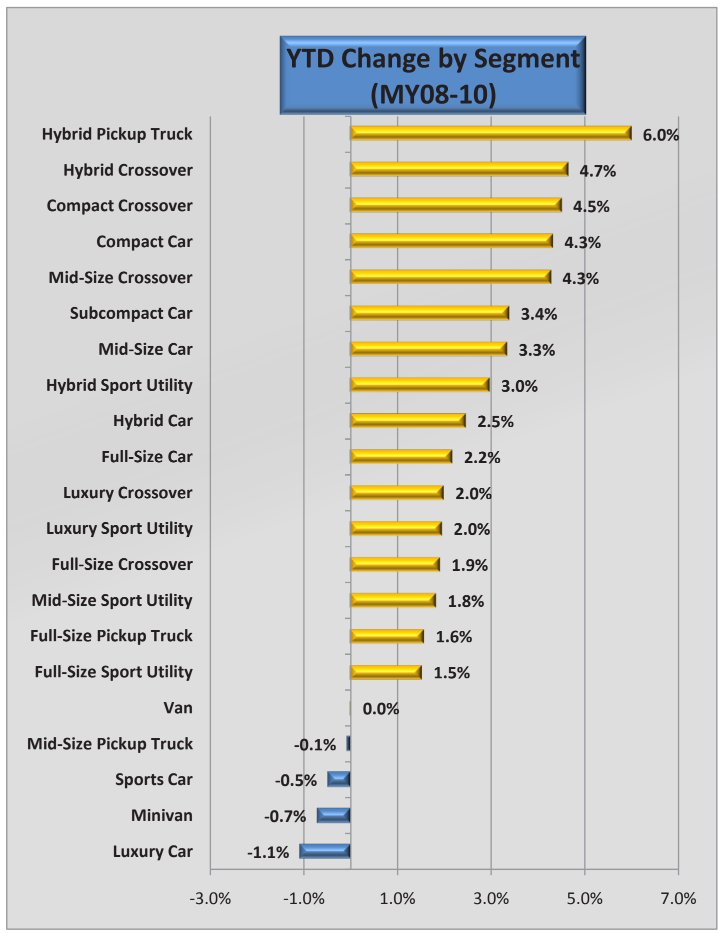
MARKET ANALYSIS:

Lack of Good-Condition Vehicle Supply Continues to Drive Market Strength

- Alec Gutierrez, manager of vehicle valuation, Kelley Blue Book

Along with the New Year came increased sales and strength in the marketplace, providing the automotive industry with hope as the market moves toward a slow recovery. This strength continued into February with supply remaining a concern among dealers. Overall used-car values rose 0.8 percent for the month, building upon the solid gains reported in January. Since the beginning of the year, values have increased 1.4 percent, driven predominantly by an overall lack of supply in good-condition, late-model vehicles.

