2015 Mid-Year Economic Update

An MDM Webcast transcript, featuring:

- Thomas P. Gale, Publisher, *Modern Distribution Management*
- Brian Lewandowski, Associate Director, Business Research Division, Leeds School of Business, University of Colorado Boulder

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This is the full transcript of the MDM Webcast "2015 Mid-Year Economic Update" from June 2015.

The Webcast presentation slides are included at the end of this transcript.

Tom Gale: Welcome, and thank you for joining us for today's MDM webcast, the 2015 Mid-Year Economic Update. Our 60-minute program today is sponsored by Epicor. My name's Tom Gale, publisher of Modern Distribution Management newsletter and the website mdm.com. I have the pleasure of moderating today's program.

Halfway through 2015 the turbulence and uncertainty that's defined the long, slow climb out of recession continues to dog the U.S. economy and with it most wholesale distribution sectors. At the same time wholesale distribution continues to outperform the overall economy on a year-to-year basis. It seems like good news/bad news has become the pattern the last three years, and, as always, it's wise to let the data drive the discussion.

Today we're going to spend most of our time together to review a snapshot of current macroeconomic conditions in end-market sectors. We'll then take a brief look at the economic trends and forecasts taking place for distribution sectors with an overview of our just-released 2015 Economic Benchmarks for Wholesale Distribution report. This is the eighth year that Modern Distribution Management has produced an economic forecast as part of our webcast programming schedule, and each year in addition to a macro outlook we've also provided a deeper look at the annual benchmarking data published exclusively by MDM.

This 2015 Economic Benchmarks for Wholesale Distribution is a comprehensive economic reference guide to the U.S. wholesale distribution industry broken out by 18 major sector reports, each with deeper sub-sector analysis. This is, in fact, the 10th edition of this report, formerly known as the Wholesale Distribution Economic Trends Report. It's published by MDM in connection with the business research division of the Leeds School of Business at the University of Colorado Boulder.

Brian Lewandowski, our speaker today, is the lead author and analyst for the report. Each sector report includes trends, quarterly and annual trend data, including benchmarks by sector and sub-sector

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for revenues, inventories, employment, gross margin and more. We'll take a deeper look at this after our macroeconomic presentation.

I'm delighted to introduce our speaker today. Brian Lewandowski is associate director at the business research division of the Leeds School of Business at the University of Colorado Boulder. He is a Leeds MBA and has worked at CU Boulder since 2006, working on economic forecasts, econometric models and market research and real estate studies. Brian has a background in banking, international development, mining and tourism working for Fortune 500 companies.

Brian Lewandowski: Thanks, Tom, for the introduction. Tom started out by describing the economic story as a good news/bad news story, and I think that's so true, especially when you see these economic indicators that are released almost every day.

Some of them are good and some of them are dismal, and what I'm going to share with you today is a story that strings a lot of economic indicators together, and I'm going to argue that the U.S. economy is on a fairly good footing right now with some risks that remain out there, and I'll acknowledge those as I go through this discussion.

Lewandowski: So I was asked to discuss the economy now that we're midway through 2015. As I go through this I will relate it to wholesale distribution and some of the important industries that I think are really a focus right now in the U.S. economy, be it oil and gas or construction or the agricultural industries, especially oil and gas and agriculture that are so heavily impacted by commodity prices, and the housing market, which is really showing some strength in select segments of the U.S. economy.

The context for some of this is the 2015 Wholesale Distribution Economic Trends report. I've been doing this statistical and analytical exercise for MDM for about the past five or six years, updating their annual book for them, and I update this with foundational data from the Bureau of Economic Analysis, the Bureau of Labor Statistics and the U.S. Census Bureau, correlating factors that come out of those bureaus with other macroeconomic indicators, albeit GDP or the ISM indices or retail sales or housing data, so this presentation includes data from multiple sources, and I've noted at the bottom left of each slide the source of the data. Most of this is publicly available information. You can go and search for it on your own if you wish.

The Wholesale Distribution Economic Trends report provides revenue, inventory, employment and other metrics on 19 industry sectors. They're all wholesale industry sectors. More than half of the industry revenue and 37 percent of industry employment is concentrated in only one-fourth of the sectors, including oil and gas, grocery and food service, electrical and electronic wholesalers, pharmaceutical wholesalers and industrial distributors.

Even though it's a 19-sector industry a lot of the activity is concentrated in just a few sectors. Overall we're seeing the industry in an expansionary phase, with 2014 marking the fifth consecutive year of growth since a pullback during the recession, and growth accelerated in 2014. We saw a little bit of slower growth in 2013 with the acceleration in 2014 to 4.3 percent for wholesale trade overall, and then when we strip off some of the volatile industries due to commodity prices, so that's excluding agriculture and oil and gas, we saw a 6.1 percent growth for those core industries.

The industry recorded more than $5.5 trillion in revenue in 2014, just a phenomenal number. Expectations as we look forward. Our model forecasts 6.1 percent growth for 2015 and 7.8 percent growth for 2016 for the sector. Of course these growth projections don't come without exceptions. We're seeing that growth could be derailed by macroeconomic events, which I'll talk about a little bit later in this, but I think one of those factors is the slower growth that we saw in the U.S. in 1Q, which I expect to be revised up, but also a slower-growing international economy, which can impact exports, which are notably important to manufacturing and wholesale.

So here are the 19 sectors' revenue that we saw in 2014, and, in fact, this data's released on a monthly basis, and I see that there was a little bit of revision to the 2014 numbers. We produced this with data as of March.

Oil and gas is the largest sector by revenue, and furniture and home furnishings is the smallest revenue sector according to the 2014 data. The annual revenue growth in 2014 was recorded in 16 of the 19 sectors in nominal terms or today's dollars, current dollars, but when accounting for inflation 17 of the sectors grew in 2014.

Prices were a much smaller factor overall in 2014 than the year prior. It's almost an opposite impact as prices fell in these commodity sectors, so oil and gas prices fell about 50 percent, but that fall didn't happen until about June or July year-over-year is when we saw prices started to top, and so they fell by 0.1 percent or so in June, but that fall precipitated very quickly, and by December or January we were down about 50 percent year-over-year.

So the largest price adjustment was negative 13 percent in the agricultural products wholesale sector, and again this is because of changing commodity prices. As far as comparing revenue or sales compared to the pre-recession levels, revenue is back for 14 of the wholesale distribution sectors.

For 2015 we're looking at nominal revenue growth in all but three sectors. We see three declining in 2015, and in 2016 we're projecting nominal revenue growth in all sectors, except we see some softer growth in a few of the sectors, which I'll point to a little bit later on. So on to some more of the macroeconomic indicators.

This is the GDP and potential GDP chart, so the GDP numbers are current in here. Potential GDP I collect from the Congressional Budget Office. They're a non-partisan office that's really charged with providing an economic forecast every year as well as a budget forecast. And you can see that there was a GDP gap that started back during the recession, and this is basically saying that we have excess capacity in the market. We're not at our full potential output. We're below full employment, below full production.

And what's interesting looking at this chart now is this data shows that we've worked through about 90 or 91 percent of this gap, so we only have about 10 percent of it left. We should completely close this gap by the end of 2016 or early in 2017, but I show this because it demonstrates that we still have some excess capacity left in the market. I think that this is demonstrated by the employment.

Even though we've rebounded to our pre-recession levels for employment we have high unemployment within some of the age cohorts and educational cohorts within this country, so our lower age groups have high unemployment rates that are still nearly double-digit even though unemployment is down to about 5 1/2 percent overall.

We see people on the sidelines with a lower labor participation rate than we've seen in decades, and we see some of our industrial sectors operating a little bit below peak. So that being said there is still excess capacity. This demonstrates that we're not quite overheating yet, but that gap is closing.

So when we look at real GDP growth this shows the quarterly GDP growth from 1990 forward with projections for 2016. This is from the National Association of Business Economics, and the historical data's all from the Bureau of Economic Analysis. When you look at the annualized growth over the last few decades in the 1990s we average 3.4 percent growth. In the 2000s that was dropped down to about 1.7 percent. Definitely the recession really drug that number down.

And in the 2010s we've averaged about 2.2 percent growth. I think what's interesting when looking at GDP growth and forecasts is there is this broad expectation that next year is going to be our breakout year, and we've had that broad expectation for about five or six years now. Just as we were exiting the recession the consensus forecast called for three to four percent growth next year, and then once that year came to fruition it got revised down to the two percent range, and they would move that three percent breakout year out one more year.

Even this year – it was late 2014, even early 2015, and economists were calling for three-plus percent growth this year and in 2016. The March consensus forecasts report, which aggregates forecasts from I think 32 or 36 agencies like JP Morgan and Wells Fargo, they have some universities in there, they were calling for three-plus percent growth, and only 19 percent of the forecasting agencies were calling for sub-three percent growth.

That was in March, and by June when the report came out there wasn't a single forecast in there for three percent growth for 2015. So again it was pushed out another year to 2016, and even 2016 now the forecasts are for sub-three percent growth. So these expectations of a breakout year are setting in that we may not have one, that we may be living in this new environment of two to three percent growth, but three to four percent growth won't be achieved, and I think a lot of that was deflated after the Q1 GDP report came out showing minus 0.7 percent growth.

While I think there are expectations that Q1 will be revised up and Q2 will show a strong number, it's showing that we are in this slower growth environment, and even if you look back over the past few years GDP growth in Q1 has been somewhat of a dismal number, so this also calls into question the seasonal adjustments that they perform.

My story revolves around three main things, so if we take a look at employment, personal income and GDP growth, and then also with that employment and personal income is consumption. So how is the consumer doing overall, and how is country growth doing overall? When we take a look at the national employment slide that's in front of you right now this shows employment from 2000 to 2016, and the recession is very much apparent on here. We were losing 800,000-plus jobs per month at the depth of the recession, and overall we lost about 6.3 percent of total employment.

Then there was this expectation that we were going to have this snapback in employment. In 2010 we averaged 88,000 jobs each month for growth. In 2011 that accelerated to 174,000 jobs, in 2012 186,000, then 194,000, then in 2014 we actually averaged 260,000 jobs per month, which is a pretty good clip. In 2015 so far for the first five months we've averaged 217,000 jobs per month, and for the same period in 2014 we were at 229,000, so maybe our job growth is starting to level off as we absorb the excess labor capacity. I mentioned that we're down to a 5 1/2 percent unemployment rate, and we're starting to see people come off the sidelines and re-enter the labor markets.

But this shows the recovery from the last six recessions, and it becomes pretty clear that the last two, the 2001 recession and the 2008 recession, really took the longest to recover. So this goes back to 1980. The 2008 recession was our deepest and longest employment recession post the Great Depression. It took 75 months to recover jobs lost during the recession, and now we're 2.4 percent above the previous peak, so it looks like we're finally gaining some momentum. We're above where we were pre-recession, but when we take a look at the recoveries – so this is the same slide, but it extends out all of the previous recessions to 88 months, because that's where we are from peak to current in this current cycle. Every recovery was better than this recovery, and if you take a look at this over time it looks like our recoveries are not as strong with every recession.

And in fact if you take a look at the 2001 recession, the employment recovery, it had already started to turn by this point, so we've sustained employment growth for a long period of time, but I think there's some headwinds on the horizon that we need to be aware of. I think it's also important to note that the employment recovery hasn't been broadly shared everywhere. Employment has increased everywhere, but not every state has returned to pre-recession levels.

In fact only about 32 states have recovered the jobs lost during the recession. States like Texas, North Dakota, Colorado and Utah have all outperformed the U.S. while others have lagged in the recovery. And so when we take a look at places like Alabama and Missouri and Nevada and Arizona those are places that are still struggling to recoup the job losses. So our unemployment rate peaked at 10 percent following the recession. We're down to 5 1/2 percent now, but another number that you may hear sometimes in the media is this labor utilization rate.

We refer to it as the U6 unemployment rate, and it's really showing people that are working under their capacity, so maybe they've taken a part-time job or they've taken a job that's below their skill level or their wage level, and it shows that this number reached 17.1 percent at the peak of the employment crisis, and now we're down to 10.8 percent, so we're working through it, but if you draw a horizontal line across this chart you're going to see that we're definitely much higher in this category than we have been at least over the past 20 years.

And I think it's also important to note that the unemployment rate among our youth – I mentioned this at the beginning – and among our lower-educated workforce, so people who didn't complete high school or earned a high school diploma but haven't gone on for additional training – the unemployment rates are really highest in those two cohorts.

The initial unemployment claims and the continuing claims. So this is a fairly good story. We're actually below our long-term trend right now for initial and continuing claims. I think I had to go back to late '99 or early 2000. Remember how the economy was heating up during that period with the tech boom that we were experiencing. That was the last time we had numbers as low as what we're seeing right now for unemployment claims, which I think is another metric just showing the health of the labor market.

When we relate this back to the wholesale distribution sector 80 percent of this industry employment is isolated with firms with 20 or fewer employees, so this is very much a small business sector. In 2014 the greatest employment gains were in building materials and in oil and gas. We think that we'll see that change a little bit in 2015, especially on the oil and gas side. Over a longer view the greatest sustained gains have been in metal service centers, alcohol distributors, industrial distributors.

Only office product wholesalers have been flat over the past five years. So this is taking a look at

five-year growth, and we've really shown pretty substantial employment gains, but when we take a look at this from the pre-recession peak to current levels only four sectors have regained total employment. So these are, again, your alcohol distributors, apparel wholesalers, industrial distributors, motor vehicle after-market parts and supplies wholesalers.

ALl of these other sectors are operating below the pre-recession peak, but I showed you at the beginning how many sectors have recouped sales or revenues from pre-recession levels, and this really points to productivity changes, increases, so employees are doing a lot more with fewer labor resources than they ever have been within this sector. So turning back to the consumer again, if we take a look at household wealth we've recovered the total household wealth that is measured by the Federal Reserve Board. This is in the balance sheet of households and nonprofit organizations.

For a long time we saw real estate holding back the total household wealth, and now we've seen real estate prices start to rise. Our financial assets are the ones that have really rebounded, though. It's extremely notable when we take a look at the stock market. This is the S&P 500. S&P 500 lost about 57 percent of its value during the recession, but post-recession now we're up 210 percent. That's just a phenomenal number. This is 20.7 percent compound annual growth from the trough in 2009 to current, but if we take a look at year-over-year growth we're up about eight percent, so there's maybe some suggestion there that the S&P or the stock market is starting to level off a little bit, and perhaps this could be somewhat related to Fed policy and the expectation of rising interest rates, which would impact asset valuations for our corporate entities in the U.S. But the consumers are definitely feeling better.

I mentioned how employment is up to all-time record levels. Personal income has rebounded to record levels. The Labor Department released their QCW data yesterday, and it shows that the average annual pay in the U.S. increased 3.1 percent last year, which is the fastest rate that we've seen since 2007, and that's faster than the rate of inflation, so we're seeing on average employees actually start to be better off, and the consumer's just feeling better about that.

And one way that we can measure that, one way we can study that is taking a look at the Consumer Confidence Index. Right now the index is at the highest level since about 2007, so about our pre-recession era, and that's really important because it impacts how consumers save and spend. Are they going to part with those dollars, or are they going to hold onto them because they're worried about the state of the economy? And when we take a look at personal consumption this chart shows disposable personal income and personal consumption. We see that incomes have been rising. In fact the forecast for 2015 is for 3.4 percent growth in disposable personal income. The forecasts for personal consumption are 2.9 percent in 2015 and 2016. So we're seeing slightly faster growth rates in personal consumption, and I think that really has to do with a more confident consumer reading a more stable labor market, feeling better in their place in this world, if you will.

As consumers start to part with their dollars we can measure this in a couple of areas. Taking a look at vehicle sales, this is a metric that really profoundly dropped in 2008, 2009 to the point that we saw the government step in if you remember the Cash for Clunkers program, if you remember the bailout to the auto industry. The auto industry is such an important manufacturing industry in the U.S. because they buy so much from other manufacturers, other suppliers in the U.S., so we refer to this as the multiplier effect. As Americans decreased their purchasing of vehicles that really had a multiplier effect through a lot of manufacturing industries within the U.S.

We went from averaging about 16,000, almost 17,000 vehicle sales per year down in the nine million range, so that's a pretty steep drop. The spike that you see in 2009 is Cash for Clunkers. You see that it didn't really take us out of bounds of our trend line, but now we're back to that 17 million range, and 17 million is the number that we saw – about 16.8 million was the average from 2002 through 2007, so that's what we're back to right now. And if we take a look at retail and food services sales you can also quickly see how steeply the decline was for retail, but that one actually snapped back really quickly.

AS of 2015 we're seeing pretty slow growth in retail and food services sales, and I've read a couple of studies on this, a couple of articles on this, and they suggest that it's not really a problem, but consumers haven't really been parting with their dollars to the same extent over the past four or five months. Household tab deleveraged. In fact our debt service ratio and the financial obligations ratio – the difference between these two – the financial obligations ratio takes into account even the money that we pay out for rent, so it's what our monthly obligations are as a percentage of disposable personal income.

