

2009 MIDYEAR ECONOMIC OUTLOOK FOR WHOLESALE DISTRIBUTORS

Adam J. Fein, Ph.D.
Pembroke Consulting, Inc.
www.PembrokeConsulting.com

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This report was prepared by Adam J. Fein, Ph.D., founder and president of Pembroke Consulting. Pembroke Consulting is a Philadelphia-based management advisory and business research firm.

Dr. Fein helps his clients to improve profitability and growth by making better strategic decisions. He is one of the country's foremost experts on channel economics and strategy. Dr. Fein's leading edge research, solid industry experience, and approachable style allows him to provide his clients with the perspective and judgment needed to solve challenging business problems in today's rapidly evolving distribution systems.

Dr. Fein has delivered hundreds of keynote presentations to more than 55,000 executives across a wide range of industries. He inspires audiences to think strategically with content-rich yet entertaining presentations and workshops.

Dr. Fein has published hundreds of academic and industry articles, authored or edited ten books, and currently writes the popular blogs www.DrugChannels.net and www.DistributionTrends.com. He is frequently sought by the media for his industry expertise and has been quoted in many leading national publications. He serves as the first Fellow of the NAW Institute for Distribution Excellence and is on the Advisory Boards of Supply Chain Equity Partners, IntegriChain, and Pharmaceutical Commerce magazine.

Dr. Fein earned his Ph.D. from the Wharton School of Business and a B.A., summa cum laude, from Brandeis University. He lives in Philadelphia with his wife and their two children.

To learn more about Pembroke Consulting, please contact Dr. Fein:

Adam J. Fein, Ph.D.
Pembroke Consulting, Inc.
1515 Market Street, Suite 960
Philadelphia, PA 19102
Phone: 215-523-5700
www.PembrokeConsulting.com
Email: afein@pembrokeconsulting.com

Executive Summary

The recession is not over, but we are at (or near) the bottom.

The latest economic data show that many sectors are either stabilizing or getting worse at a slower rate.

While the 2009 outlook for many wholesale distribution sectors has worsened, we are still on track for recovery in 2010.

The recovery will probably be slow compared to historical norms. However, there is a credible scenario developing for unexpectedly rapid growth in 2010/2011.

Be prepared for significant economic volatility and new risks associated with the coming economic recovery.



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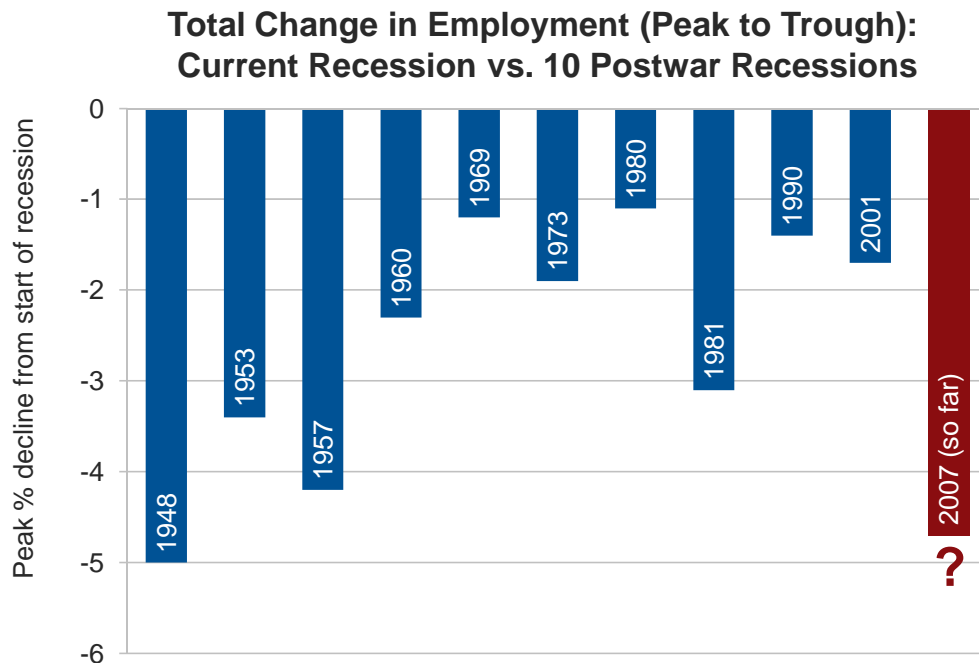
- The question is no longer “when will the recovery begin?” but rather “what will the recovery look like?” The most likely scenario appears to be a slower “U-shaped” recovery, assuming no major policy errors.
 - Economic recoveries have typically been led by interest-rate sensitive industries such as housing and auto sales. However, the excesses of the 2004-2006 housing boom will take years to be resolved. The balance sheets of commercial banks remain weak due to housing-led slowdown due to mortgage defaults and losses from mortgage-backed securities. Consumer debt remains high relative to incomes.
 - We are also in the first global recession since the 1930s, which limits the ability of exports to support the domestic economy.
- There are at least two credible alternate scenarios :
 - A rapid recovery (“V-shaped”) due to the combination of monetary stimulus combined with the fiscal stimulus money hitting next year. The high levels of U.S. debt would trigger dollar devaluation, raising commodity prices. Inflation would spike, creating the risk of higher interest rates and a double-dip recession.
 - A very weak recovery (“L-shaped”) driven by cautious consumers, increasing unemployment, ongoing foreclosures, and the prospects of significant deflation. This scenario would echo Japan’s so-called lost decade of the 1990s.