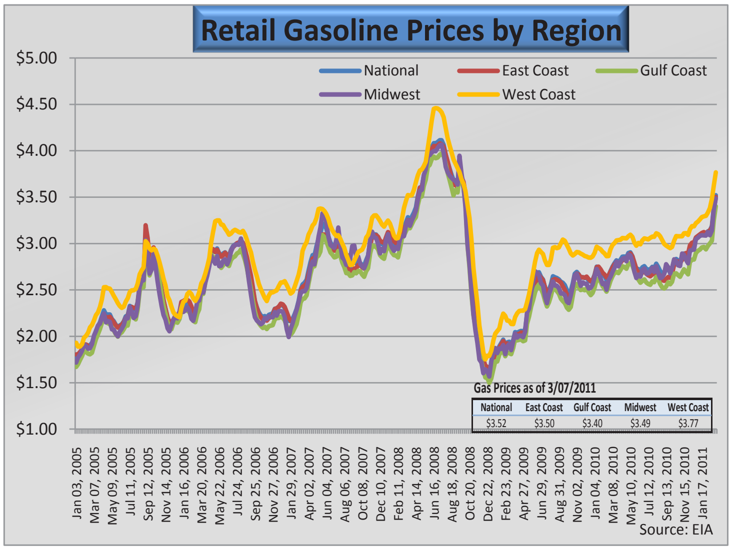


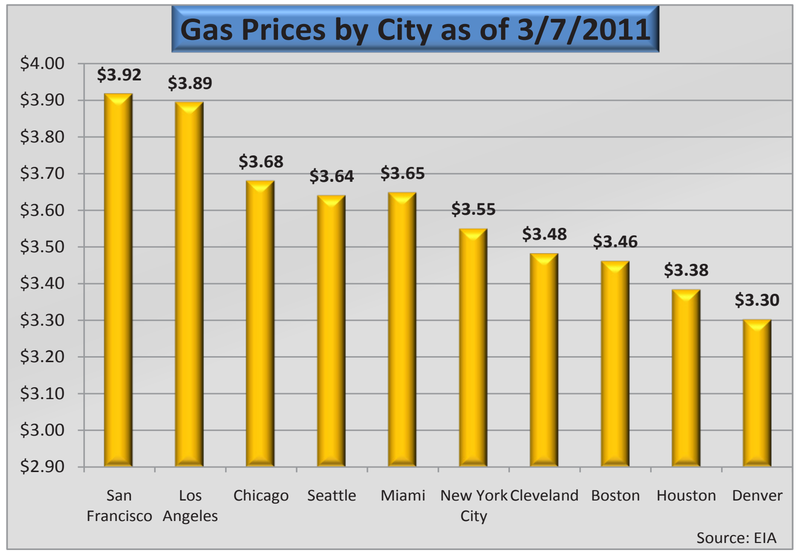
As dealers returned to auction in January after a seasonal fourth-quarter lull, they bid up auction values in an effort to stock up inventory with vehicles consumers' desire most. In the past, dealers went to auction with plans to fully replenish their inventory, buying large quantities of vehicles to ensure a full lot. Dealers were less concerned with days to turn and focused only on having a variety of vehicles in inventory to satisfy consumer preferences. In today's environment, dealers are reluctant to buy vehicles that they won't be able to sell within 30-45 days. In recent conversations with dealers, Kelley Blue Book increasingly is hearing that dealers are only buying vehicles that they have customers lined up to buy. With so much information available online, consumers are able to scour the Web to find a vehicle that best fits their needs. With this in mind, dealers need to be cognizant of changing consumer demands, ensuring they are buying the right cars at the right time.

A dealer that offers affordable, fuel-efficient vehicles will do well with today's rising gas prices. The dealers that will be most successful are those who purchased fuel-efficient vehicles during the first month of this year, as well as those who educate consumers with the fact that you don't need to give up interior space to get more miles per gallon. Drivers do not need to move toward small, sub-compact models to achieve fuel efficiency, as there are several efficient full-size car and crossover options. Moving forward, dealers must consider the changing economic conditions in their market and the potential impact they have on the purchasing habits of consumers. The information age can be a double-edged sword for dealers, providing them with market insights never before available, while simultaneously providing consumers with the information they need to be as informed as the most seasoned industry veterans. The dealers that will remain in business in the long run are those who are able to utilize all of the resources available so that they can better predict the future needs of consumers, as opposed to the current needs of today.

Gas Prices Spark Demand for Fuel-Efficient Vehicles

Many are wondering just how high gas prices will rise, and how long they will remain inflated. Retail gasoline prices started the year at $3.07 and currently sit at $3.52 nationally. While gas prices have been on the rise around the United States, depending on where you live it could be costing you more than in other parts of the country. Most notably, West Coast gas prices are significantly higher than the rest of the country. In fact, according to Kelley Blue Book field analysts, it has gotten to a point where fuel-efficient vehicles are being shipped to the West due to higher demand relative to other parts of the country. This could be a short-term phenomenon as gas prices in the rest of the country continue to creep up and demand spreads elsewhere.