This chart goes back to 1992, and it shows that we're below 1992 levels for both of these metrics. We

saw an uptick in late 2012, early 2013, but then that again reverted to this slow decline. So what is this? A lot of this is the deleveraging during the recession; perhaps a fourth deleveraging where people were foreclosed on. So, that wiped their mortgage liability off their personal balance sheets.

Part of that was people taking advantage of the low interest rate environment, and refinancing their homes. But, we should see a turn in this number soon. We have seen that revolving credit has been increasing over the past six quarter or so, and now we're also seeing mortgage credit start to increase over the past couple of quarters. So, I would expect that this debt service ratio, the financial obligations ratio will start to increase soon.

But, home prices, I think, are one area where there's kind of a good story here and a bad story here. The good story is that these asset values are coming back. I live just outside of Denver. Denver has been really the hottest appreciation market over the past year if you look at the S&P/Case-Shiller Home Price Index, but if you take a look at the top five here, Denver, San Francisco, Miami, Dallas, even Seattle and Portland, these are the types of growth rates that are reminiscent of the 2004 to 2007 era. We're just seeing extremely fast, unsustainable growth rates in home values. I think that this is something that has the potential to slow some of these individual markets.

As Denver becomes an expensive housing market, that should naturally slow employment growth and neighbor growth in some of these markets. But, there's debate about if home prices are starting to overheat in some of these markets. We're definitely seeing rents at record high levels within the Denver region.

A more broader view; while the S&P/Case-Shiller shows the 20 largest metropolitan areas, the Federal Housing Finance Agency shows this for all metropolitan areas in the U.S. Kind of like the labor slides that I showed at the beginning, the home appreciation that we're seeing nationally isn't shared equally everywhere. You can see the hottest states are the dark blue states; so, Texas, Colorado, California, Nevada, Alaska, Washington, while the slowest growth states are Arkansas, Missouri, New Mexico, West Virginia. So, I think that's something to just be cognizant of is that this overall recovery, while it's fairly broad, there are some places that are still struggling to get back to where we were pre-recession.

As these home prices increase – the downside of this is our housing affordability. We reached this peak in affordability back in 2012 and now we've witnessed some pretty steep declines in housing affordability. Not only is that painful for some of the consumers within these markets, but I think it does pose a risk to economic growth within some of these markets because you start to price people out of your labor market or your employment market.

Housing supply – we saw a pretty profound buildup of single family homes for sale just prior to the recession, and builders quickly responded. We see the inventory, the gray bars here, the gray shaded area. The inventory came down very quickly, and in 2012, we hit our trough. We started to rebuilt that inventory of homes in 2013, but it's somewhat leveled off as of 2015. The months of supply also came down very steeply. Even though we've started to rebuild than inventory, the months of supply have stayed about constant there. So, we had this delayed household formation stemming from the recession. People couldn't afford to go out and build their own household. We hear stories of students living with their parents post-graduation and what not. We're at a point now where people can go out and start their own households.

This inventory hasn't built up very quickly because consumers are buying those houses as they come on the market. So, that's keeping the months of supply low, and it's also keeping the inventory of homes low. The other problem is we have a shortage of capacity to build a large stock of housing units. We saw the construction industry get hit very hard during the recession. Employment demand HAS pulled back about 26-percent. This chart is showing year-over-year growth.

Now, while we are building construction jobs year-over-year right now, we're still below our pre-recession peak by about 16-percent or so. Where did those construction workers go is a question that we often get asked. There's some indication that some of these workers went to the oil and gas industry, which was one of the first industries to recover from the recession. There are some transferrable skills there. We know that other workers within this industry completely left the occupation. Maybe some retired.

Maybe some are self-employed now. So, they're not showing up within this data. But, the shortage of workers I think is holding back capacity for homebuilding, and it's also driving up wages. This is one of the fastest growing wage industries in the U.S. right now. We're told anecdotally that some major builders are having issues retaining workers where an entire sheetrock group will be lured away to another

company. So, they're left without sheetrockers or without welders. So, they're having to pay those workers more to retain them. The skills training that takes place on the job takes a fairly considerable amount of time to rebuild that workforce.

U.S. building permits – this year, we were at just over a million building permits. If you take a look at the long-term average in the U.S. it's about 1.5 million units. During the peak of the housing boom, pre-recession, we were at 2 million, or just over 2 million units a year, which is a pretty phenomenal number that I think most economists don't believe we'll ever get back to. But, housing starts is a number that is smaller than building permits. So, someone is issued a building permit. They may or may not actually start that home.

The forecast for housing starts for 2015 are just over a million units. For 2016, they're looking at about 1.25 million units. The green line on this shows the mix of multifamily to single family, this ratio over time. Except for a spike that we saw just before 2009, we're at very high levels of multifamily housing as a ratio of multifamily to total housing. So, I already mentioned what the national housing starts are expected to be.

Moving onto the manufacturing industry, the Institute for Supply Management has their monthly index that they put out there. The ISM manufacturing index is about 52-53 right now. It's an uptick from the last two months that were starting to approach the 50 mark, or the neutral mark. So in essence, above 50 is expansionary; below 50 is contractionary for the industry. So, why has this number been lower over the past few months? I think that there's a couple of reasons for this. One of them can be the stronger dollar. That makes U.S. goods more expensive. It's driving down our exports, especially to some of the European markets, but the good news here is that our non-manufacturing index is staying pretty strong.

Our export of services is an area where we run a surplus on a monthly basis and is becoming a larger and larger part of our export market. I mentioned the broad dollar index. So, our currency has strengthened against the basket of other currencies. Back in 2009, a lot of this was because of the Safe Haven status during the global recession. Now we're seeing it strengthen because the U.S. economy is actually outperforming many other economies, especially Eastern and Western European economies. Maybe we're not growing quite as fast as some of the Asian markets, but we're still doing relatively well from the global standpoint.

The right chart on this page is showing that it's starting to impact our real net exports. The forecast for that deficit is expected to get greater over the next couple of years. Relating back to the wholesale distribution industry, when we take a look at the nominal inventory value, the scale on the left hand side starts at $350 billion and goes up to $550 billion. So, it's a little bit deceptive because I adjusted the axis there, but what I wanted to show you is just how steady and profound the growth has been in inventory values.

When we take a look at the right chart, the inventory-to-sales ratio, this is actually an area where I think we're getting a little bit uncomfortably high for the wholesale distribution industry. This is a number that has rebounded to levels that we didn't see since the recession started. I think this is a metric for people in your industry to watch. If inventories continue to build, it'll have impacts upstream for your suppliers because you'll be buying less from those suppliers, and it could be some sort of indication that this buildup of inventory is a reflection of a softer, broader economy for some reason that's not showing up elsewhere yet.

A question that we get asked is, what's the Fed going to do and how will it impact our economy? The Fed grew the balance sheet to about $4.5 trillion. A lot of this they were buying mortgage-backed securities. They were doing this at a rate of I think it was $30 billion or $40 billion a month. If you look closely at this chart, there is an inflexion point there from a few months ago. We're below peak for the Treasury balance sheet.

The discussion now is that the Fed will begin to raise interest rates. They do that by selling some of these securities, and reeling in that cash, making the money supply a little bit tighter. But, I think the expectation is that the increase will be small and the increase will be slow. I think there's a good article in "The Economist" that came out yesterday. It's called "Better Than It Looks," and it has a good summary of this discussion, the difference between the financial markets and households. I think the risk here is that as you raise interest rates, it will deflate some of these asset values, the financial markets, but also it could slow home appreciation rates and make housing a little bit more expensive from the standpoint that more of your monthly payment goes to interest rather than principle. So, it decreases the purchasing

power of the consumer when it comes to buying homes.

But, this particular article talks about how it affects Main Street more than it affects the financial markets. So, I think it's a good one to read. If we take a look at the interest rate over the past 15 years, the three-month T-bill, the short-term interest rates have pretty much been zero. That's why you say, how much can they raise interest rates if it's 25 basis points or 50 basis points? We're still at historically very low interest rates for the short-term. The short-term rate does affect the long-term rates, but it doesn't set the long-term rates, but we do see a correlation there and long-term rates would start to rise at least to some marginal extent.

So lastly, what I'm going to close out with is talking about oil prices and commodity prices in general. Over the past five years, we've seen a really profound oil and gas boom in the U.S. It's mostly on the oil side. We've produced more oil than we ever have in our history. With that, we've seen our commercial crude oil storage increase really dramatically. This chart shows inventories, excluding our strategic petroleum reserves. This number peaked a couple of months ago. And so, now these inventories have started to come down a little bit.

The inventories are coming down partially as a response by oil producers, maybe the slow down drilling or not backfill with new production. But, we're still at these historically very high levels of inventory. A lot of this has to do with the geopolitical environment, what happens with OPEC setting production, they deciding leave production as is. So, there's software global demand for oil. As a result of that, our oil inventories have increased.

So, what's happened with oil prices? When we take a look at June 8, 2015, the price was $58 a barrel for West Texas intermediary. When we take a look at a year ago, it was $105 per barrel. So, this chart shows the last 11 years, and we're well below our average over that time period. But, there has been an increase over the past couple of months.

The forecast thought – if we take a look at the Energy Information Administration, their forecast still shows fairly low oil prices in 2015 and 2016. I also pulled the forecast from Moody's Analytics and they're a little bit more bullish, but still shows that we don't get back to that $100 a barrel mark at least through the medium-term horizon, through 2020-2021.

It's a different price environment, and that impacts what the oil and gas companies do. Partially, it makes drilling less feasible in certain areas. So, where the rock is a little bit harder, where the resources are a little bit deeper, where the political environment is a little bit tougher, it just costs more to do business in those areas. So, those potential wells become off limits. So, that's one way that price restricts drilling. But, as we see prices rebound, more and more of those wells have the potential. Those wells have the potential to come back online.

I showed you the oil price forecast, but here's the natural gas, the Henry Hub Natural Gas stock price. I think this gets talked about less, but I think it's equally important. The prices here as of June 5th, these are the weekly averages, $2.65 for the June 5 number; $4.61 for June 6, 2014. So again, they're nearly cut in half, not quite as dramatic, but well below the ten-year average and well below even the five-year average.

This lower price environment is a little bit more familiar to gas prices than it has been to the oil producers. But, the flipside to that, we've seen oil and gas extraction jobs start to come down. We've seen the rig count come down nationally if you take a look at the Baker Hughes rig count. There's a lot of indicators that we can look at. So, if you drew four lines, and the first line was oil prices and the second line was industry rig count, the third line is employment, and the fourth line is production, it's really interesting to see the lag effect within the industry. So, prices started to fall, I mentioned, that summer.

We didn't see the rig count start to fall until some period after that. I think it was about four months later, and it's followed a similar trajectory. And then, we started to see employment churn a couple of months later, but production has remained stable. I think a lot of that has to do with the technology and the capacity of the existing wells. So, while prices are down and value is down, we've seen production hold fairly stable, but the lag effect definitely has started to impact employment. That's an industry like the auto industry that I mentioned. The oil and gas industry is one that has a pretty has vast supply chain where they're buying goods and services from a lot of other companies domestically.

And so, as the prices got softer, employment within support activity started to decrease first. Contractors were the first to let go, and then some of those more discretionary purchases from the industry were cut back. And so, that's something to be cognizant of is that supply chain, that deep supply chain that

goes into the industry is softer than it was.

But, what's the benefit of lower oil prices and lower gas prices, natural gas prices? There is a benefit, and that benefit is to consumers and even to businesses. So to consumers, the way that we notice it most often, most in our face is through lower gasoline prices. Prices as of June 15 averaged $2.92 in this country. A year ago they were $3.76. While we got down near the $2 mark, these prices have come back pretty strongly. These prices impact inflation. If you take a look at overall inflation, it's been extremely flat in this country, even negative some months because of these commodity prices, because we're paying so much less for gasoline.

If you take a look at core inflation, that's at a somewhat more expected level, between one-percent and two-percent. The cost of shelter has increased faster than core inflation, and then overall inflation. So, that relates back to housing prices and rents. So, gasoline prices have been a benefit to consumers; some heating. If you have heating oil in your home, that's been a benefit. Natural gas is more of a lag effect as the contracts go with the utilities, but that's been a benefit to consumers. So, I think from that standpoint, there's a little bit of an offset, and there's papers out there that show that overall lower oil prices are at a net benefit to economic growth.

Some papers dispute that. There's one paper from the Dallas Fed that shows state-by-state which states are winners and which states are losers with the lower oil prices. So with that, I'll just close by saying that – just to summarize; I do think we see that the U.S. economy is on a much firmer footing. Some of the headwinds include global economic growth and Fed policy, how that could impact sustained growth in this country, and I think also just realizing that while growth has been fairly good, it's not necessarily shared everywhere.

We are in a slower growth environment where 2 percent to 3 percent GDP growth is definitely the norm; 3 percent to 4 percent looks to be history, and I'll turn it back to Tom.

Gale: Well, thank you very much, Brian, for that analysis of the three key areas that you addressed and also the individual sectors, and especially for the oil gas.

Just anecdotally to add what you said, in the past two months, I've been hearing from a lot of diverse wholesale distribution sectors the story of just how unexpected the depth of the impact, and you talked about that multiplier effect.

I've just heard repeatedly that many distributors didn't expect the depth of the impact on revenues of the oil and gas downturn. I'm not sure the illustration that you have up there is, "Red at night, sailor's delight or red in the morning, sailor's warning," but based on what you say, there could be a little bit of both going forward. I just wanted to take a brief minute to talk about the forecast.

You addressed a lot of the key points that we capture in the economic benchmarks in the annual report. We pulled out four sectors here out of the 19 that you mentioned in terms of the first column being the 2014 actual revenue and then a 2015 and 2016 forecast for each of those. When we look at the overall combined, the total wholesale distribution industry, the actual percent change in revenue versus the previous year was just over 5-percent, 5.1-percent.

The 2015 forecast you come up for all sectors combined is about 6.1-percent and then for 2016, 7.8-percent. So, it looks like the overall forecast for the industry is generally a little bit better for 2015, and then strengthening even more so in 2016. I guess my question is – it's just relating back to your discussion around overall GDP where you're saying that expectations really got whacked back from that five-percent range year-to-year to more of a sub-three-percent growth looking for this year and next year. Are the forecasts for wholesale distribution versus GDP essentially that wholesale distribution will continue to outpace the overall economy?

Lewandowski: Yeah, that's what we're seeing right now. When I talked about the GDP numbers, we're talking about real GDP. So, these strip out price inflation numbers.

The numbers that you have up on the slide right now are showing nominal industry growth. So, the report that NPM publishes has numbers in both nominal and real terms. But what we see here in oil and gas for instance, the change in oil and gas revenue is really driven by a change in prices.

The 2015 forecast, the minus 22-percent, that's mostly price-driven and then the expectation is that as prices stabilize a little bit higher in 2016 that there's a rebound. The 2016 number reflects both real industry growth, and it reflects the price adjustment.

Gale: Great. Thank you. I do have another question here related to your discussion of GDP. Somebody was asking that aerospace and medical manufacturing in the U.S. are also key industries. How do they impact the GDP in relation to the automotive sector that you said was so important?

Lewandowski: Yeah, and I think healthcare especially is just a very comfortable industry. It's one that somewhat bucked the trend during the recession, at least in terms of employment where we can always count on healthcare to be adding jobs.

In terms of GDP, it's also grown really at a stable rate over the past five years. So, I don't mean to take away from medical manufacturing when I talk about the auto industry or the oil and gas industry. I think that the medial manufacturing piece is also key because we do a lot of medical manufacturing here domestically, and we see continued growth within that industry. Aerospace is a little bit harder – one, it's a little bit harder to pinpoint because there's not a single industry to quantify aerospace. It's what we refer to as a cluster. It's pulling from a lot of different sectors.

So, if you think of professional scientific and technical sectors, these are your R&D components. A lot of aerospace is also government-related. So, government funds a lot of aerospace activity. To the extent that our federal budget is constrained, as long as we have some austerity majors out there, I think that aerospace could be at risk a little bit because so much of that funding is routed through our federal labs, or through universities, or through private R&D. So, that's my opinion on aerospace, but I think both are very important industries. Aerospace I talked about a lot in Colorado because it is a big cluster within Colorado. We have public entities that are working on aerospace, as well as private industries, like Ball Aerospace, that do a lot of that work locally.

Gale: Great. Thank you, Brian. With that, we are at the top of the hour. So, thank you, again, for your analysis on this.