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2. Update on wholesale distribution sector performance
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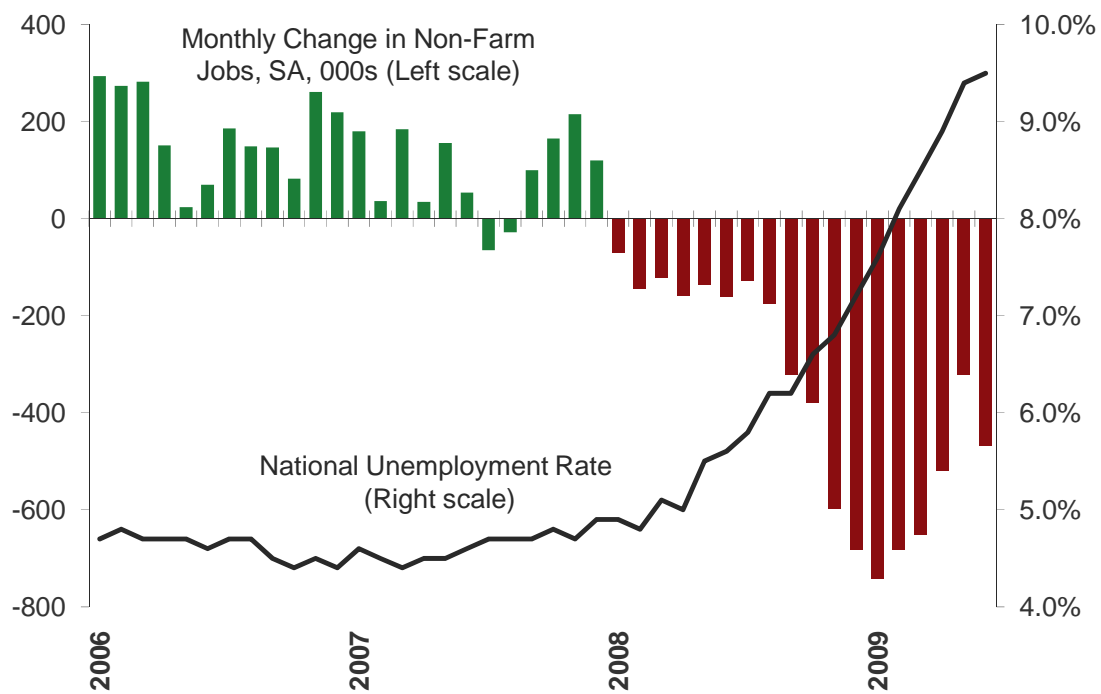
- This report will help you understand the key dynamics behind the economy. It is more important to understand the drivers of change than to be focused on the specific point predictions provided in the forecast data.
- All analyses in this report are based on data from the following sources:
 - Bureau of Economic Analysis (www.bea.gov)
 - Bureau of Labor Statistics (www.bls.gov)
 - Census Bureau (www.census.gov)
 - Commodity Research Bureau (www.crbtrader.com)
 - Federal Reserve (www.federalreserve.gov)
 - S&P/Case-Shiller Home Price Indices (www.standardandpoors.com)
 - The Wall Street Journal Economic Forecasting Survey (online.wsj.com)
- Unless otherwise noted, forecast data come from Pembroke Consulting, Inc.
- This report contains the most current available data at the time of writing (July 15, 2009). Please note that these data are subject to (sometimes substantial) revision by the reporting organizations.

Today's Recession in Perspective



- The recession that began in December 2007 is still on track to be the most severe downturn in employment during the post WWII period. At 18 months, we are now experiencing the longest post-war recession.
- Since peaking in December 2007, total non-farm employment has dropped by 6.4 million jobs, with 3.3 millions of those jobs lost in 2009. Even more troubling is the fact that the number of workers taking part-time jobs has doubled in this recession to about nine million people (5.8% of the work force). Many workers are taking pay cuts or reducing their hours rather than lose their jobs.

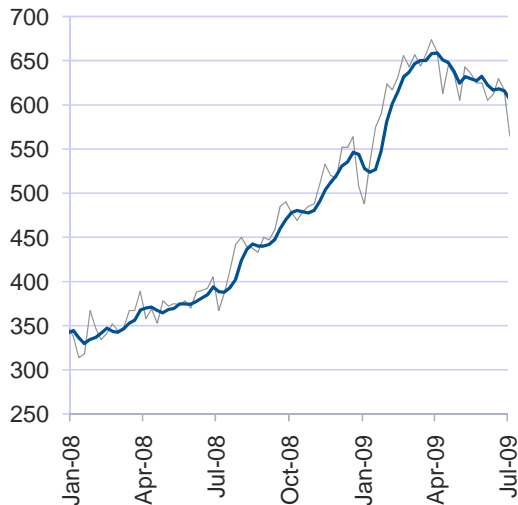
Employment situation is grim but improving



- The rate of job loss has slowed despite an unexpectedly large decline in June. Monthly employment declines averaged 436,000 in the second quarter of 2009 compared with 691,000 in the first quarter.
 - The biggest job losses continue to occur in construction and manufacturing industries, which are core customer groups for wholesaler-distributors. Education and health care are the only major sectors that have added jobs.
 - The unemployment rate is now at its highest rate since the early 1980s. 14.7 million people are considered to be officially unemployed. It will take years to reabsorb these people back into the labor force.
 - One warning sign about the “less bad” employment figures was the continuing decline in “total number of hours worked,” which equals (a) the total number of workers employed multiplied by (b) the average length of the workweek for the average worker. The average workweek was only 33 hours in June 2009, which is the lowest level on record.
- Employment in the wholesale distribution industry is declining at a slightly faster rate (-6.6%) than the overall economy. However, employment started to increase in May 2009 for the first time since June 2008.

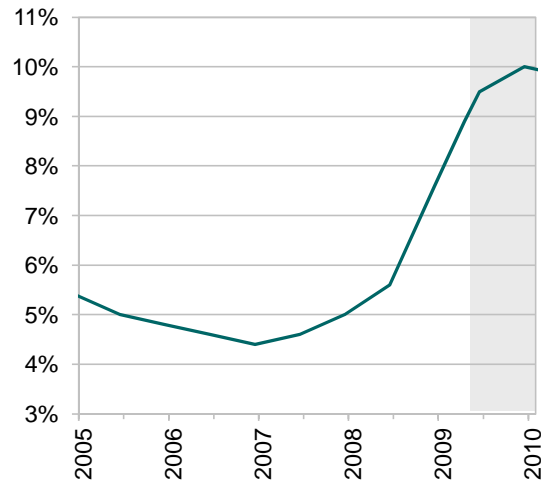
Employment losses are stabilizing

Initial Claims for Unemployment Insurance*
(SA, thousands)