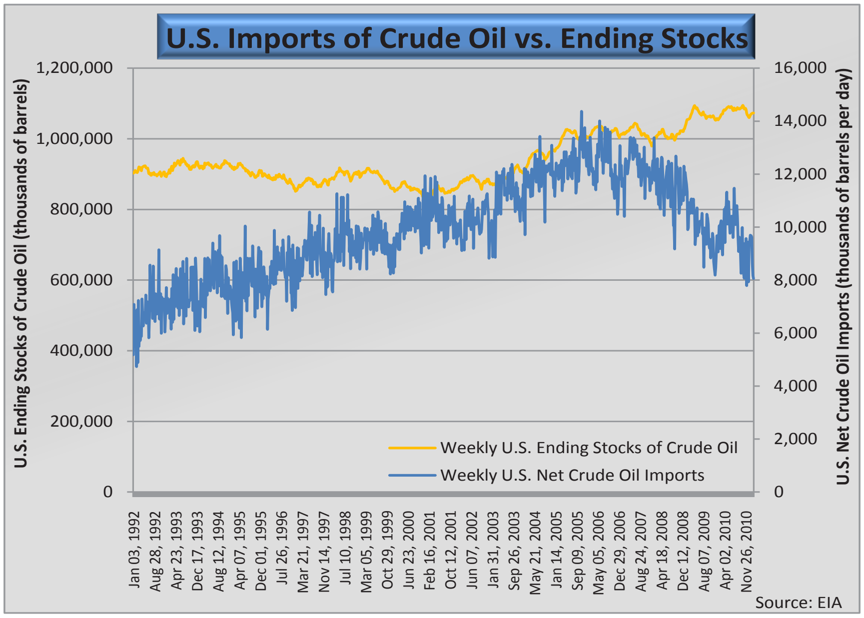




Instability in the Middle East has sparked fears of production halts, contributing to the rapid rise in fuel prices. According to Libya's National Oil Corporation Chairman Shokri Ghanem, the country's oil production has been cut in half. Libya currently is the world's 15th largest crude exporter, producing 1.2 million barrels per day. Although Libya's oil production does not account for a significant portion of global production, we should not discount the impact of a prolonged decline in the country's production. If there is a bright side to the situation, a decline in Libya's production could be absorbed by Saudi Arabia. Saudi Arabia currently produces eight million barrels per day with a capacity of up to 12.5 million barrels of oil per day.

Unrest in Libya has not yet drastically impacted global supply; however, traders fear that the instability in the region could spread to Organization of the Petroleum Exporting Countries (OPEC) heavyweights such as Iran and Saudi Arabia. This is the key to rising gas prices. If this unrest does not spread into Saudi Arabia or Iran, then the current rise in gas prices may be short-lived. Global supply and demand remain relatively balanced, so in the long run fuel prices could come down. In the short run, consumers should prepare to continue to pay a premium at the pump, at least through 2011. The Energy Information Administration's (EIA) long-term forecast projects gas prices to remain around $3.56 per gallon nationally through 2011, with a 25 percent chance of gas hitting $4.00 per gallon in the summer. Until the uncertainty in the Middle East begins to subside, consumers should expect to continue to live with high gas prices.

Gas Prices Spark Demand for Fuel-Efficient Vehicles (Continued)



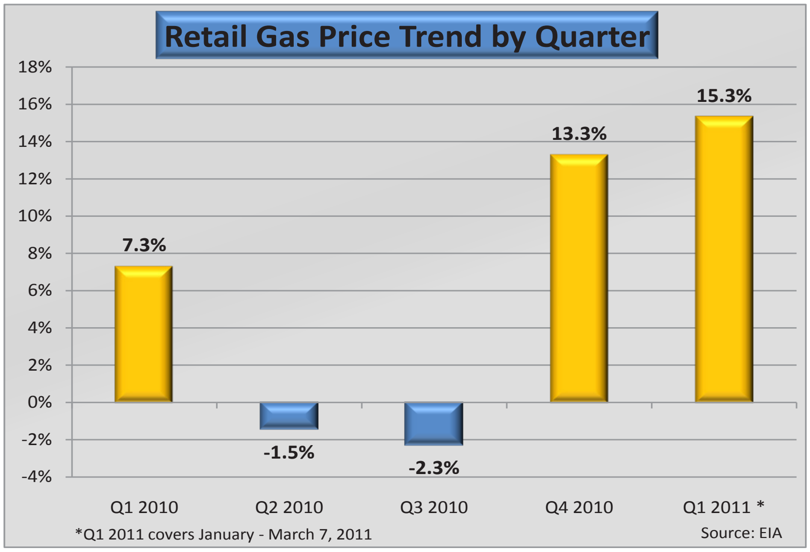
At this time, Kelley Blue Book recommends that consumers who do not absolutely need to replace a vehicle wait for gas prices to come back down. With gas prices on the rise, we anticipate fuel-efficient vehicle values to increase, while values for trucks and SUVs are expected to decline. The rate of gas price appreciation will strongly correlate with the degree to which used-car values fluctuate. Kelley Blue Book suggests that dealers use this time to stock up on trucks and SUVs if this is what they traditionally sell. Once gas prices drop, they can expect consumers to return to these spacious family haulers.