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The 2015 Mid-Year Economic Update

Brian Lewandowski and Thomas P. Gale

June 18, 2015

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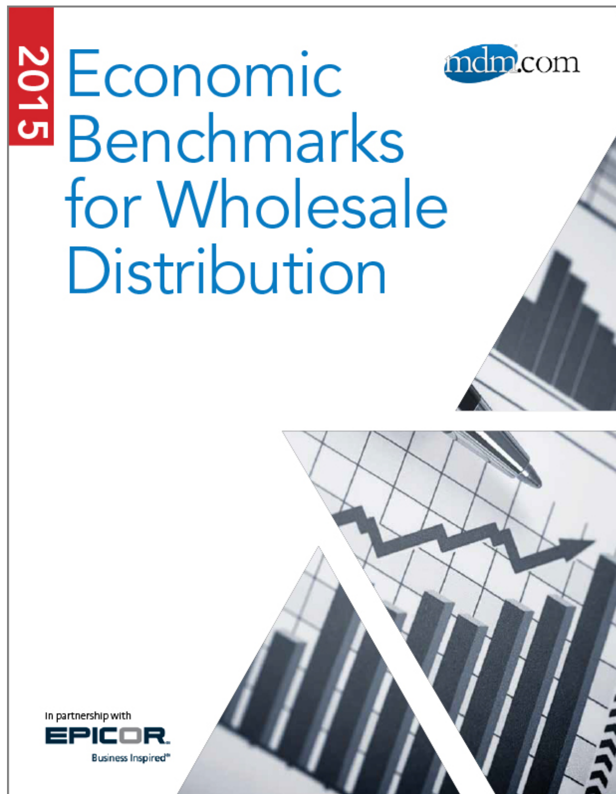
Agenda

- **Introduction**
- **Macroeconomic Overview –** Brian Lewandowski
- **2015 Economic Benchmarks for Wholesale Distribution –** Thomas P. Gale
- **Q&A**

2015 Economic Benchmarks for Wholesale Distribution



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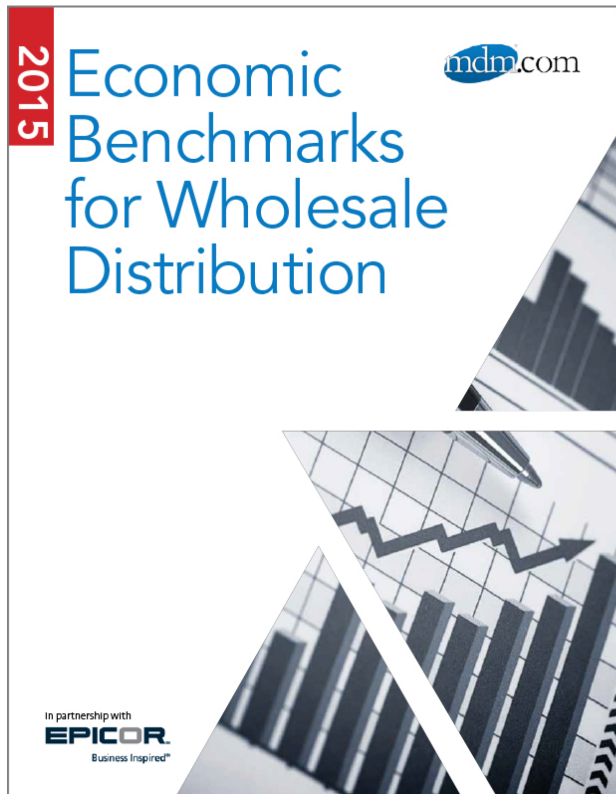
- Hardware, Plumbing & Heating Equipment/Supplies
- Industrial
- Metal Service Centers
- Miscellaneous Durable Goods
- Motor Vehicle & Motor Vehicle Parts
- Office Products
- Oil & Gas
- Other Consumer Products

2015 Economic Benchmarks for Wholesale Distribution



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  Revenues, Inventories, Inventory-to-Sales Ratio, Total Employment, Average Annual Revenues per Employee and Average Weekly Earnings
- **Sector Summary**
  2014 Revenues, Percent of Industry Revenues, No. of Companies and Average Gross Margin
- **Summary Trend Data**
  2014 Actual Revenues, 2014 Real Revenues, Revenue Gap and 2014 Q4 Employment
- **Revenue Forecasts** for 2015 & 2016
- **Sector Growth vs. U.S. GDP Growth** - 2004:Q1 to 2014:Q4
- **Employment Size Distribution**
- **Actual Revenue Growth** – Quarterly 2004 to Present
- **Real Revenue Growth** – Quarterly 2004 to Present
- **Employment Growth** – Quarterly 2004 to Present
- **Inventory-to-Sales Ratio** – 3-Month Moving Average with Trendline

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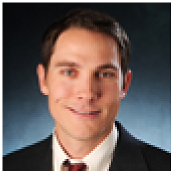

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49%
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56%
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39%
Wholesaler Top 100

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The 2015 Mid-Year Economic Update: Positive Prospects for the Industry

Brian Lewandowski
Associate Director, Business Research Division
June 18, 2015

Economic Benchmarks for Wholesale Distribution and the Economic Outlook

Today's Discussion

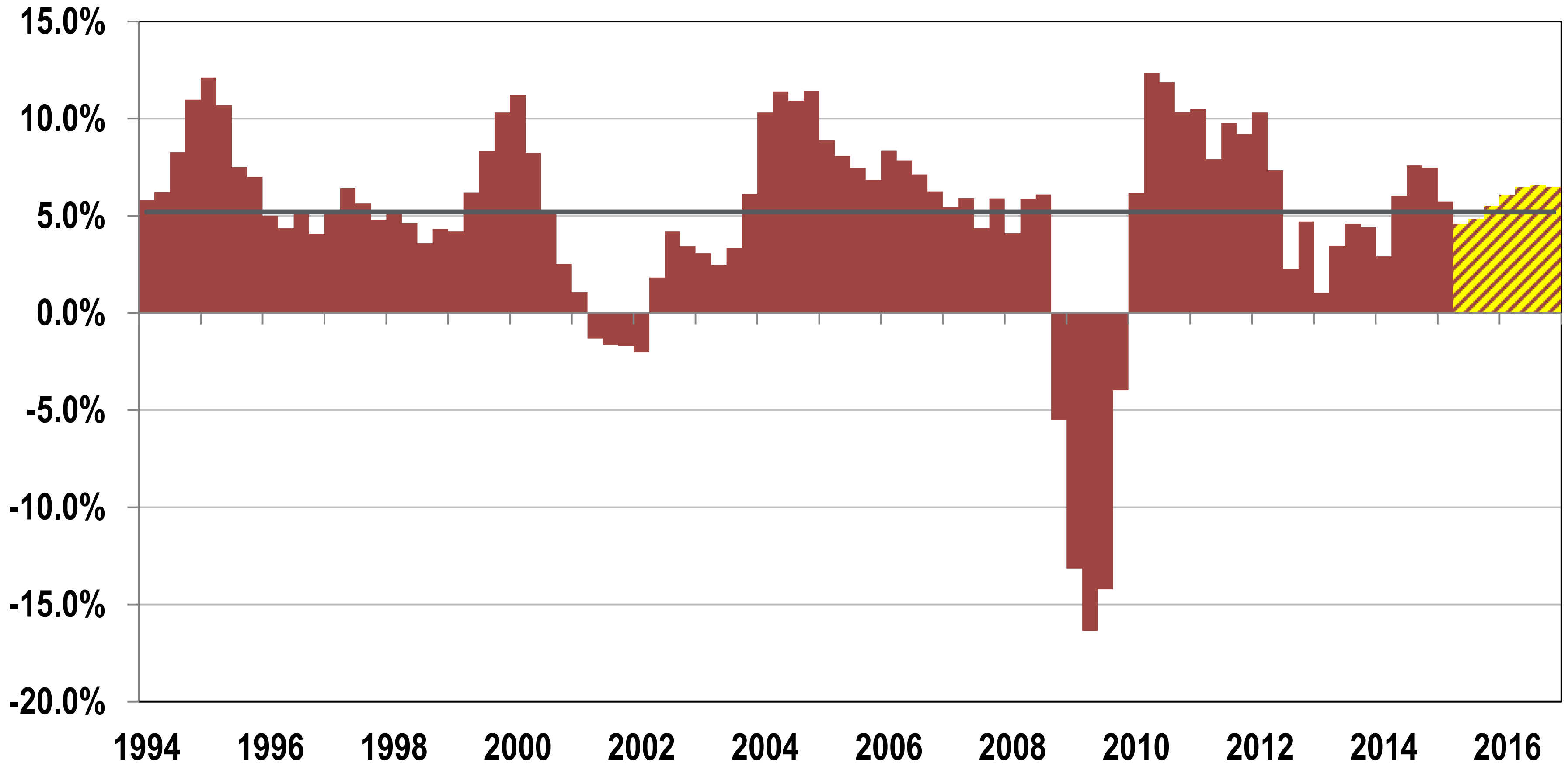
- Economic outlook
- Sales and inventory trends
- Specific industries
- Highlights from the 2015 Economic Benchmarks report

About the Economic Benchmarks for Wholesale Distribution report data

- Foundational data from U.S. Census Bureau, Bureau of Labor Statistics and Bureau of Economic Analysis
- Based on latest Wholesale Trade Survey and Economic Census
- Include revenue growth forecasts

Core Wholesale Distribution Revenue Growth

1994-2016

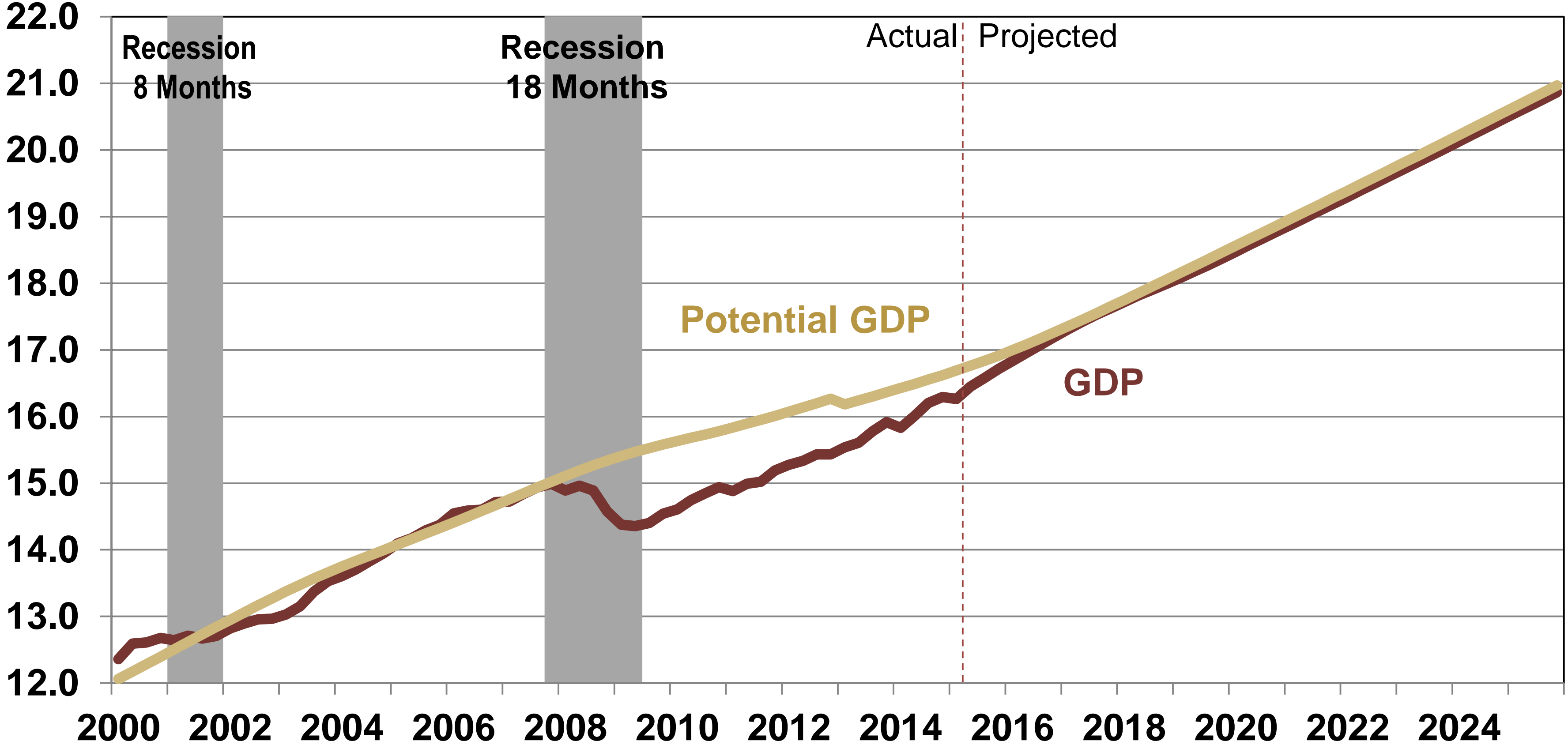


Note: Core excludes the agriculture and the oil and gas sectors.

Summary of 2014 Performance by Sector

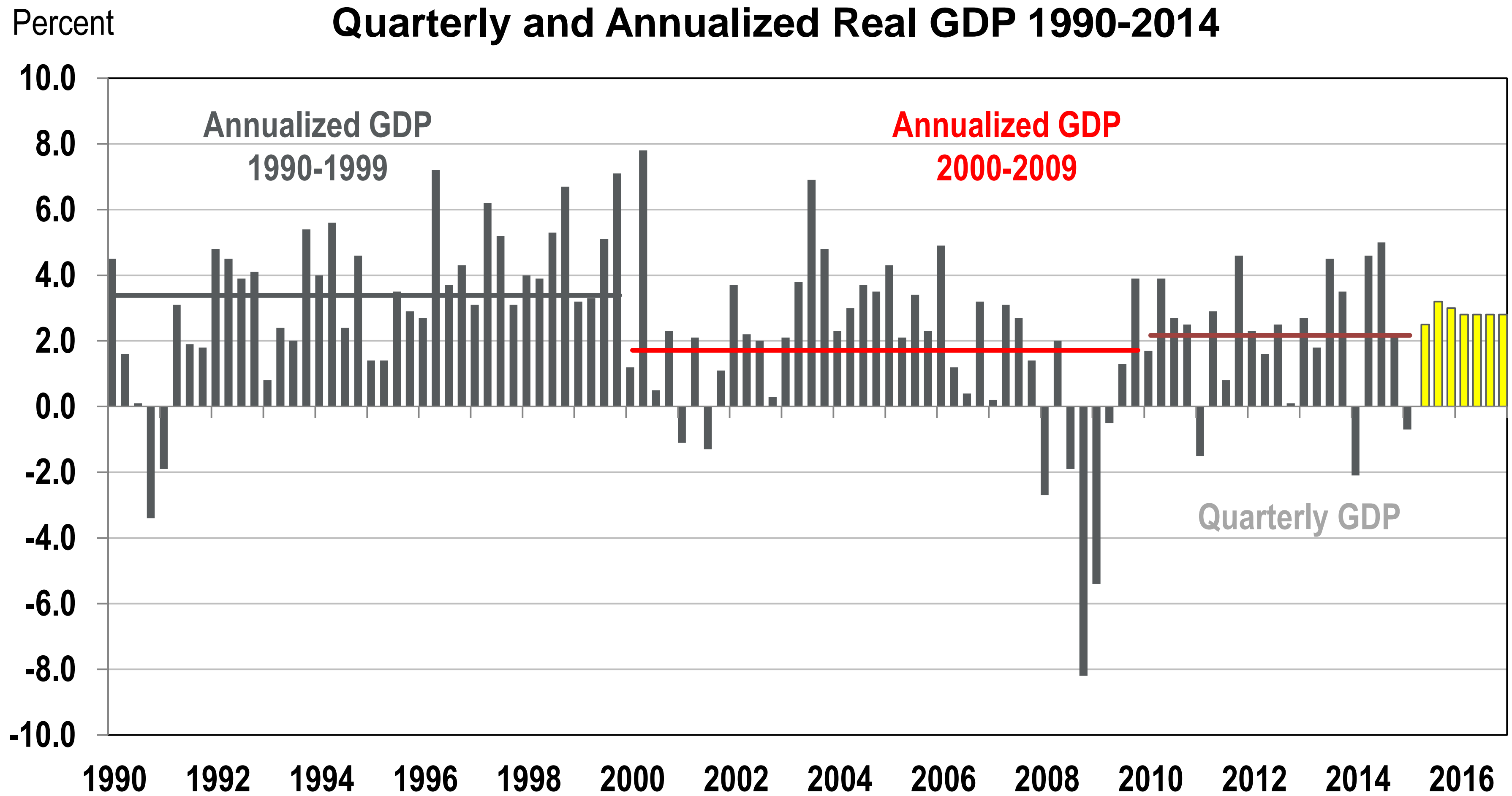
Major Sector (Largest to Smallest Sector Revenues)	Actual Revenues (2014)	Real Revenues* (2014)	Revenue Gap (Actual - Real)
Oil and Gas Products Wholesale Distributors	1.3%	6.9%	-5.7%
Grocery and Foodservice Wholesale Distributors	7.0%	3.4%	3.6%
Pharmaceutical Wholesalers	12.7%	6.9%	5.8%
Industrial Distributors	10.7%	9.1%	1.6%
Electrical and Electronics Wholesalers	5.2%	5.5%	-0.3%
Motor Vehicles and Motor Vehicle Parts Wholesale Distributors	4.9%	4.3%	0.6%
Computer Equipment and Software Wholesale Distributors	3.9%	6.1%	-2.3%
Other Consumer Products Wholesale Distributors	-1.5%	-1.4%	0.0%
Agricultural Products Wholesale Distributors	-3.0%	10.6%	-13.6%
Miscellaneous Durable Goods Wholesale Distributors	-2.3%	-3.1%	0.8%
Commercial Equipment and Supplies Wholesale Distributors	5.9%	6.8%	-0.9%
Metal Service Centers	11.6%	10.1%	1.4%
Apparel and Piece Goods Wholesale Distributors	9.6%	9.1%	0.4%
Chemicals and Plastics Wholesale Distributors	5.8%	6.1%	-0.3%
Beer, Wine and Liquor Wholesalers	2.6%	1.7%	0.9%
Building Material and Construction Wholesale Distributors	6.2%	1.9%	4.3%
Hardware, Plumbing, and Heating Equipment/Supplies Wholesalers	5.1%	3.7%	1.4%
Office Product Wholesalers and Paper Merchants	6.0%	4.4%	1.6%
Furniture and Home Furnishing Wholesale Distributors	5.9%	3.0%	2.9%
Total	5.1%	5.4%	-0.3%

GDP and Potential GDP



Sources: Congressional Budget Office, Budget and Economic Outlook; Bureau of Economic Analysis.