* Through week of 7/4/09

National Unemployment Rate

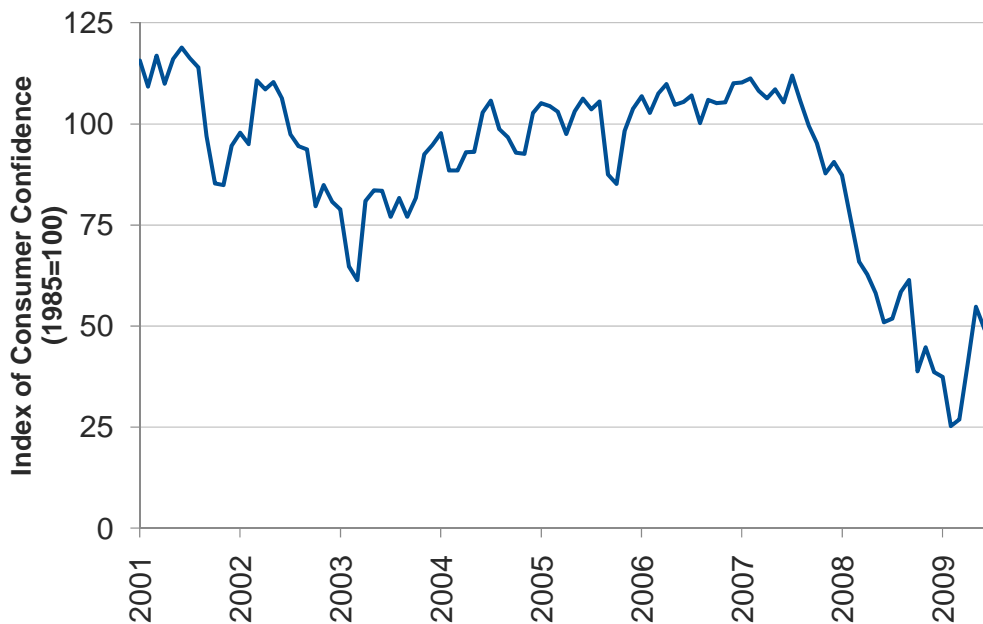


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- The unemployment rate rose to 9.5% in June – the highest rate in 15 years. The unemployment rate is now forecast to exceed 10% by the end of 2009. For comparison, unemployment peaked at 10.8% in late 1982 during the recession of 1981-82. The broad measure of unemployment – which includes the unemployed, underemployed, and people who have become discouraged from looking for work – now stands at 16.5%.
- The number of Initial Claims for Unemployment Insurance, which is a coincident indicator of labor market conditions, appears to have hit a turning point. This suggests that the initial wave of layoffs may have peaked in April. Continuing claims (not shown) have also started to level off, although the four-week moving average remains very high at 6.7 million people.

Consumer confidence bouncing off historic lows



Source: The Conference Board



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- Consumer panic seems to be easing. The Conference Board index of consumer confidence has rebounded from the all-time record low in February 2009. (The Conference Board began surveying consumers in the 1960s.)
- Business confidence – as measured by the National Federation of Independent Business' survey of small business owner confidence – is also starting to increase from historic lows. All three of the "hard components" in the NFIB survey – job creation plans, inventory investment plans and capital spending plans – are rising although they are still at anemic levels.
- The collapse in consumer confidence is one of the biggest differences between the current downturn and the previous 10 post-war recessions. This index is a leading indicator of consumer spending, although it can be highly influenced by short-term external events. Confidence is now beginning to improve as the credit crunch eases and financial markets begin to stabilize.

A Horrible First Half for Distribution

% Change in Revenues, 2009 vs. 2008 (YTD through May)

Major Sector (Fastest to Slowest Revenue Growth)	% change in revenues, 2009 vs. 2008, YTD	
	Q1	Q2*
Pharmaceutical Wholesalers	+ 4.1%	+ 3.2%
Beer, Wine and Liquor Wholesalers	+ 4.4%	+ 2.2%
Apparel and Piece Goods Wholesale Distributors	- 1.4%	- 6.9%
Other Consumer Products Wholesale Distributors	- 2.8%	- 6.0%
Grocery and Foodservice Wholesale Distributors	- 3.0%	- 6.2%
Commercial Equipment and Supplies Wholesale Distributors	- 6.5%	- 6.4%
Computer Equipment and Software Wholesale Distributors	- 8.9%	- 8.9%
Office Product Wholesalers and Paper Merchants	- 8.8%	- 12.6%
Electrical and Electronics Wholesalers	- 9.8%	- 12.8%
Industrial Distributors	- 12.1%	- 18.5%
Hardware, Plumbing, and Heating Equipment/Supplies Wholesalers	- 15.1%	- 19.9%
Furniture and Home Furnishing Wholesale Distributors	- 18.2%	- 19.7%
Chemicals and Plastics Wholesale Distributors	- 18.3%	- 21.9%
Agricultural Products Wholesale Distributors	- 23.6%	- 18.9%
Building Material and Construction Wholesale Distributors	- 23.4%	- 27.5%
Motor Vehicles and Motor Vehicle Parts Wholesale Distributors	- 32.8%	- 34.8%
Miscellaneous Durable Goods Wholesale Distributors	- 29.4%	- 43.1%
Metal Service Centers	- 28.7%	- 44.8%
Oil and Gas Products Wholesale Distributors	- 47.0%	- 47.6%
Total Wholesale Distribution Industry	- 17.2%	- 21.1%