In 2008, gas prices hit $4.00 per gallon and many consumers behaved irrationally by selling their trucks and SUVs in a panic, taking a significant loss only to spend a premium for a new or used fuel-efficient car. After it became apparent that this appreciation was largely driven by speculation rather than market fundamentals, gas prices came down sharply and values eventually leveled off. Consumers should be cautious as they decide whether or not to sell a vehicle for something more fuel efficient. Gas prices will remain high until the situation in the Middle East is resolved, but consumers should only sell if their budget forces them to do so.

The trouble is that many consumers are in difficult financial situations. According to a recent Consumer Sentiment Survey of new- and used-car shoppers on kbb.com conducted by Kelley Blue Book Market Intelligence, 23 percent of respondents with a poor economic situation planned to buy a vehicle within one month. Of those respondents, 21 percent reported purchasing a vehicle with better fuel economy as the main reason for needing to purchase a new vehicle. If possible, shoppers should wait until after Summer, when gas prices typically drop. Hopefully, the troubles in the Middle East will have subsided by then.

Affordable, Gas-Sipping Models Resurge from Relatively Flat 2010

Rising fuel prices and uncertain economic conditions drive values of gas-sipping, affordable vehicles higher. While values have been strong for nearly all segments tracked by Kelley Blue Book, values for fuel-efficient models have truly outperformed them all. Gas prices rose a substantial 13.3 percent during the fourth quarter of 2010 and already have climbed 15.3 percent since the beginning of the year.



Values for hybrid vehicles were relatively flat through much of 2010; however, as gas prices have increased aggressively during the past several months, we started to see values for hybrids increase. Hybrid crossover values are up 5 percent year-to-date. The top performers for this segment include Mazda Tribute Hybrid (+9.6 percent), Mercury Mariner Hybrid (+8.3 percent), Toyota Highlander Hybrid (+7.4 percent) and Ford Escape Hybrid (+5.4 percent). Hybrid cars also increased by 1.7 percent since the beginning of the year with support from Honda Civic Hybrid (+5.1 percent) and Toyota Prius (+4.6 percent).

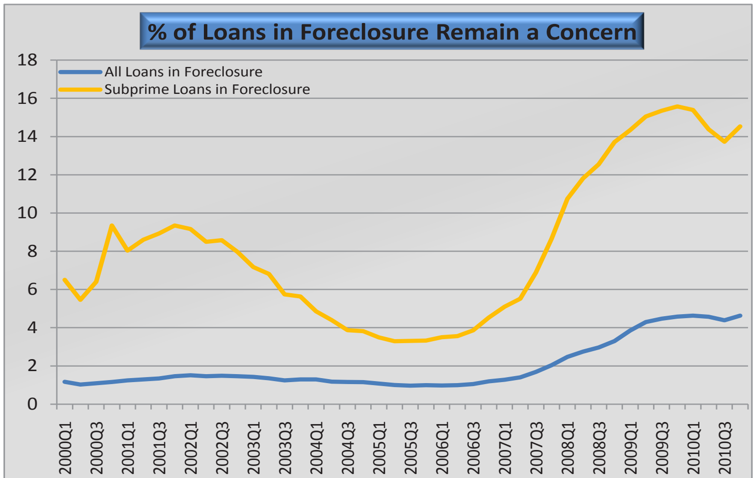
In addition to strength in hybrid vehicles, more traditional fuel-efficient models also have performed well, likely due to their low cost of entry. According to the aforementioned Consumer Sentiment Survey conducted by Kelley Blue Book Market Intelligence, 27 percent of all respondents indicated that their economic situation is 'poor.' This is a 7 percentage point increase from January. Rising gas prices have added to consumers' financial concerns, and as a result, they have turned to the most affordable, gas-sipping vehicles on the road. For this reason, vehicles traditionally seen mostly in rental car fleets such as Chrysler PT Cruiser, Chevrolet Aveo and Kia Rio currently are performing very well.