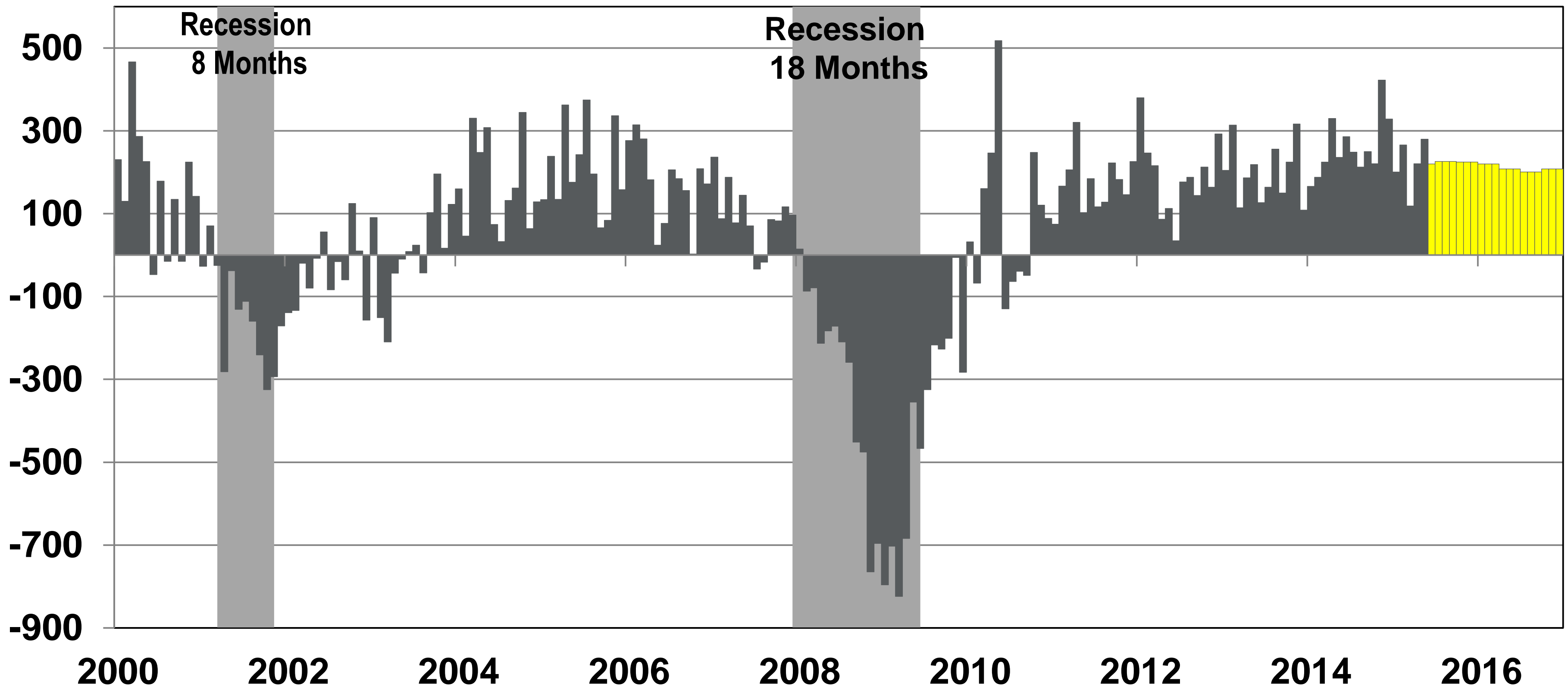
Real GDP Growth



Sources: Bureau of Economic Analysis and February 2013 NABE Forecast.

National Employment

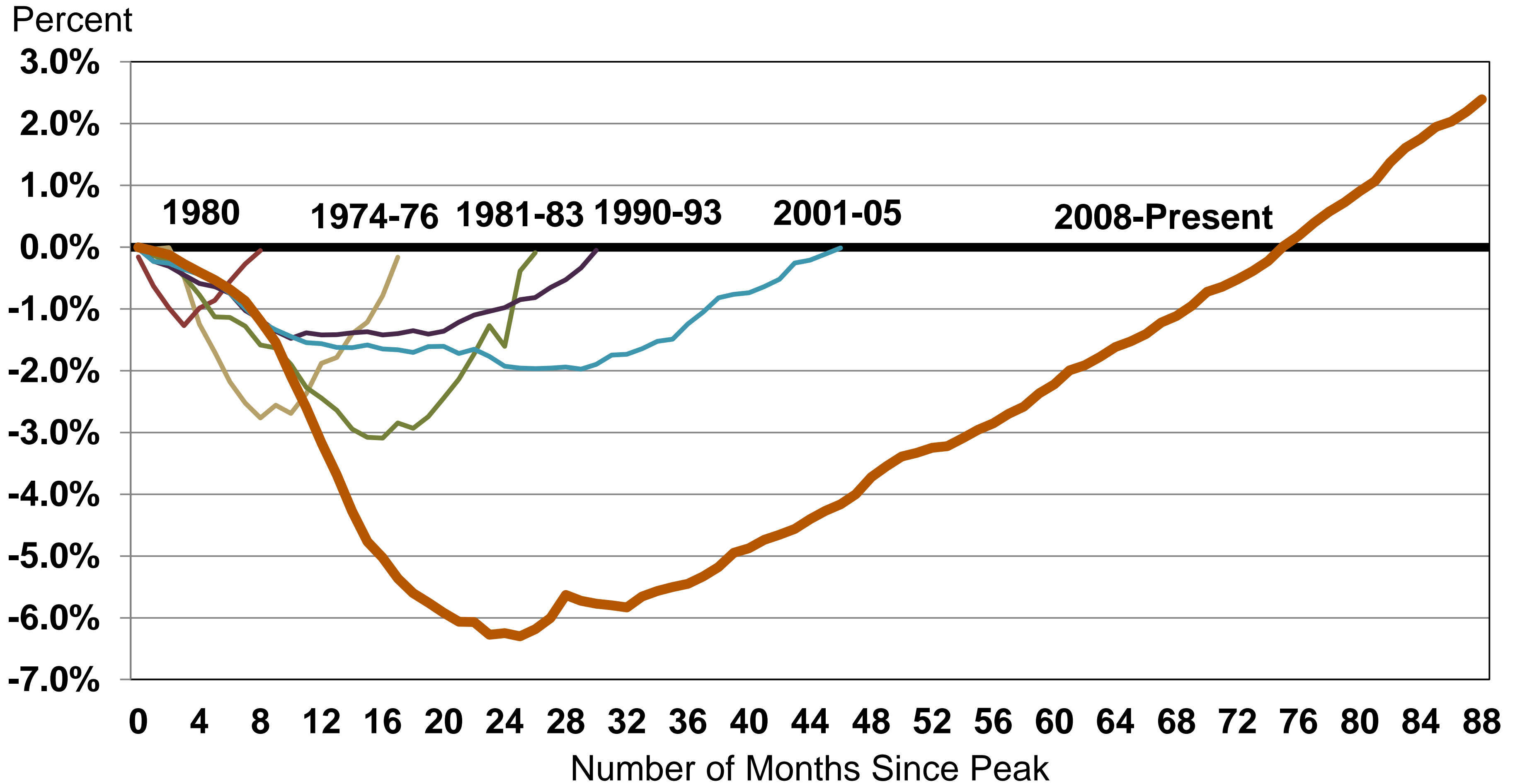
Monthly Change



Sources: Bureau of Labor Statistics (Seasonally Adjusted), National Bureau of Economic Research, and NABE Outlook February 2013.

National Employment

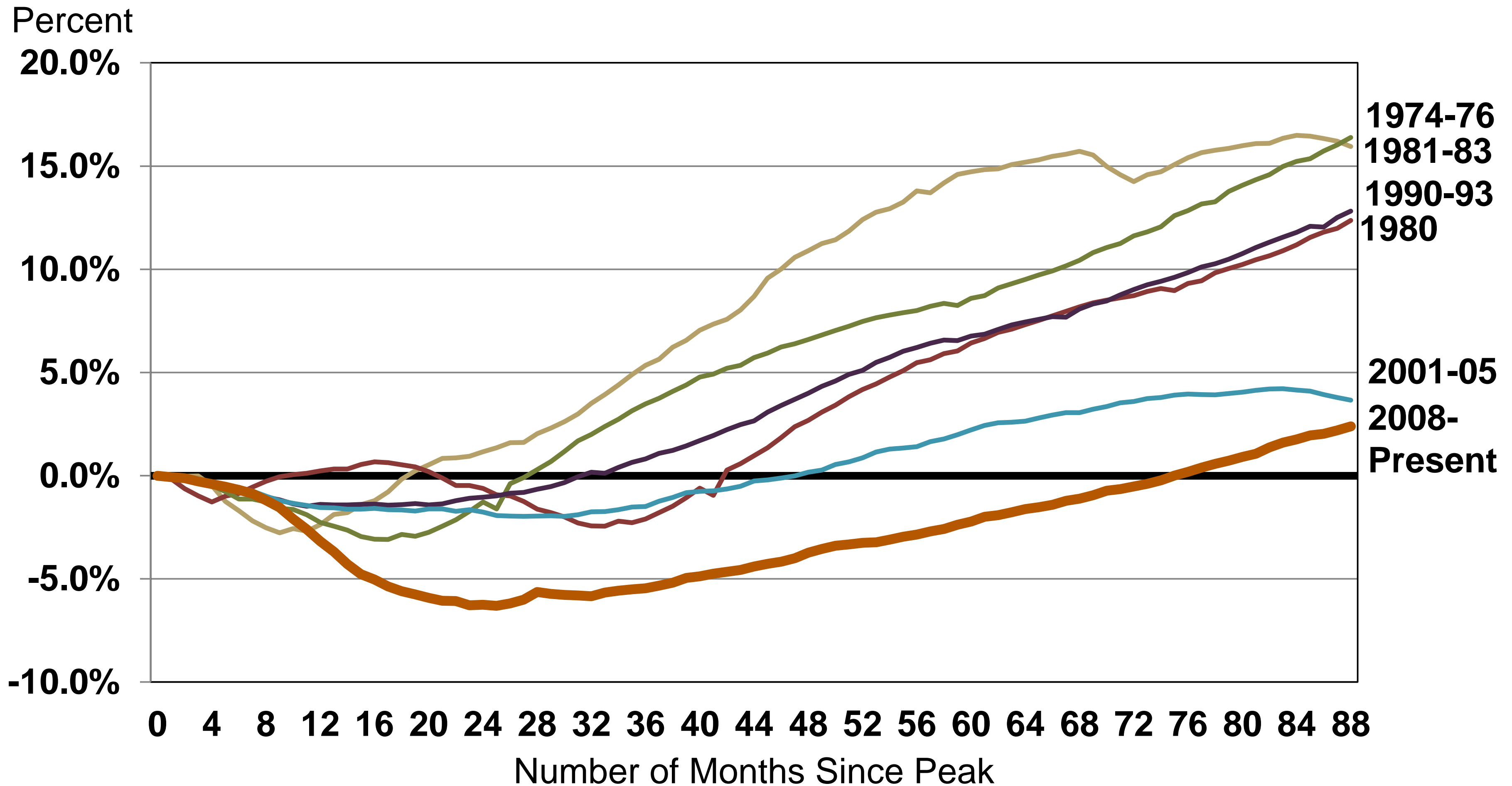
Months to Recovery



Source: Bureau of Labor Statistics (Seasonally Adjusted).

National Employment

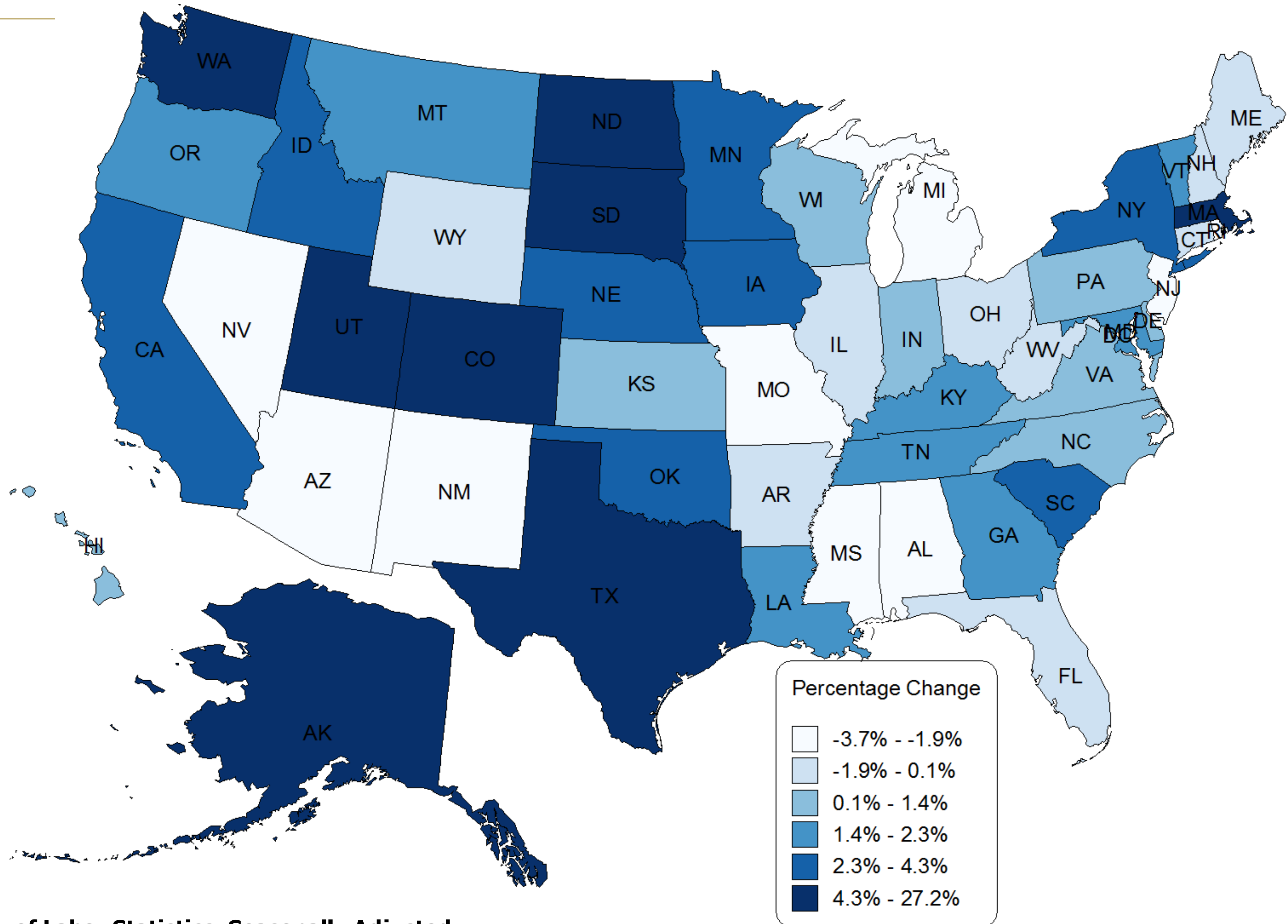
Months to Recovery



Source: Bureau of Labor Statistics (Seasonally Adjusted).