* April and May only

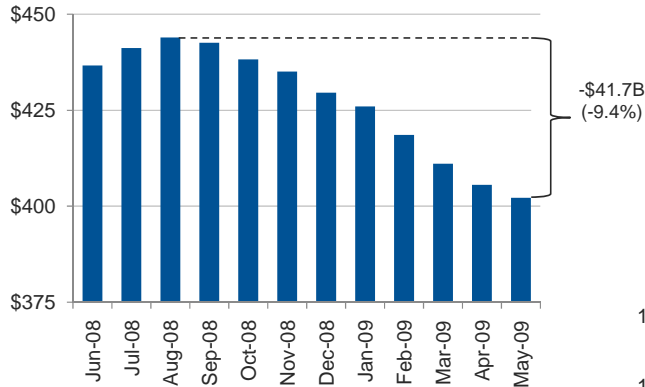
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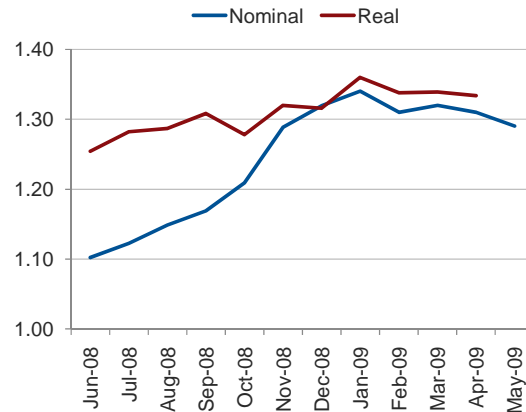
- Revenues at wholesale distribution companies continue to drop significantly compared to comparable periods in 2008. The table above compares revenue growth for the first quarter and the second quarter (through May) for the 19 major sectors of the wholesale distribution industry. These data are not seasonally adjusted, making it easier to compare with individual company results.
- The revenue-enhancing benefit of product price inflation has hurt top-line revenue growth at many wholesale distributors. Certain sectors, such as oil and gas and durable goods, are suffering from the dual effect of declining demand combined with the after-effects of the commodity price bubble. However, the drop in gas prices has been positive for many wholesaler-distributors given the direct impact on transportation costs. Distributors of oil-based products – such as plastics, chemical, or industrial lubricants – have seen revenues deflate quickly.

Interpreting Inventory Adjustments

Total Value of Wholesale Inventory
(\$B, SA)



Inventory-to-Sales Ratio for
Wholesale Distribution

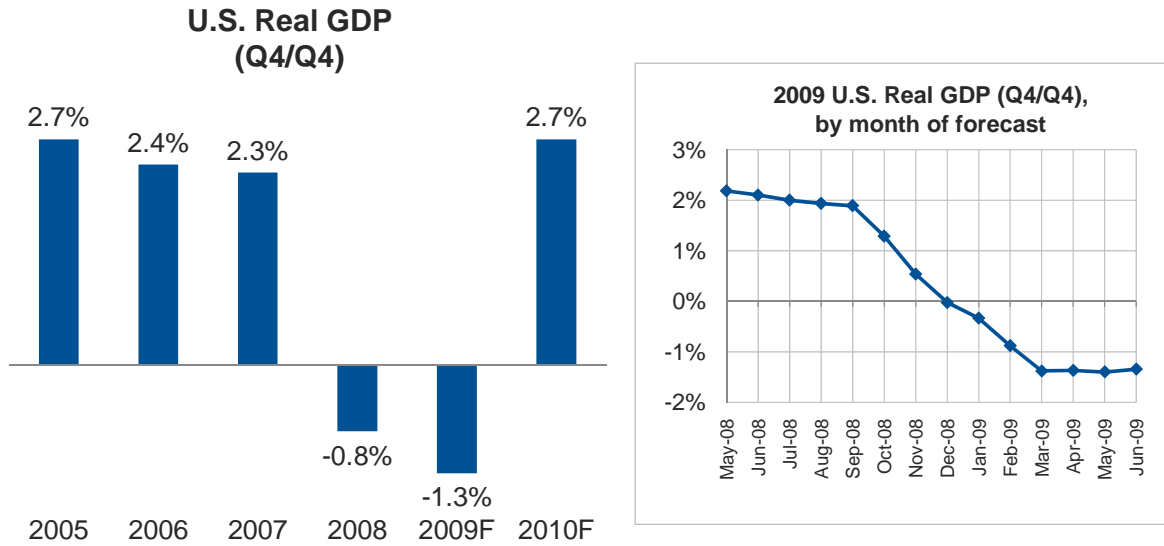


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- Total inventories at wholesaler-distributors have declined by \$41.7 billion since August 2008. However, sales dropped more quickly, leading to the headline increase in the inventory-to-sales (I/S) ratio from 1.10 in June 2008 to 1.29 in May 2009.
 - These data, which come from the Monthly Trade Inventories and Sales reports of the Census Bureau, reports inventories on a current cost (pre-LIFO) basis. Thus, the MTIS inventory data reflect a mixture of current and prior prices that depends on accounting practices and the length of time goods are held in inventory.
- This increase overstates the actual increase in I/S ratio as the commodity price bubble popped during the same period. The dollar's strength since September also affected commodity prices because most major commodities are denominated in dollars. As the dollar got stronger versus other currencies, the local currency price of dollar-denominated commodities decreased for U.S. buyers.
 - The "real" (inflation-adjusted) I/S ratio has increased by a much more modest amount. The real data come from the Bureau of Economic Analysis, which revalues the inventory data in the Census Bureau's MTIS report from current cost to current replacement cost. The revaluation amount removes ordinary gains and losses that could come from holding inventories purchased at prices either higher or lower than current cost.