The compact car segment is up 3.5 percent year-to-date with strength in the Chrysler PT Cruiser (+9.3 percent), Dodge Caliber (+8.5 percent) and Chevrolet Cobalt (+6.3 percent). Subcompact cars increased 2.3 percent with help from the Chevrolet Aveo (+8.6 percent), Pontiac G3 (+7.3 percent), Kia Rio (+6.3 percent) and Hyundai Accent (+4.2 percent).

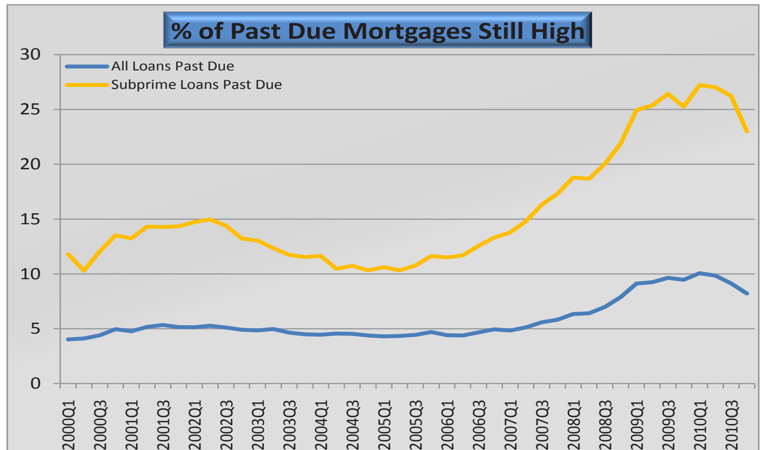
Crossovers also have performed well. Now that America's love affair with the SUV has long since passed, crossovers seem to have stepped up to fill this void in the market. Today, the most fuel-efficient crossovers are reporting the best numbers, given today's increased gas prices. Compact crossovers rose 4.7 percent since the beginning of the year, with Mercury Mariner up 12.5 percent, followed by Mazda Tribute at 9.7 percent, Ford Escape at 8.2 percent and Jeep Patriot at 7.1 percent. Kelley Blue Book expects values for fuel-efficient cars and crossovers to continue to rise as gas prices remain high. For consumers in the market for one of these vehicles, it may be best to wait until the third quarter of the year or later, assuming gas prices will become steadier at some point.

High-End Luxury Takes a Backseat

According to Housing Pulse, distressed sales accounted for 49.6 percent of all U.S. home sales in January 2011. Foreclosures remain high among both prime and subprime loans. Past-due payments also remain high.

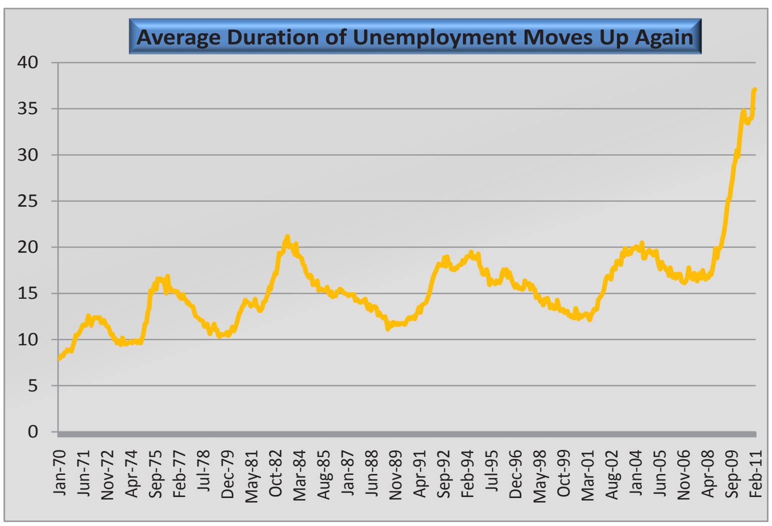


Source: Economy.com (Mortgage Banker's Association Survey)