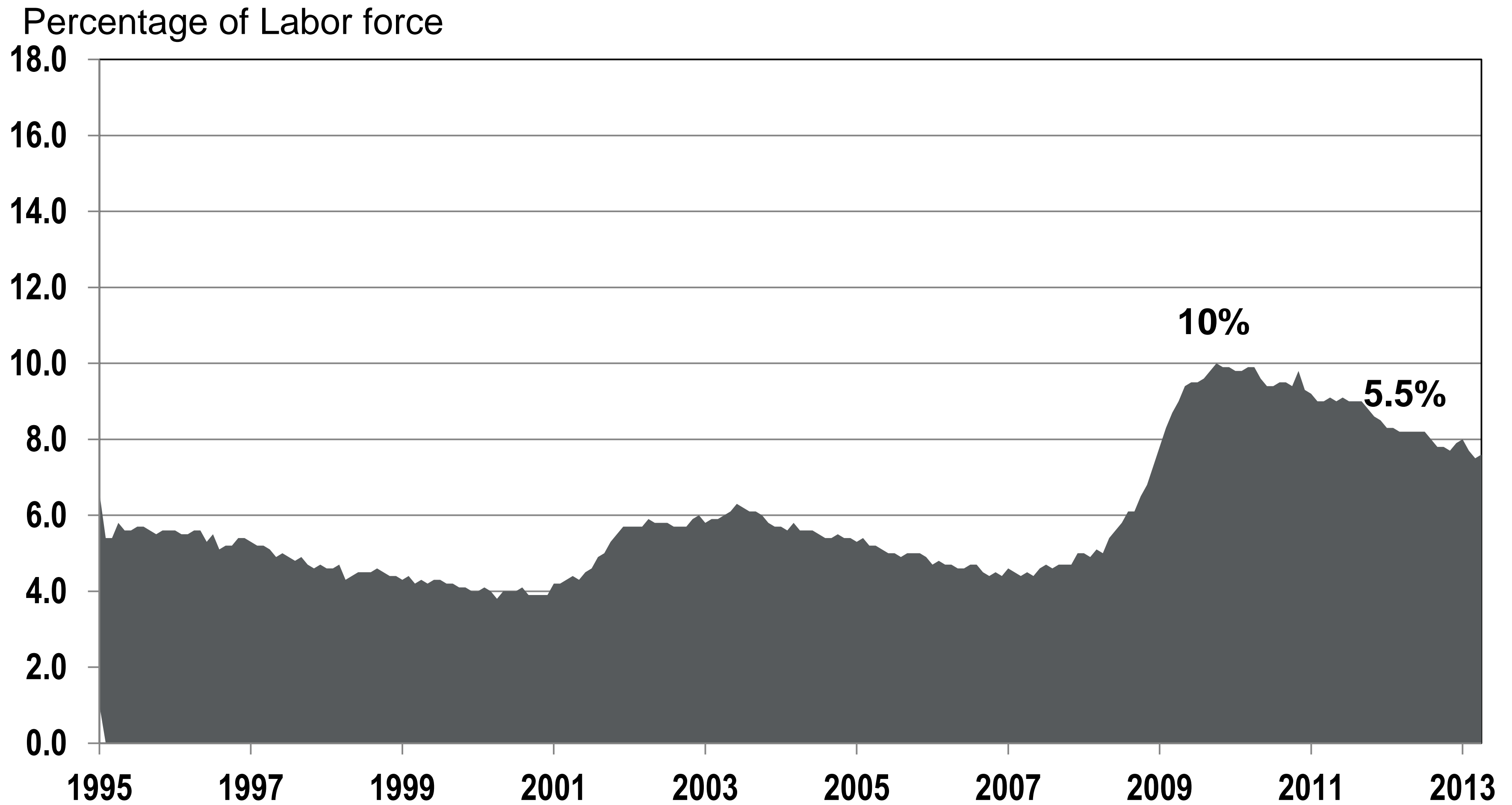
National Employment Growth

Prerecession Peak-to-May 2015



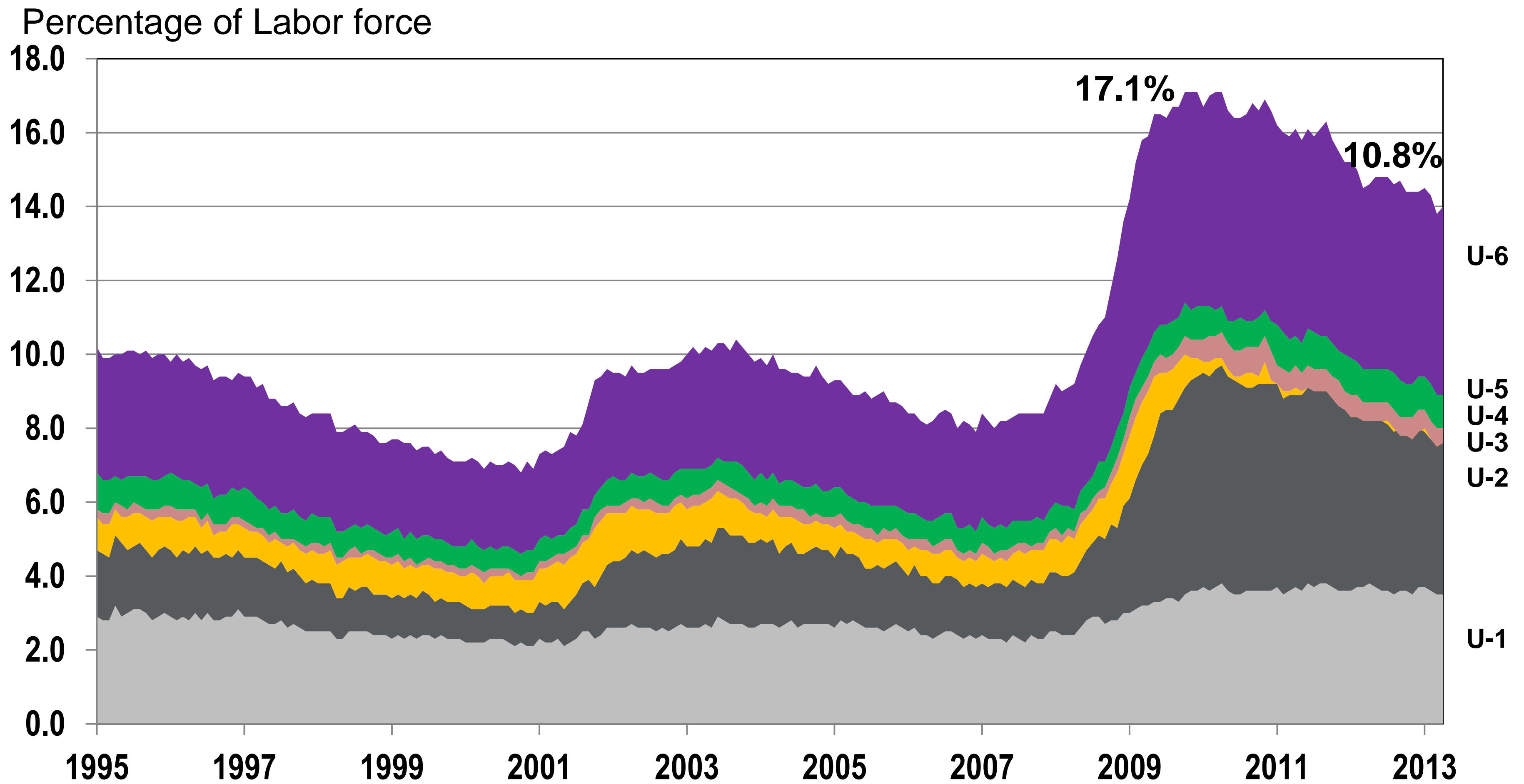
Source: Bureau of Labor Statistics, Seasonally Adjusted.

Labor Underutilization



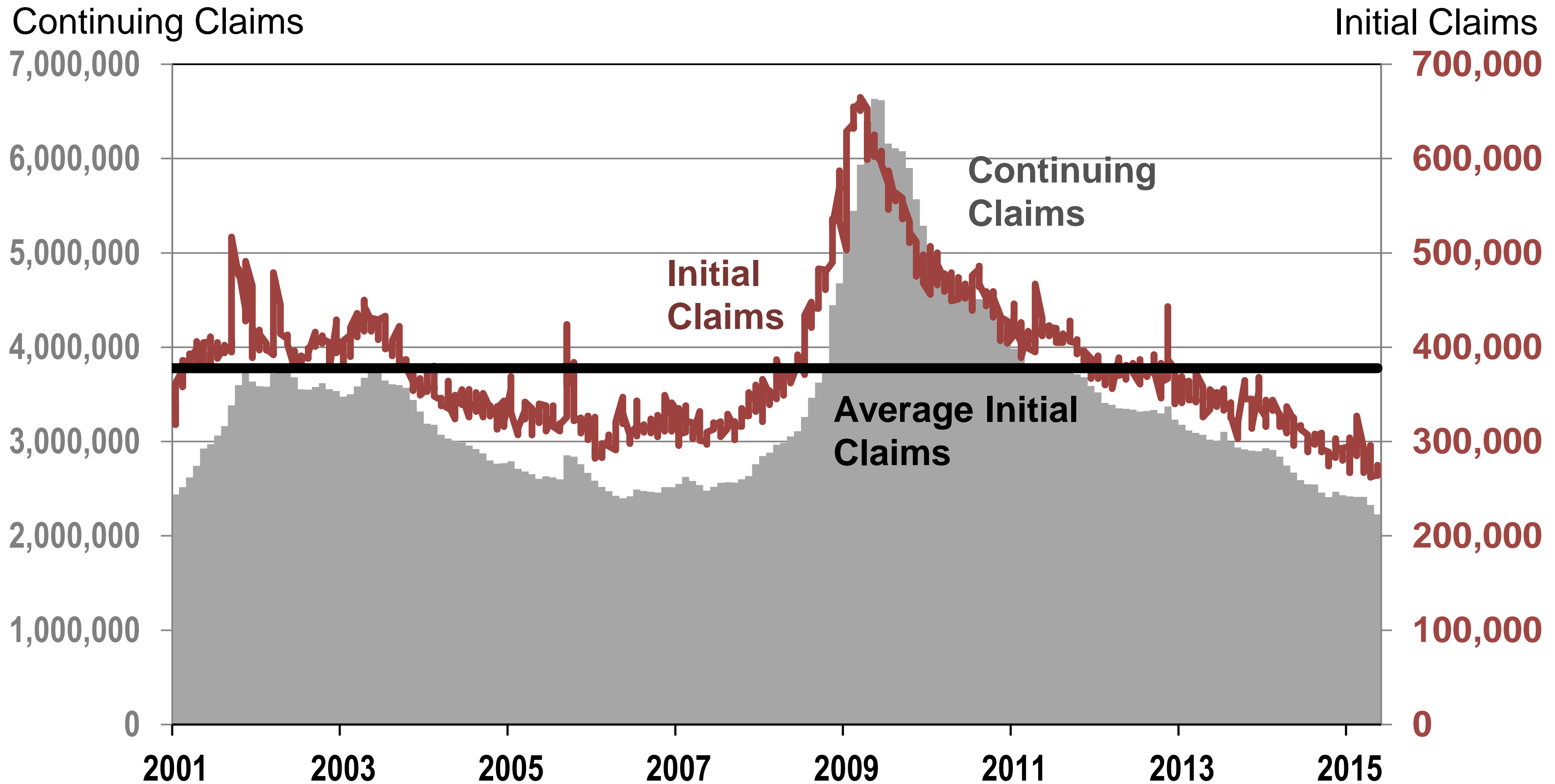
Source: Bureau of Labor Statistics (Seasonally Adjusted).

Labor Underutilization



Source: Bureau of Labor Statistics (Seasonally Adjusted).

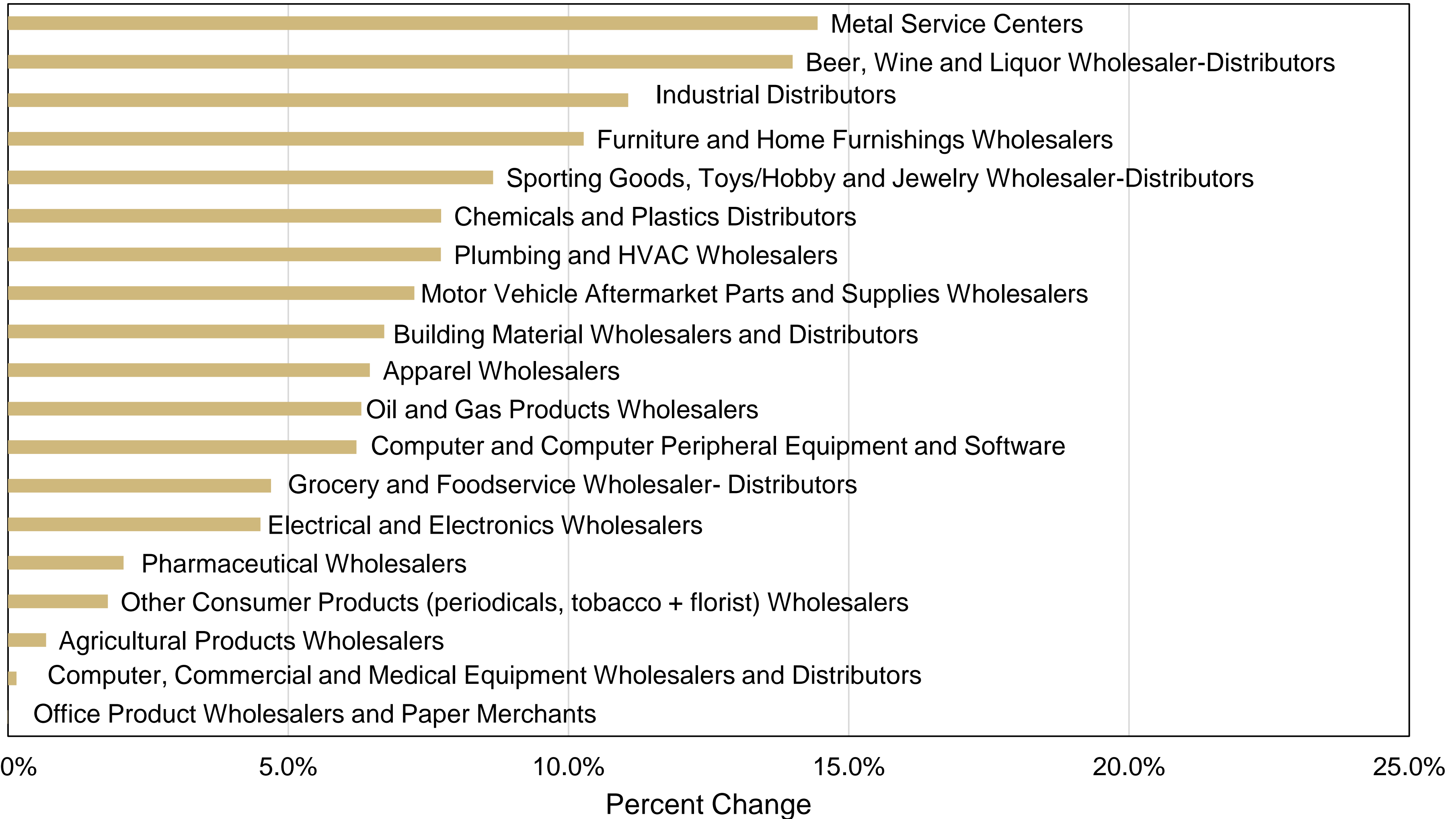
Initial and Continuing Claims



Source: Bureau of Labor Statistics.

Job Gains by Wholesale Distribution Sector

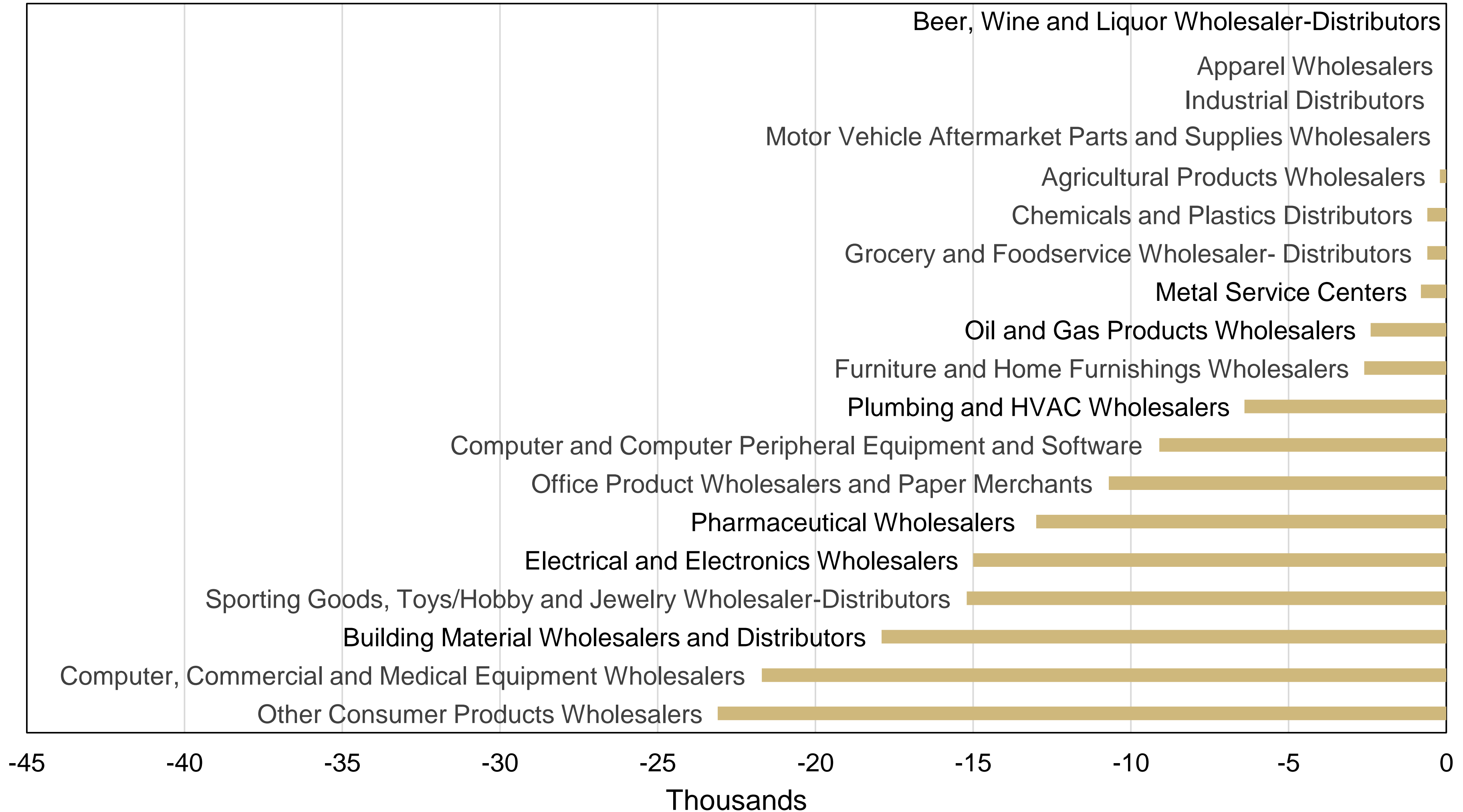
2010-2014



Source: Bureau of Labor Statistics (Seasonally Adjusted).