Economic forecasts are stabilizing



Source: Wall Street Journal survey of economic forecasts



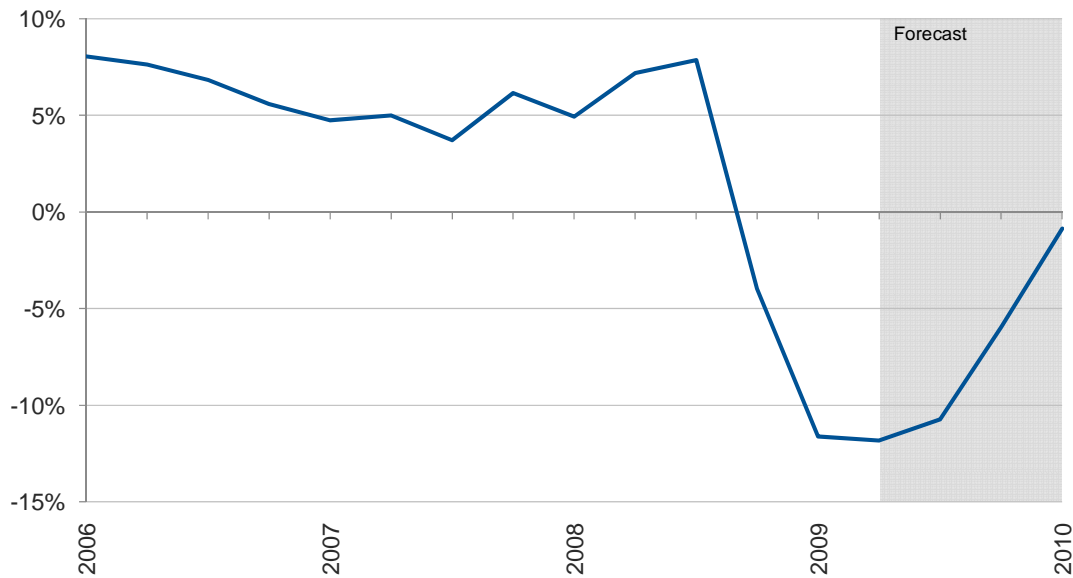
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- The consensus 2009 forecast has stabilized. It looks like 2008:Q4 and 2009:Q1 will appear to be the trough of the recession, although year-over-year growth will not return until 2010.
- The U.S. Gross Domestic Product (GDP) forecasts are based on the Wall Street Journal's survey of economic forecasters. The chart on the right shows how much the 2009 forecast has been reduced since September 2008 due to deteriorating conditions.

Core* Wholesale Distribution Revenue Growth, 2006:Q1 to 2010:Q1

Quarterly change
from year ago



* Core Revenues excludes (a) Oil and Gas and (b) Agricultural products



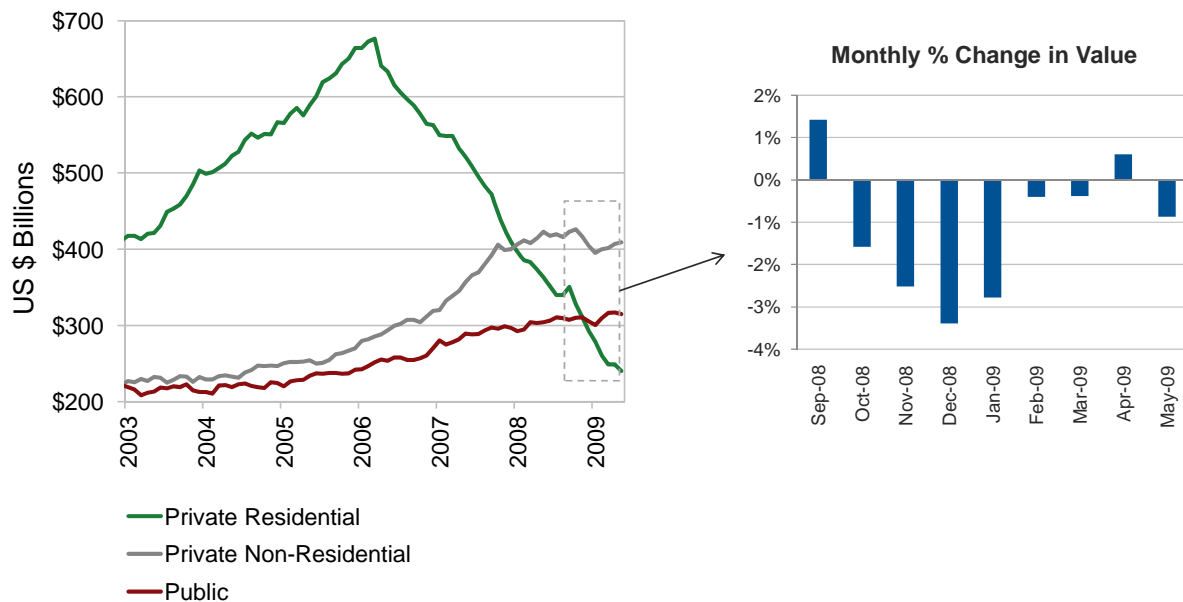
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- The 2009 projection is based on Pembroke Consulting's proprietary statistical models of wholesale distribution sector revenues.
- The overall relationship between wholesale distribution revenues and U.S. GDP is relatively strong, although growth in wholesale distribution tends to be more volatile than overall economic growth. The correlation of growth rates is 75%. See The 2009 Wholesale Distribution Economic Reports (<http://www.naw.org/wder>) for detailed calculations on the statistical relationship between GDP and the 19 major wholesale distribution sectors.

Signs of life in a depressed construction market

Value of Construction Put in Place
(Seasonally adjusted at an annual rate)