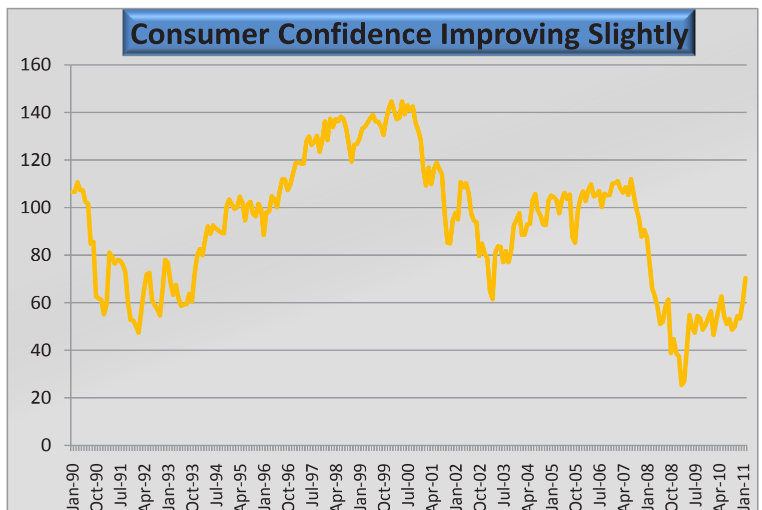


Source: Economy.com (Mortgage Banker's Association Survey)

In addition, employment remains challenged. The unemployment rate is down to 8.9 percent; however, average duration of unemployment is historically high. With this as a primary factor, consumer confidence remains low, although it has rebounded some in the past few months.



Source: Economy.com (BCI)



Source: Economy.com (The Conference Board)

Challenges on the homefront limit the strength of high-end luxury vehicles. With many homeowners facing foreclosure and many other Americans struggling to find work, purchases of luxury goods remain low. The housing boom allowed many homeowners to cash out equity of their homes to finance the purchase of expensive, impractical luxury vehicles. Now that the housing bubble has long since burst, demand for this segment has waned.

Used luxury car values have lagged the overall market, down 1.1 percent year-to-date, with the most expensive luxury vehicles struggling more than others, while the rest of the market strengthened. In the last month, Cadillac DTS is down 8.2 percent, Lexus LS dropped 3.5 percent and Audi A8 slumped 3 percent. With so much uncertainty in employment and the housing market, luxury vehicles will continue to lag the market.

This commentary focuses on model years 2008-2010. The statements set forth in this publication are the opinions of the authors and are subject to change without notice. This publication has been prepared for informational purposes only. Kelley Blue Book assumes no responsibility for errors or omissions.

Peak Fuel Prices Are Not Sustainable

- Eric Ibara, director of residual value consulting, Kelley Blue Book

With fuel prices back in the headlines, it is easy to become lost in the hysteria over the pinch to our pocketbooks. After all, it was only three years ago when prices shot up unexpectedly, and we remember the pain that followed. However, like most commodities sold in the free world, the price of fuel is subject to the law of supply and demand and therefore is self-correcting. As demand for fuel rises, prices go up. As profits rise, technology can be brought in to extract hard-to-reach oil that only becomes feasible once payoffs are greater. This increases the supply of oil causing prices to ease. Simultaneously, the run-up in fuel price causes consumers to cut back on discretionary spending and the economy swoons. This reduces the demand for fuel, causing oil inventories to build, and eventually prices drop. In fact, this is what happened in 2008 as demand for gas dropped after prices topped $4 per gallon, causing prices to subsequently fall by 50 percent.

Developments since the last fuel spike have brought more fuel-efficient vehicles to market. Manufacturers diligently developed new vehicles to meet the more stringent CAFE requirements proposed for 2016. Early examples include muscle cars that achieve 30 miles per gallon, while delivering more than 300 horsepower and also are fun to drive. A number of compact sedans with conventional gas engines now boast 40 miles per gallon, a feat that was only possible with expensive hybrid technology just a few years ago. Electric vehicles (EVs) and plug-in hybrids promise even greater fuel efficiencies. At the commercial level, many buses and trucks in urban areas are powered by natural gas (of which we have an abundant supply in the United States). Over time, these developments will contribute to a reduction of the amount of gasoline consumed in this country. As the demand for fuel decreases, the ability of gas suppliers to raise prices should decline. This is a day we surely all welcome.