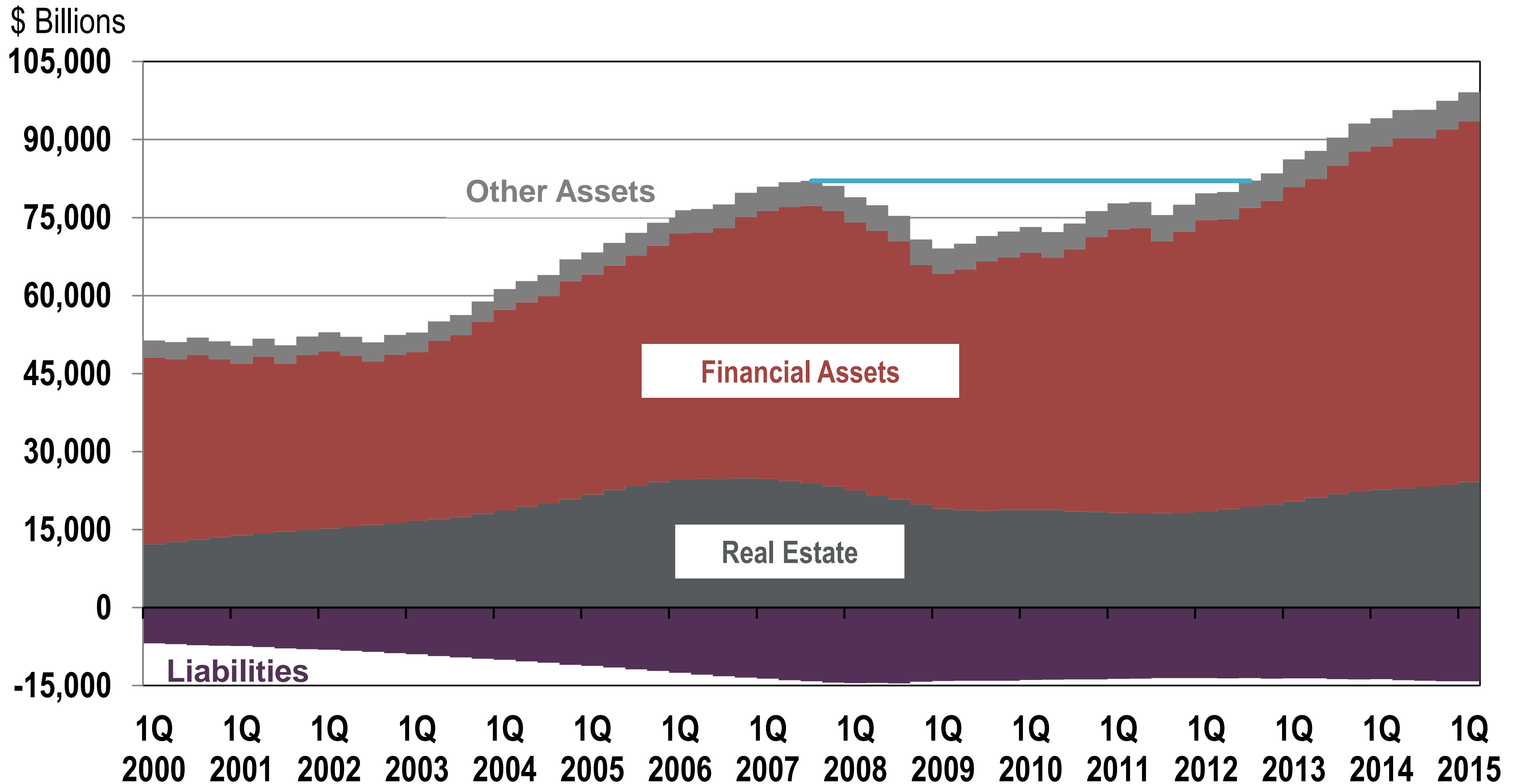
Jobs Deficit by Wholesale Distribution Sector

From Pre-recession Peak



Source: Bureau of Labor Statistics (Seasonally Adjusted).

Household Wealth

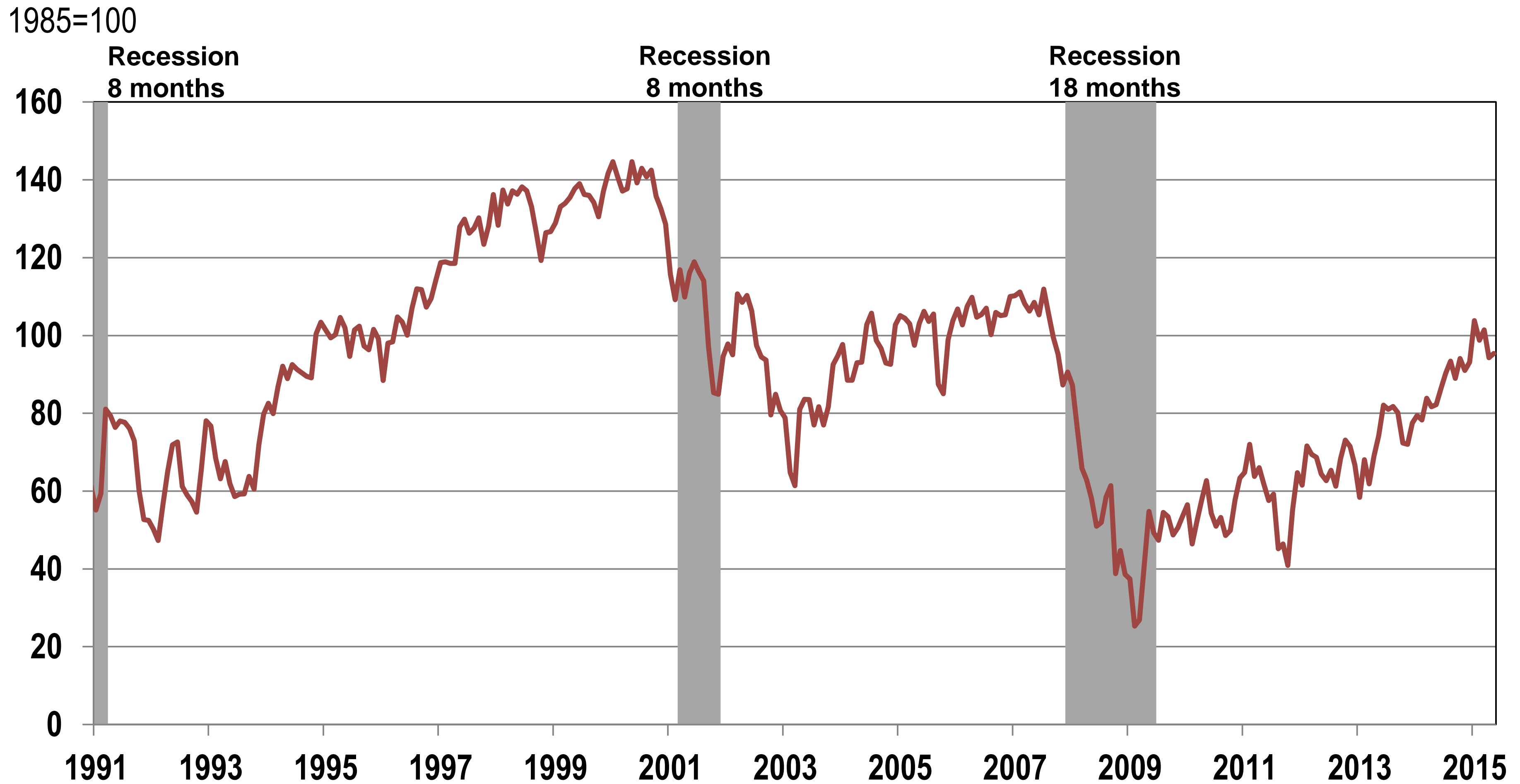


Source: Federal Reserve Board, Balance Sheet of Households and Nonprofit Organizations (B100) (Not Seasonally Adjusted).

S&P 500

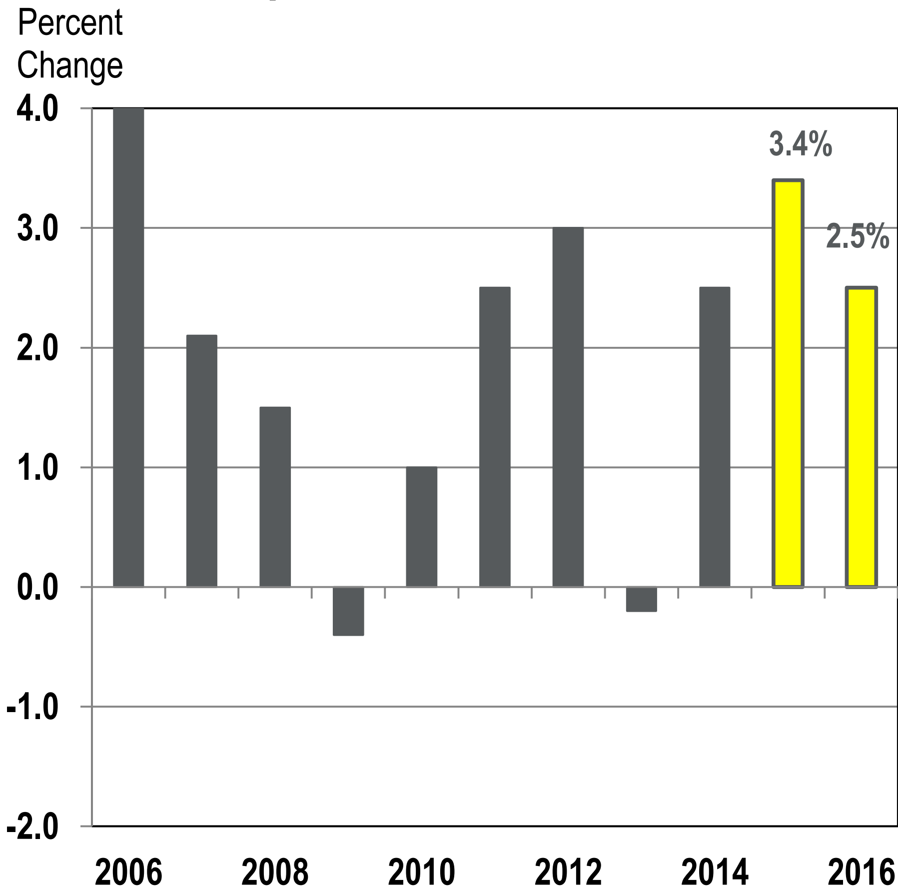
Source: Bloomberg.

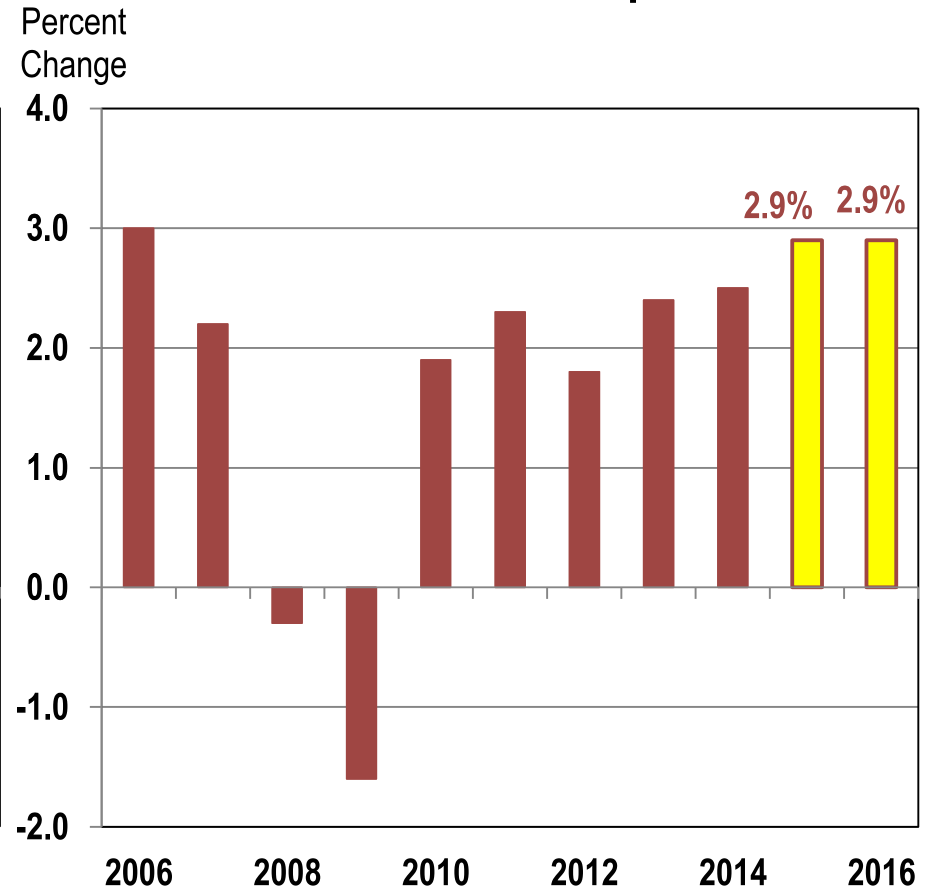
Index of Consumer Confidence



Sources: The Conference Board and National Bureau of Economic Research.