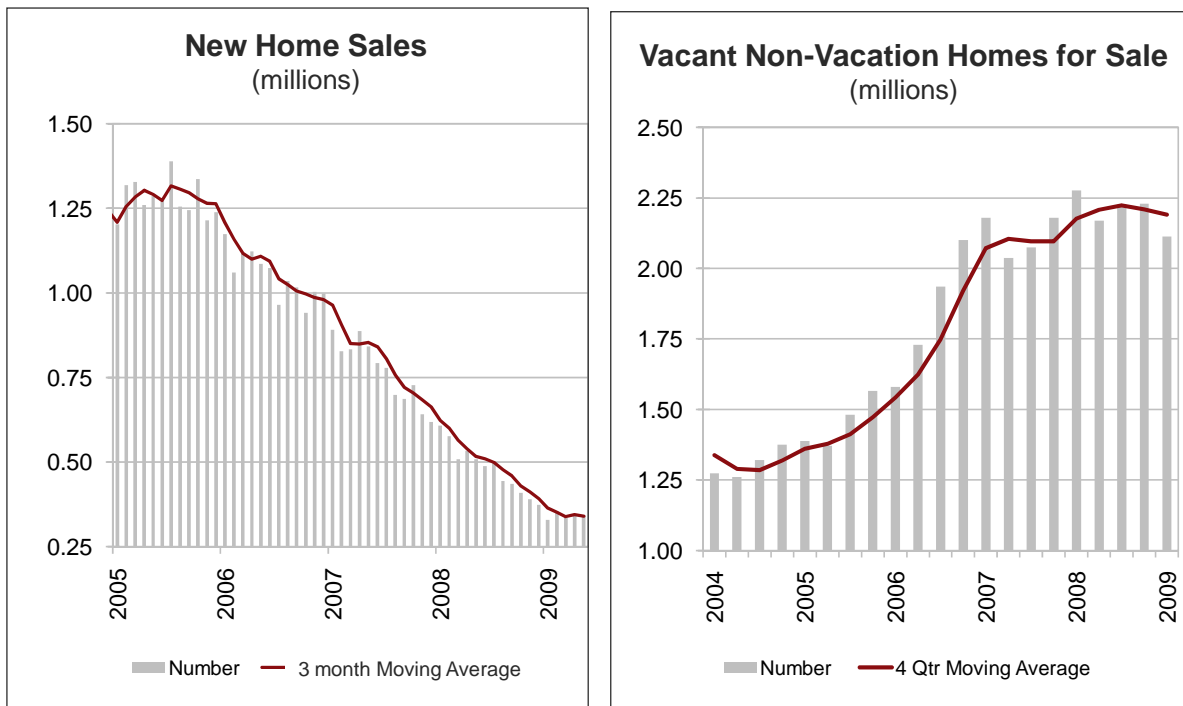
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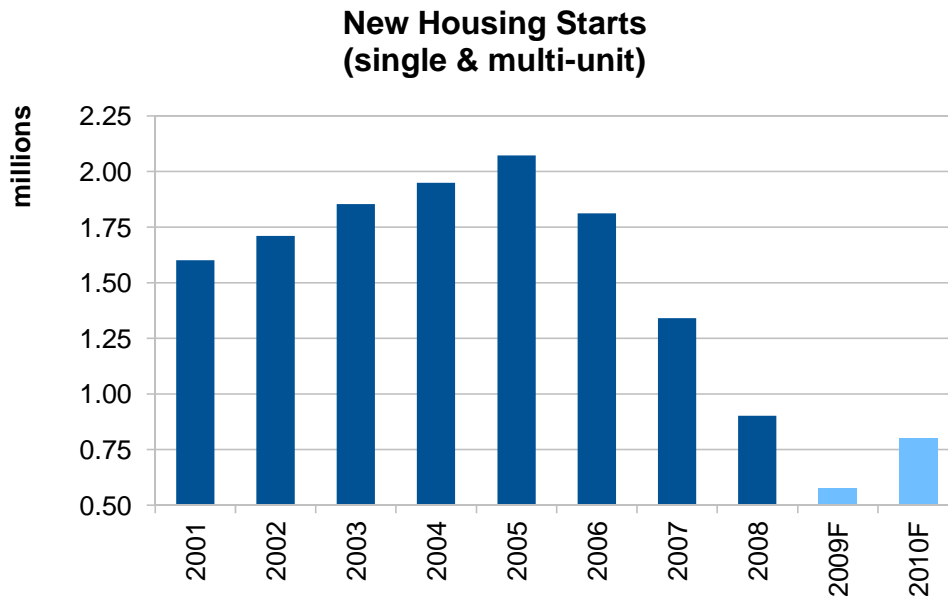
- The overall construction market is showing signs of life, although residential construction remains deeply depressed relative to the bubble years. Total construction spending in May 2009 was 0.9% below the April 2009 level and down by 11.6% since May 2008.
 - Private residential construction spending continues to decline. However, private nonresidential construction is showing the strongest growth this year, suggesting that the worst of the credit crunch may be past. This part of the construction market has grown for the past four months in a row, especially among manufacturing-related structures.
 - Public construction reflects the poor financial condition of the U.S. state finances. The effects of the stimulus bill are being felt in public construction budgets, especially through increases in street construction and transportation structures. However, most of the impact will be felt in 2010 and 2011 (see page 17).
- Note that these data series are typically subject to substantial revisions by the Census Bureau, so the month-to-month changes may be different following these revisions.

Residential housing market is stabilizing



- The market for single-family home appears to have hit bottom in January and is stabilizing, albeit at dramatically lower levels compared to just a few years ago. New home sales are at a 48 year low.
- The supply of homes still exceeds demand, resulting in vacancy rates that are far above historical averages. New homes are sitting on the market for more than 10 months before selling despite two potential supports to home sales:
 - The stimulus bill (American Recovery and Reinvestment Act of 2009) provides a first-time homebuyer credit for homes purchased by first-time buyers between January 1, 2009 and December 1, 2009. The tax credit equals 10 percent of the purchase price of a home up to \$8,000.
 - Mortgage rates remain low (below 6%) by historical standards, although the recent rise in long-term interest rates have pushed rates up by about 75 basis points in the past few weeks.
- The high vacancy rates and unprecedented number of vacant are contributing to ongoing weakness in home prices. Median home prices were \$199,700 in April 2009, down 15% compared to the same period in 2008. Sellers are also competing with distress sales in highly troubled markets in the Western U.S. Until these trends start to reverse, then home prices will not recover.

Residential construction recovery in early 2010?



- New home starts are down almost 70% from their peak. Homebuilders have sharply reduced construction, which will help to reduce vacancy rates and suggest that excess capacity should be worked down within the next two years.
- Housing demand will continue to grow in the U.S. This growth will (eventually) resolve the imbalances between supply and demand. The Harvard Joint Center for Housing Studies forecasts that U.S. household growth will average between 1.3 to 1.5 million new households per year. Over the next 10 years, Echo Boomers are entering their peak household formation years of 25–44 with more than five million more members than the baby boomers had in the 1970s, while Baby Boomers will drive growth in older households.
- Existing home sales are starting to increase, although demand is up in part due to foreclosure sales. Investors and first-time home buyers are slowly getting back into the market as prices decline, which should help the housing market reach a bottom. Mortgage rates remain low, although lending standards are tightened.

Manufacturers face a global demand collapse...