What does all of this mean for residual values? Higher gas prices are not sustainable in the long run in a weak economy. Kelley Blue Book also recognizes that manufacturers are introducing new and refreshed vehicles into the subcompact, compact and hybrid categories. A large number of EVs and plug-in hybrids also are scheduled to hit the market during the next few years. With gas prices currently under $4 per gallon, Kelley Blue Book projects that consumer appetites for these fuel-efficient vehicles will not match the greater supply of vehicles entering the market. This means intense competition in pricing, potentially greater volume in rental service and more generous incentives to consumers. With all of these factors, it should be a buyers' market for small, fuel-sipping vehicles, which generally means lower resale values.

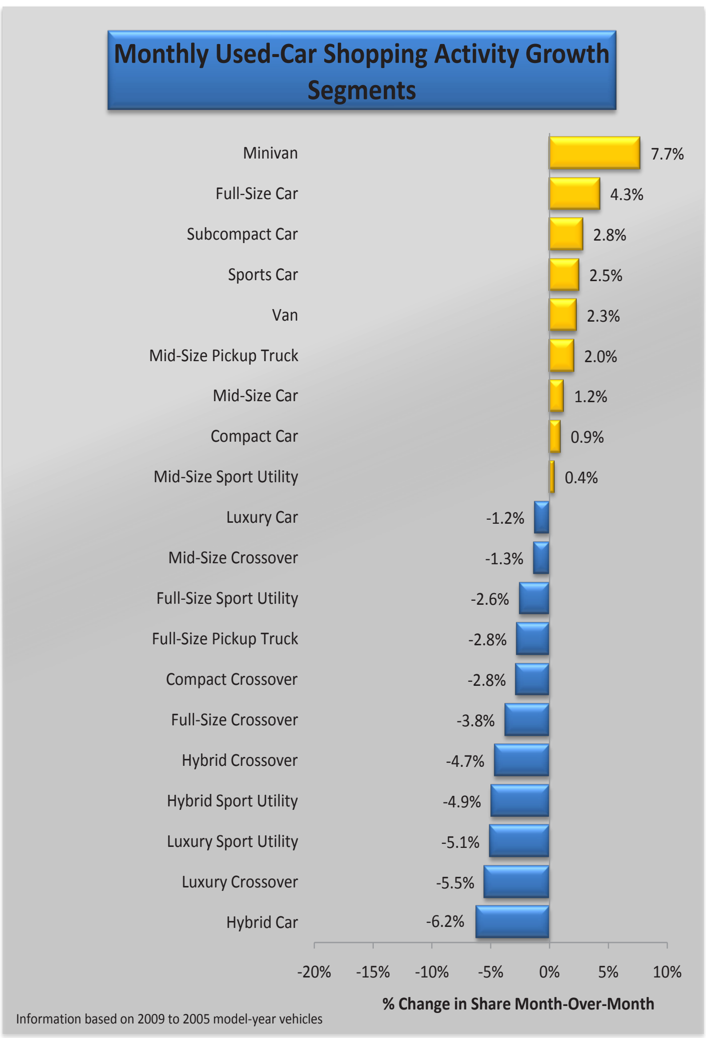
> "…CONSUMER APPETITES FOR THESE FUEL-EFFICIENT VEHICLES WILL NOT MATCH THE GREATER SUPPLY OF VEHICLES ENTERING THE MARKET."
>
> *- ERIC IBARA*