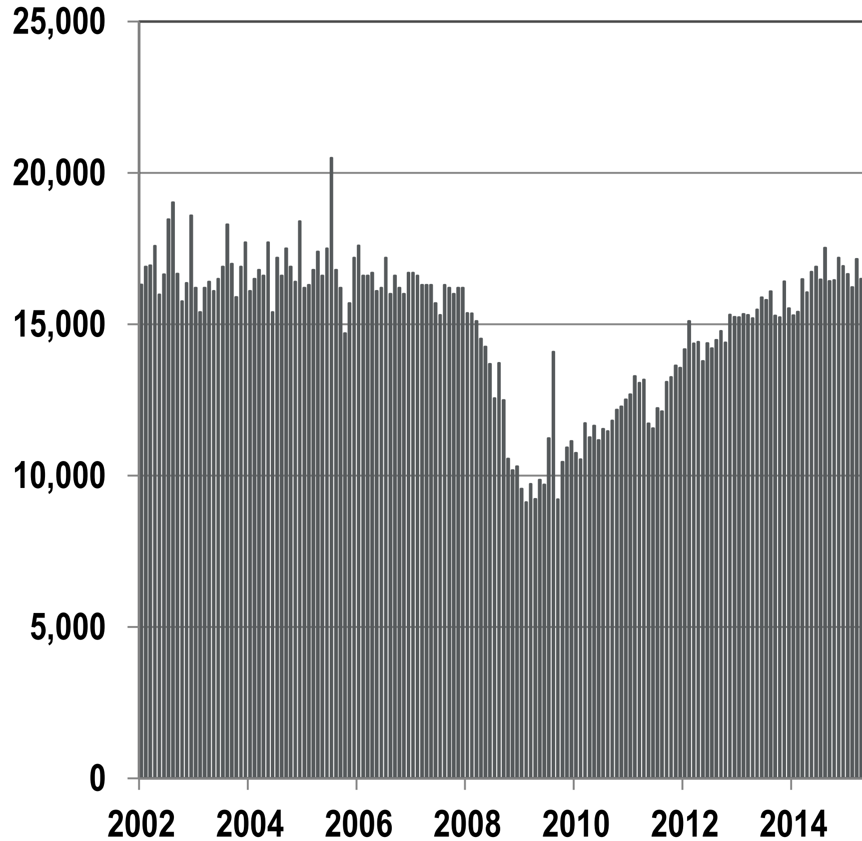
U.S. Income and Consumption

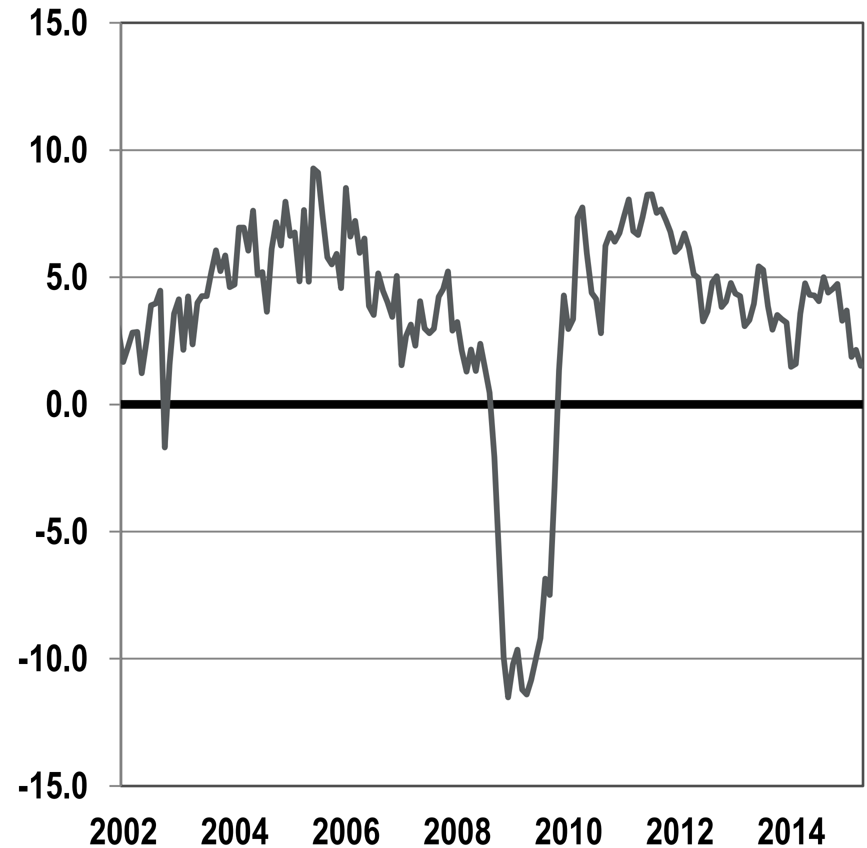




Sources: Bureau of Economic Analysis and Blue Chip Economic Indicators.

Vehicle Sales and Retail Sales

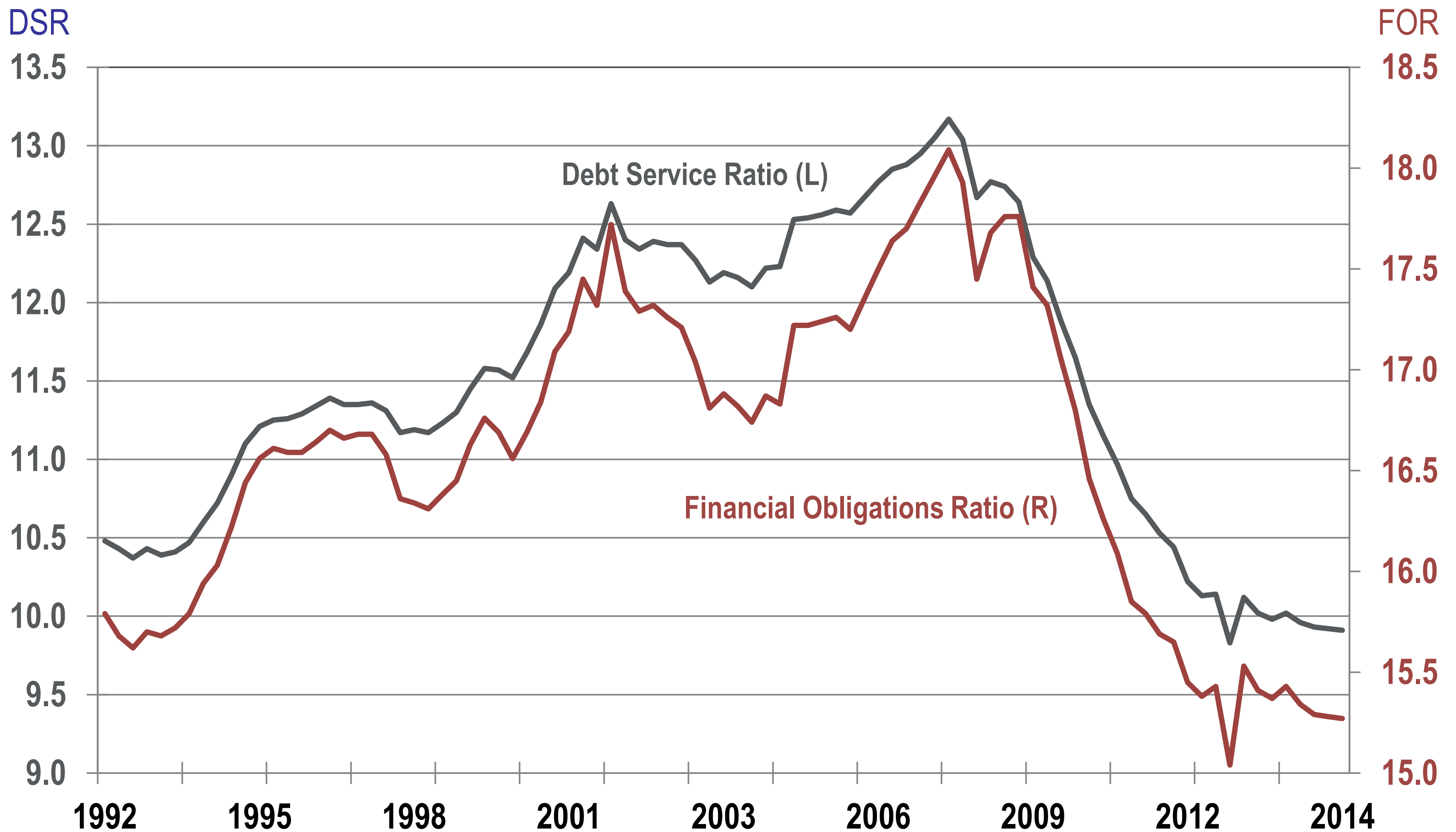




Sources: Autodata Corp., Motor Intelligence, U.S. Census Bureau (Seasonally Adjusted Annual Rate).

Household Debt Burden

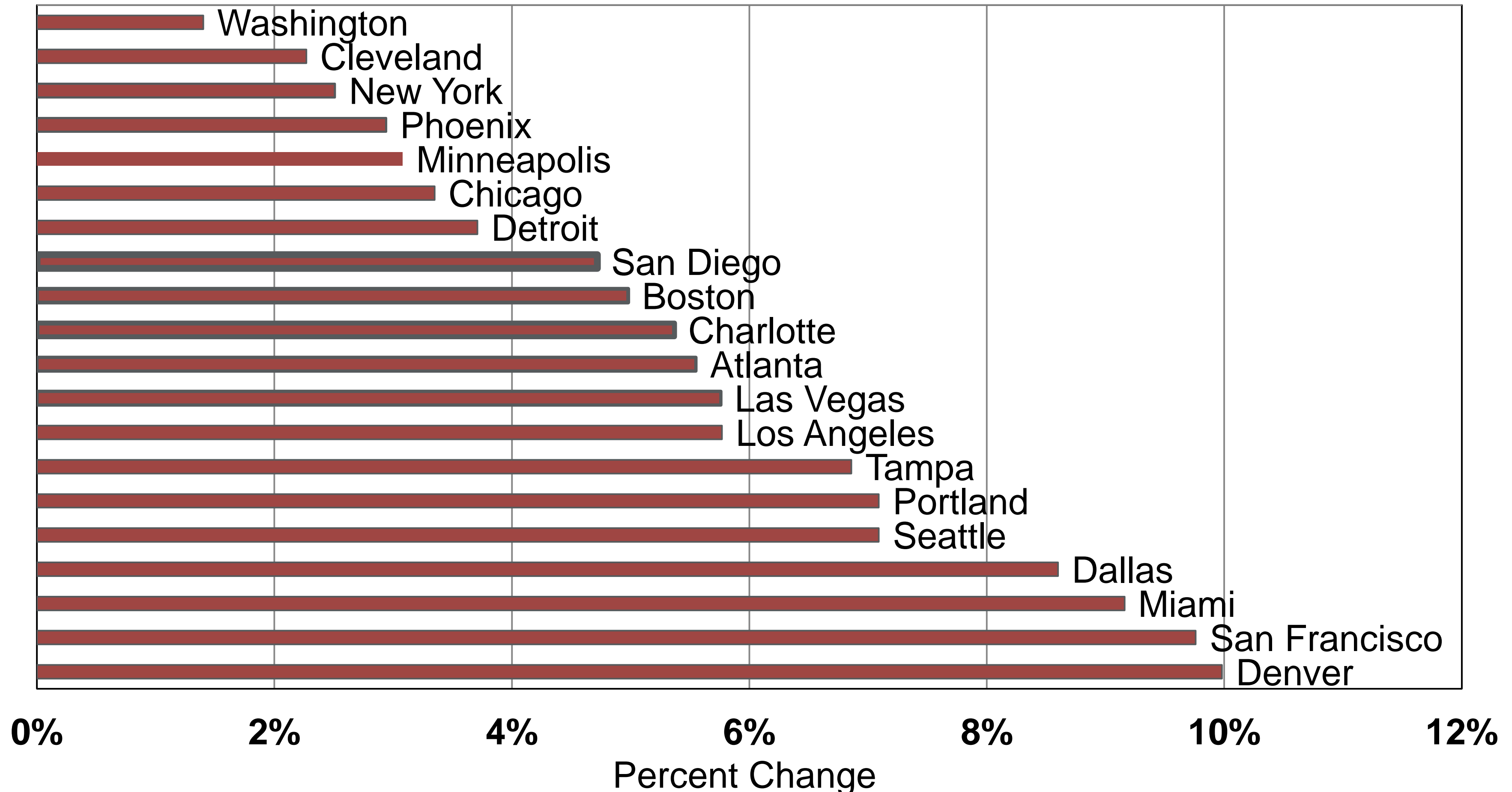
Percent of Disposable Income



Source: Federal Reserve, Household Debt Service and Obligations Ratios.

S&P/Case-Shiller Home Price Indices

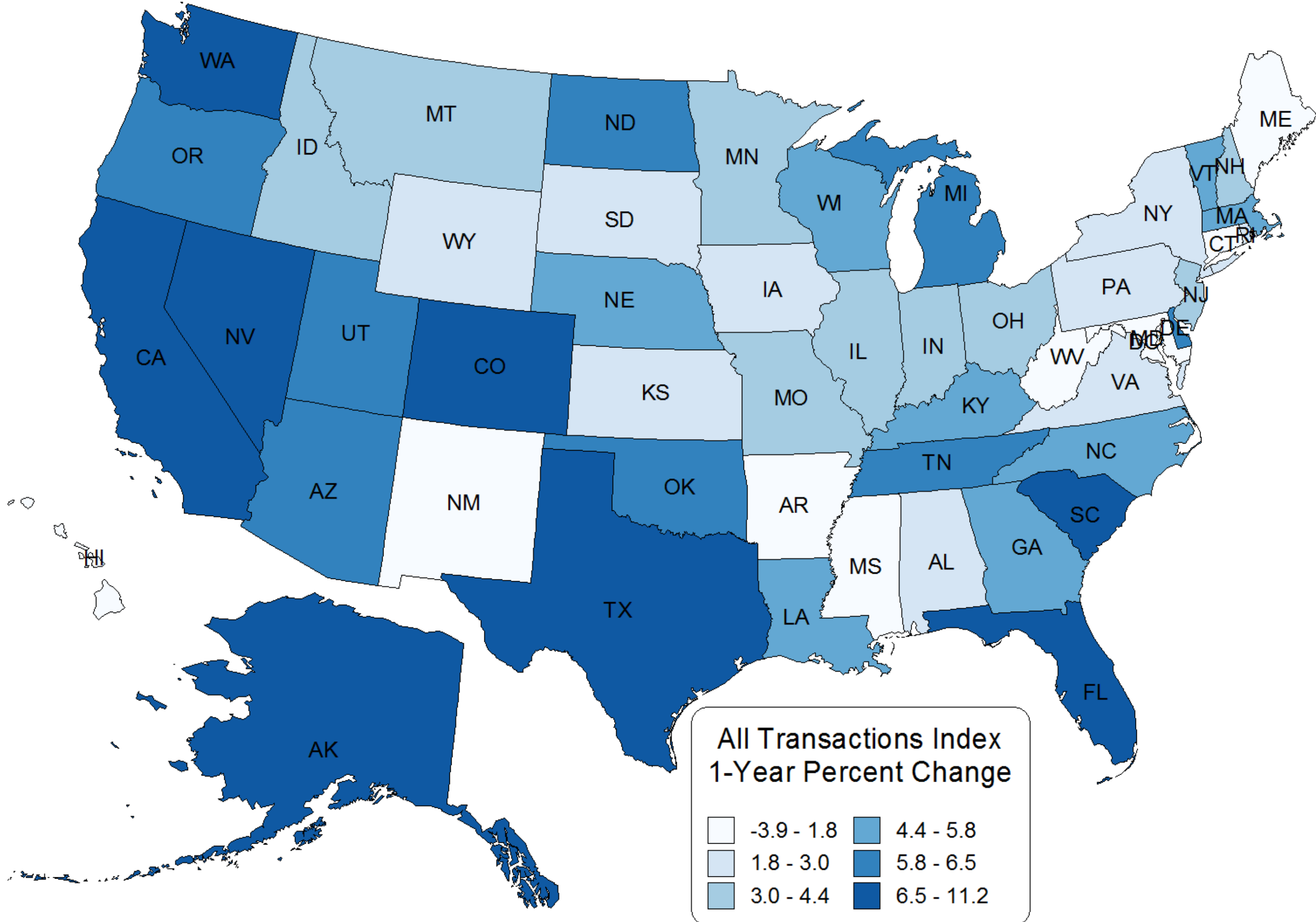
1-year Home Price Change, April 2015



Source: Standard & Poor's (Not Seasonally Adjusted).