Global demand drove export-led manufacturing growth

- Computers
- Electrical equipment
- Industrial machinery

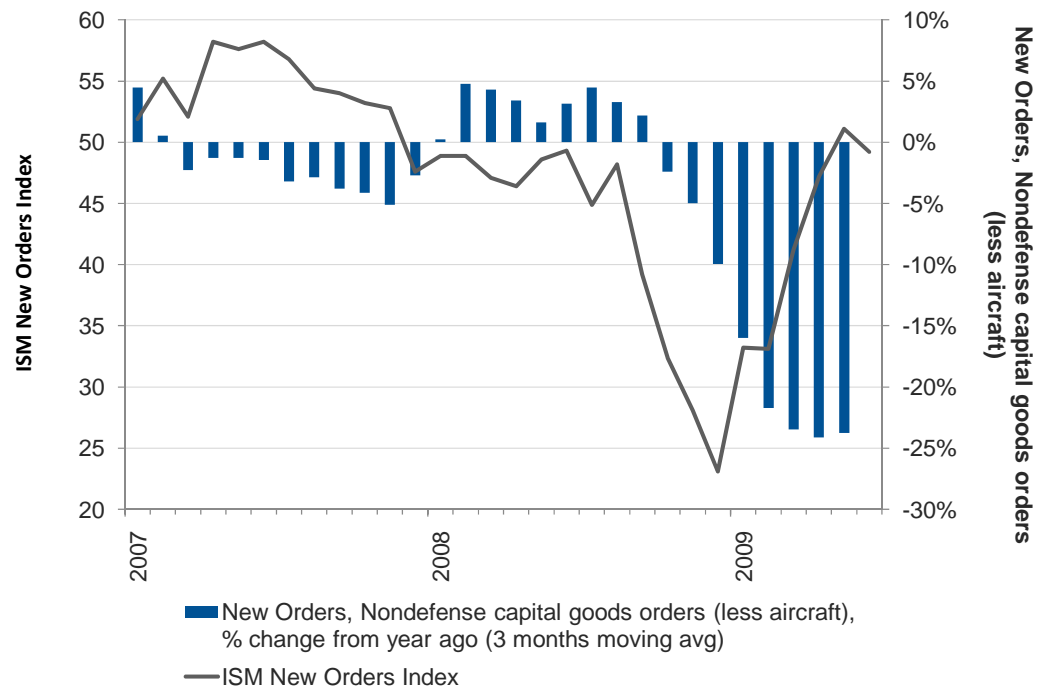
The first worldwide depression since 1930s

Vehicle sales are at their lowest level since early 1980s



- Export-oriented manufacturing sectors (Computers; Primary Metals; Electrical equipment; Industrial machinery) have grown the fastest over the past few years and are now being hit by the global nature of the downturn. World GDP is expected to decline by 2.6% in 2009, which would be the first annual decline in the post-war period. Asian markets look set to grow again first. China's economy is already starting to recover due to a massive fiscal stimulus.
- Revenues from non-export dependent manufacturers have grown more slowly or even declined in the past year. The outlook for durable goods tied to domestic demand is especially weak. Banks are less willing to make consumer installment loans and have tightened credit standards for both mortgage and non-mortgage loans.
- Vehicle sales have essentially collapsed and may have hit bottom. Car and truck sales were about 17 million per year as recently as 2005. In June 2009, vehicle sales fell to 9.6 million units on a seasonally adjusted annualized basis – the lowest level of sales in the U.S. since the 1970s. Incentives by the major automakers have stabilized sales and the three-month moving average shows a slight improvement.

... but new orders show signs of recovery.



- Like wholesaler-distributors, inventories at manufacturers built up in the last quarter of 2008. However, inventories are now fairly lean due to production cuts and new orders are showing signs of turnaround.
- Capacity utilization in manufacturing was 65.8% in April 2009, down from the 80%+ levels of 2006 and 2007. But excluding auto manufacturing, manufacturing output had the smallest decline in six months ("only" 0.4% decline). While the rate of decline has slowed, there is still substantial slack capacity.

2009 Forecasts for Wholesale Distribution Sectors

Major Sector (Fastest to Slowest Forecast Revenue Growth)	% change in revenues	
	2008 Actual	2009 Forecast Range
Pharmaceutical Wholesalers	+7.7%	+4.7% to +5.7%
Commercial Equipment and Supplies Wholesale Distributors	+5.3%	+3.7% to +4.7%
Beer, Wine and Liquor Wholesalers	+4.4%	+1.9% to +2.9%
Apparel and Piece Goods Wholesale Distributors	+3.6%	+1.8% to +2.8%
Grocery and Foodservice Wholesale Distributors	+4.6%	-0.2% to +0.8%
Chemicals and Plastics Wholesale Distributors	+9.1%	-4.1% to -3.1%
Computer Equipment and Software Wholesale Distributors	+3.6%	-7.2% to -6.2%
Miscellaneous Durable Goods Wholesale Distributors	+13.4%	-9.0% to -8.0%
Office Product Wholesalers and Paper Merchants	+4.1%	-9.4% to -8.4%
Other Consumer Products Wholesale Distributors	+6.4%	-11.5% to -10.5%
Hardware, Plumbing, and Heating Equipment/Supplies Wholesalers	-4.9%	-11.8% to -10.8%
Industrial Distributors	+9.7%	-12.8% to -11.8%
Building Material and Construction Wholesale Distributors	-8.9%	-14.1% to -13.1%
Motor Vehicles and Motor Vehicle Parts Wholesale Distributors	-9.5%	-14.7% to -13.7%
Furniture and Home Furnishing Wholesale Distributors	-7.1%	-17.7% to -16.7%
Oil and Gas Products Wholesale Distributors	+30.4%	-20.7% to -19.7%
Electrical and Electronics Wholesalers	+3.6%	-23.5% to -22.5%
Agricultural Products Wholesale Distributors	+36.6%	-30.6% to -29.6%
Metal Service Centers	+7.6%	-32.9% to -31.9%

For details behind these forecasts, see the *2009 Wholesale Distribution Economic Reports* at <http://www.naw.org/wder>.