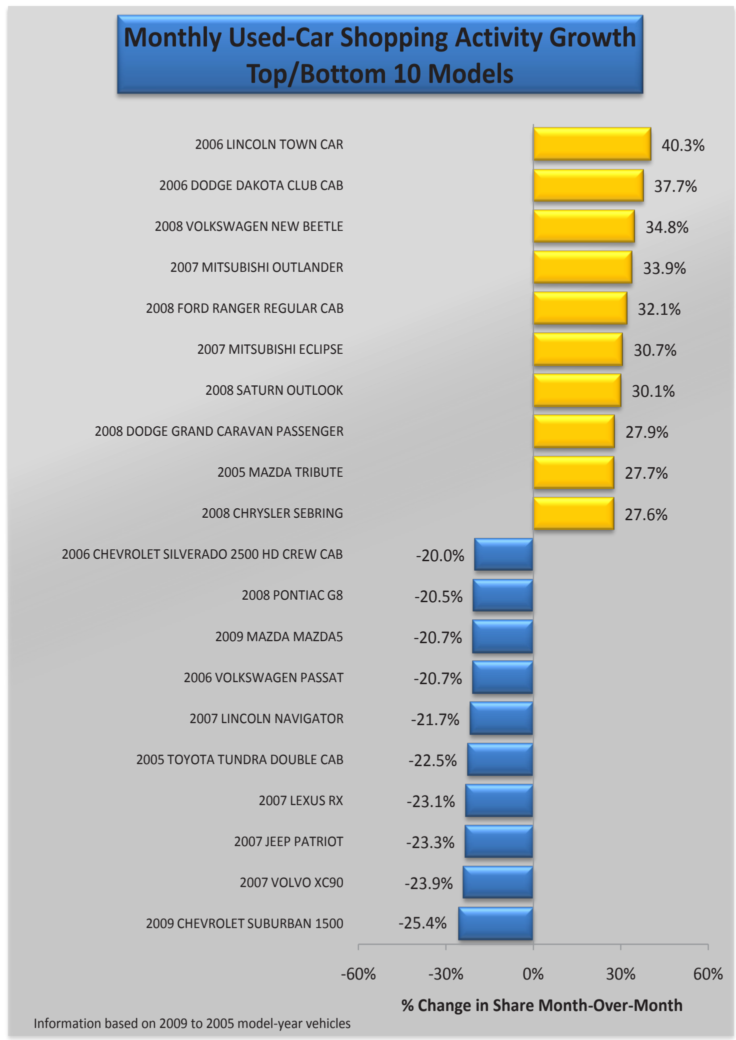
It also is important to examine the cost-benefit analysis that will be applied to these new technologies. Today, EVs cost thousands of dollars more than a comparable conventional gas-powered vehicle, even after a $7,500 federal tax credit. Early adopters either feel strongly against driving a vehicle that emits carbon emissions or want to be the first on the block to drive an EV. In order for these vehicles to become mainstream products, they also will have to appeal to buyers from a financial perspective. However, it could be possible that the fall-off in demand for gasoline in the future will be significant enough to cause gas prices to drop. In this environment, EVs may have to survive a cost-benefit analysis with gas priced at $3 per gallon rather than $5 per gallon. That will be a tall order.

Minivan, Full-Size Car Segments Spur Consumer Interest as Values Drops

Kelley Blue Book's Hot Used-Car Report captures monthly used-car shopper activity on kbb.com, including a list of the top and bottom movers in the same time period. Results are provided by the Kelley Blue Book Market Intelligence Team, in an effort to help dealers better understand which used vehicles consumers are looking at most each month.

The top-performing segment in used-car traffic for February was minivans, with a 7.7 percent month-over-month jump in kbb.com share of shopper interest. This rise is attributed to softening market values and increasing interest in the 2008 Dodge Caravan, which experienced an upward shift in share of 27.9 percent. Another segment that has gained in popularity this past month is full-size cars. This segment's increase is spurred by the 2006 Lincoln Town Car, which increased 40.3 percent in traffic share. "The Town Car's popularity could have to do with March 2011 being the final production month for the Town Car L trim, while the overall Town Car is expected to cease production in August 2011," said Alec Gutierrez, manager of vehicle valuation for Kelley Blue Book. "With this increase in trade-in traffic, perhaps owners of the current Town Car are thinking about trading in their vehicle to purchase one of the final Town Cars that will ever be produced." These two segments typically do not generate a lot of demand; however, because they currently are the top-performing used-car segments on kbb.com, it could bode well for any inventory of these vehicles currently on the dealership lot.





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