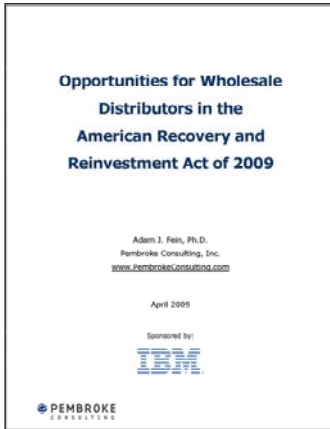


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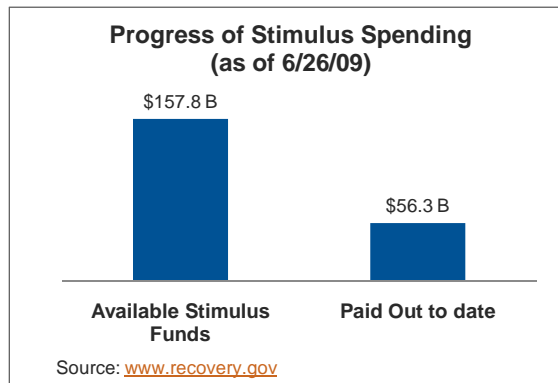
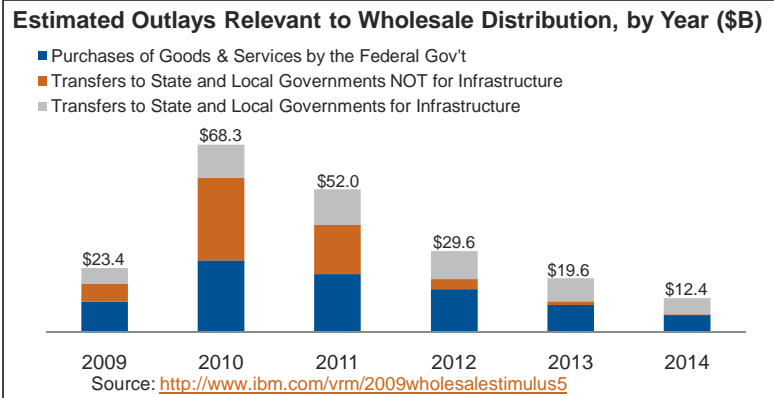
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- The 2009 projections are based on Pembroke Consulting's proprietary statistical models of wholesale distribution sector revenues.

Economic Stimulus Update: Stay Tuned



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<http://www.ibm.com/vrm/2009wholesalestimulus5>



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- *The American Recovery and Reinvestment Act (ARRA) of 2009* provides \$787 billion in spending or tax cuts from 2009 through 2019.
 - We believe that distributors and their suppliers will benefit most from the money spent directly by the federal government and the money transferred to state governments for spending. We estimate that about \$200 billion in direct and indirect spending – about one-quarter of the \$787 billion total spend from 2009 to 2019 – will impact wholesale distribution companies.
 - A much larger amount of money from the stimulus bill is being spent on social programs and transfer payments, both of which have historically limited stimulative effects.
- The timeline for many appropriations to states requires half of the funds to be obligated by September 2009. States must identify the specific uses and projects for the funds by these timelines, even though the actual funds will not be spent by this deadline. The ARRA includes provisions that require federal agencies to make funds available on an accelerated schedule. The ARRA legislation has many “use it or lose it” provisions, which means that funds are reallocated to other states if they are not obligated by the given deadline.
- Most of the outlays will be hitting in 2010, just when the economy will likely be moving into recovery. The funds with the most relevance to wholesaler-distributors will spent in the 2010 to 2012 period. In general, these funds are flowing out very slowly.

Questions to keep you up at night

Do consumer saving rates signal a thrifty future?

What are the downsides to the fast recovery scenario?

Will the stimulus trigger inflation?

What is the risk that we will “monetize” our debt?

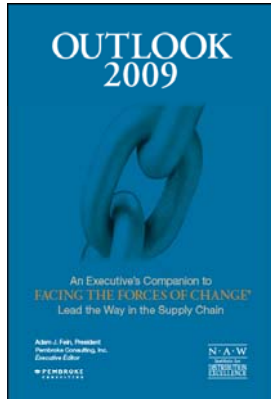
Will the value of U.S. dollar collapse?

- The personal savings rate is now about 6%, compared to an essentially zero savings rate one year ago. Households are trying to rebuild their shattered balance sheets, which continues to dampen consumer spending.
- Right now, there are still substantial deflationary risks given the very weak employment market, low levels of manufacturing capacity utilization, and other sources of slack in the economy. Businesses lack pricing pressure, containing inflationary pressures.
- Government spending as a share of GDP has now climbed to levels not seen in more than 60 years. According to the Office of Management and Budget (OMB), government spending is approaching 30 percent of GDP compared to the 18% to 22% levels of the past 25 years. The U.S. has borrowed unprecedented amounts of money while not tackling the enormous unfunded liabilities associated with Social Security and Medicare. The U.S. could raise taxes to try to pay down the debt, but the cost to economic growth could be significant and therefore ultimately self-defeating.
- As a result, there now is a credible inflationary growth scenario developing. High inflation would allow the U.S. to more easily pay its debt with future dollars that are worth less than today's dollars. In this scenario, our creditors – foreign and domestic buyers of government debt – will require higher interest rates to compensate them for this inflationary risk. The majority of the stimulus dollars will be hitting the economy in 2010 and 2011, adding more money and growth to a recovering economy. The value of the dollar will drop, increasing the dollar cost of imported products such as oil and other major commodities. As Warren Buffett recently noted regarding the U.S. debt: "My guess is the ultimate price will be paid by a shrinkage of the value of the dollar."

Additional Resources

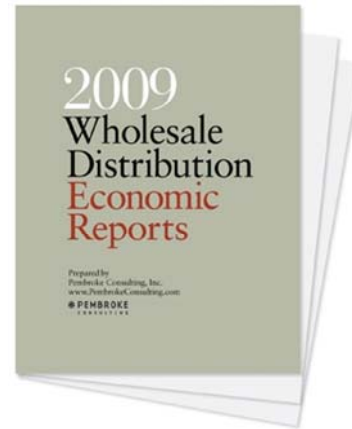
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