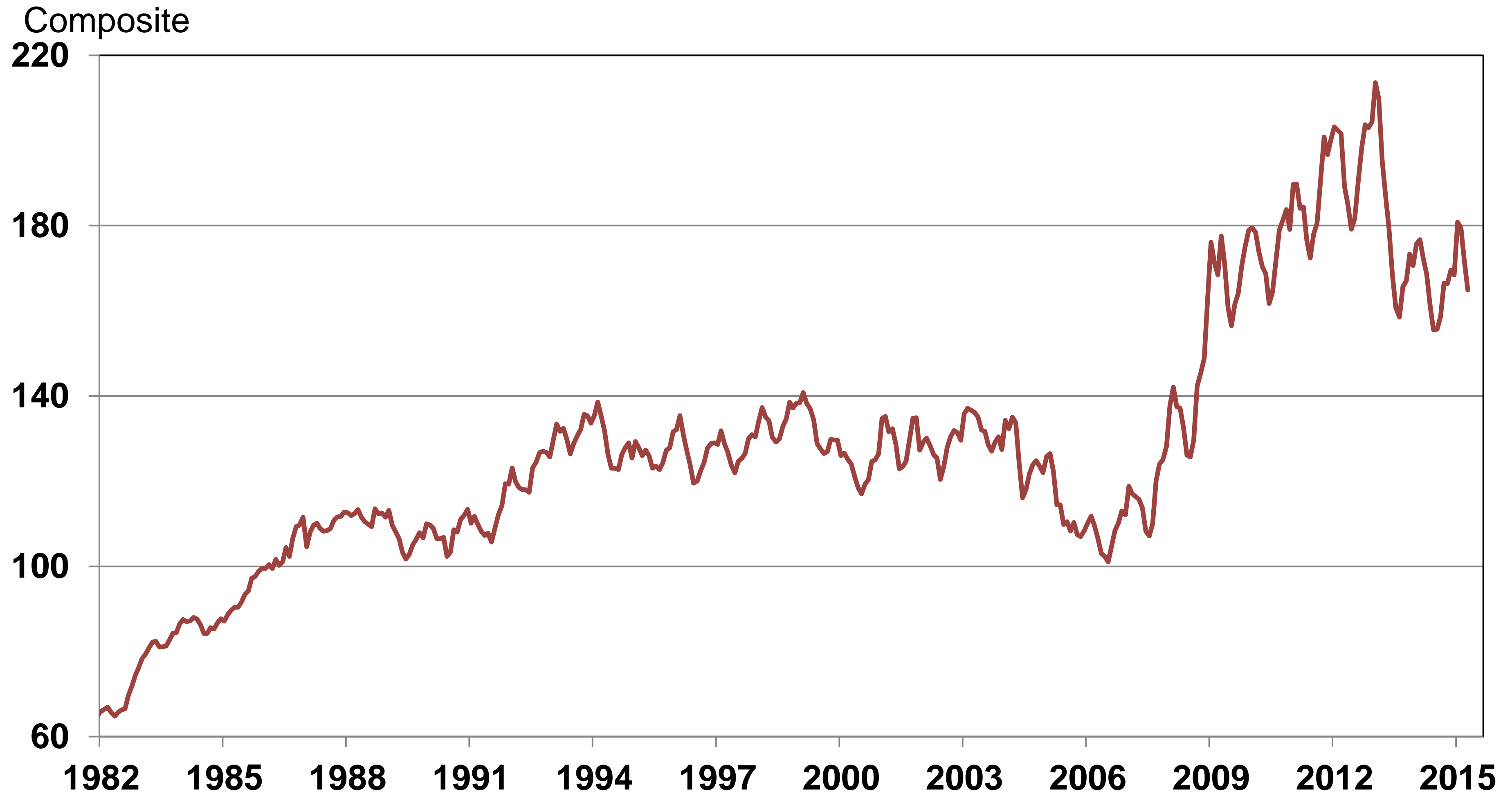
National FHFA Home Price Growth

Year-over-Year Q1 2015



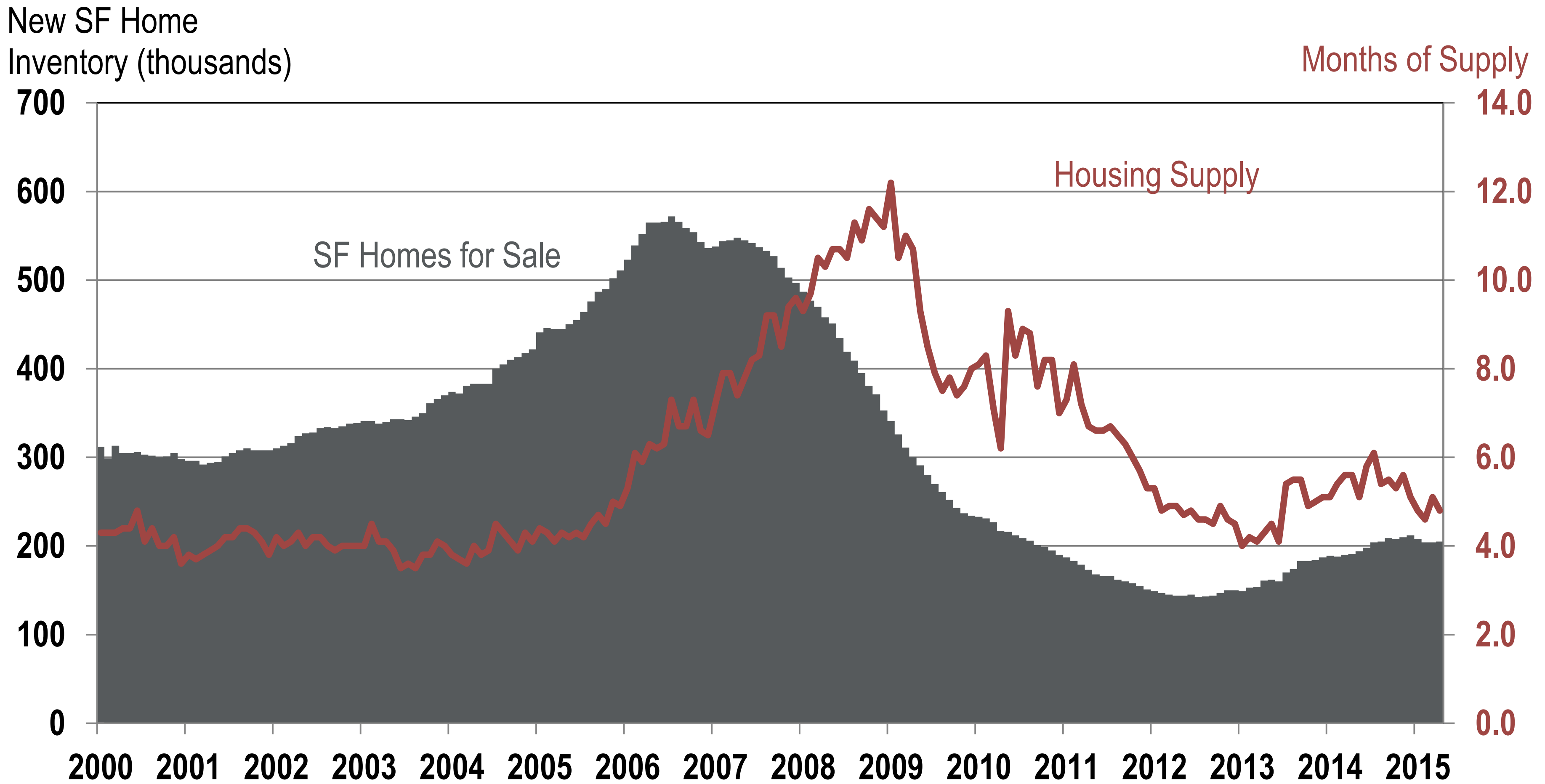
Source: Federal Housing Finance Agency Home Price Index, All Transactions Index.

Housing Affordability Index



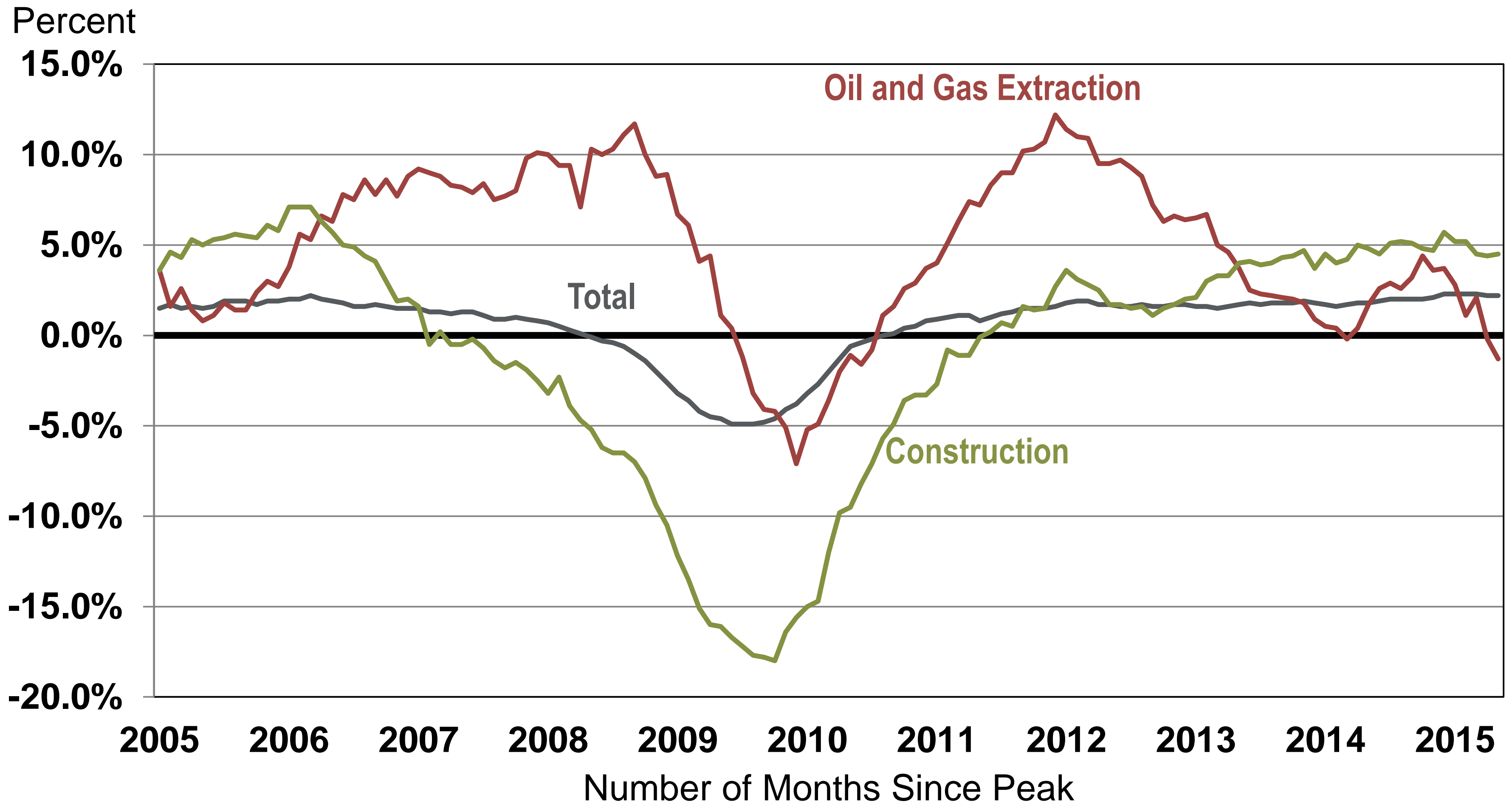
Source: National Association of Realtors, Composite Index.

Houses For Sale and Months' Supply



Source: New Houses Sold and For Sale, U.S. Census Bureau.

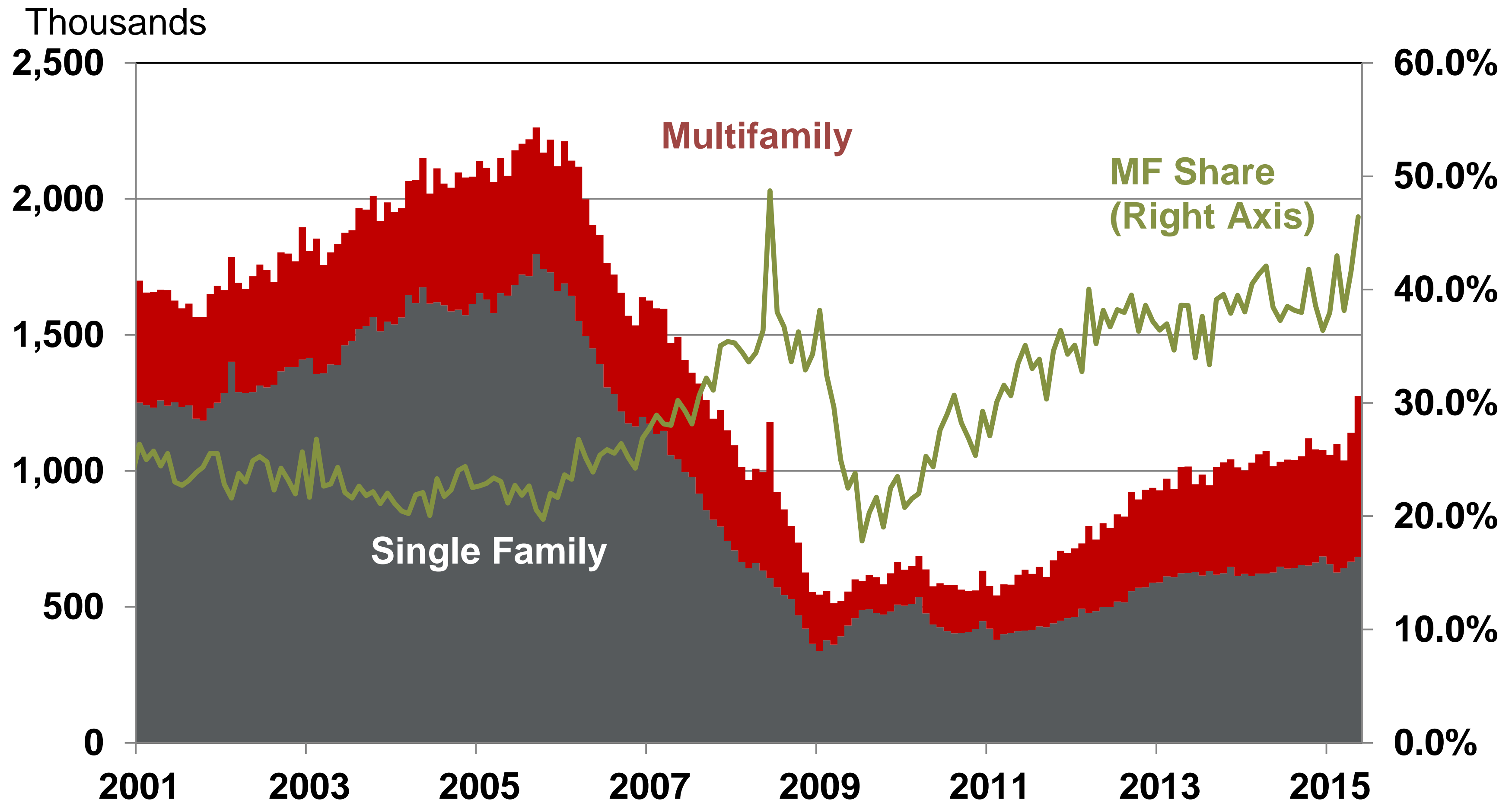
Total Employment v. Construction



Source: Bureau of Labor Statistics.

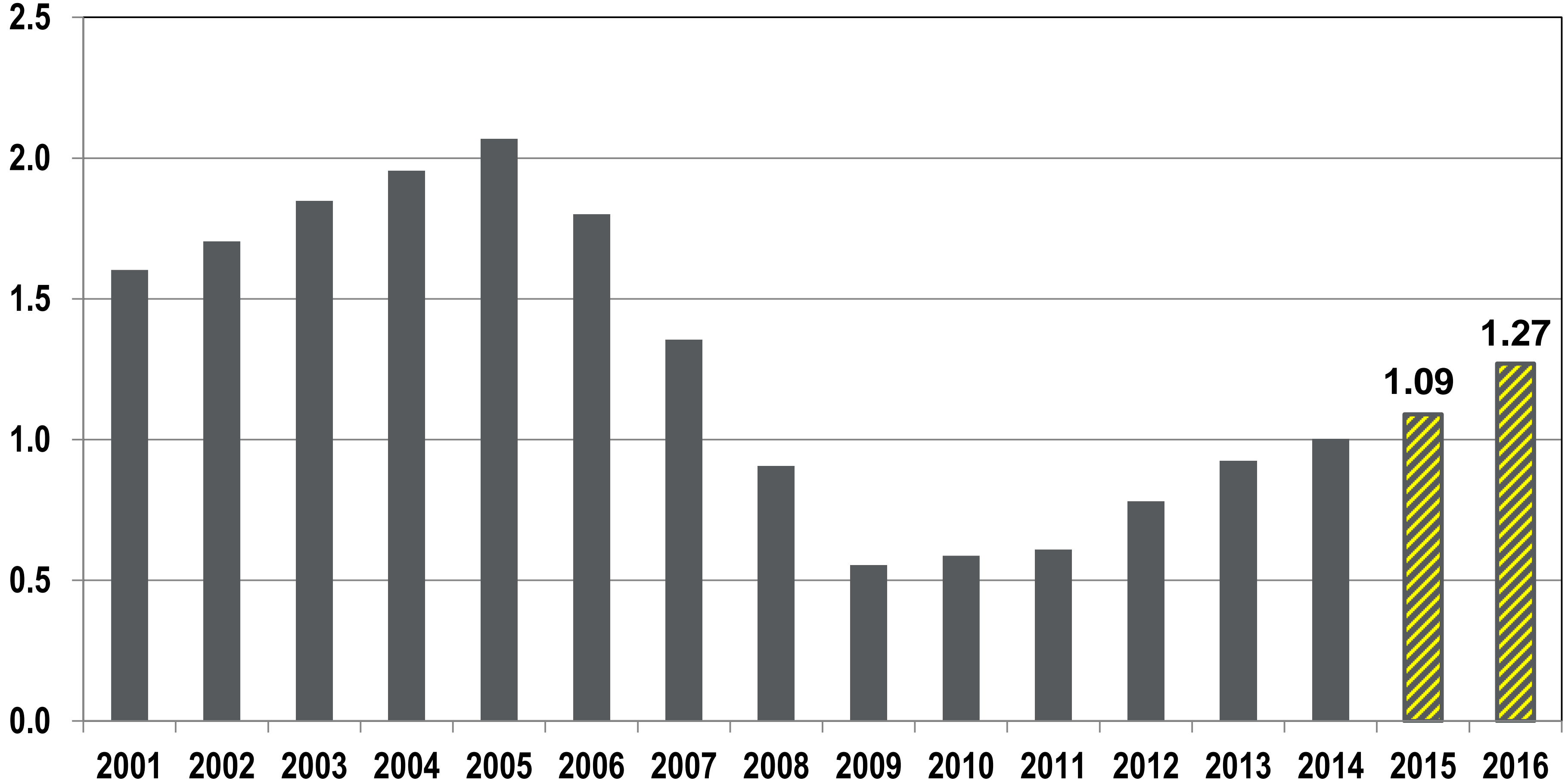
U.S. Building Permits

Seasonally Adjusted Annual Rate



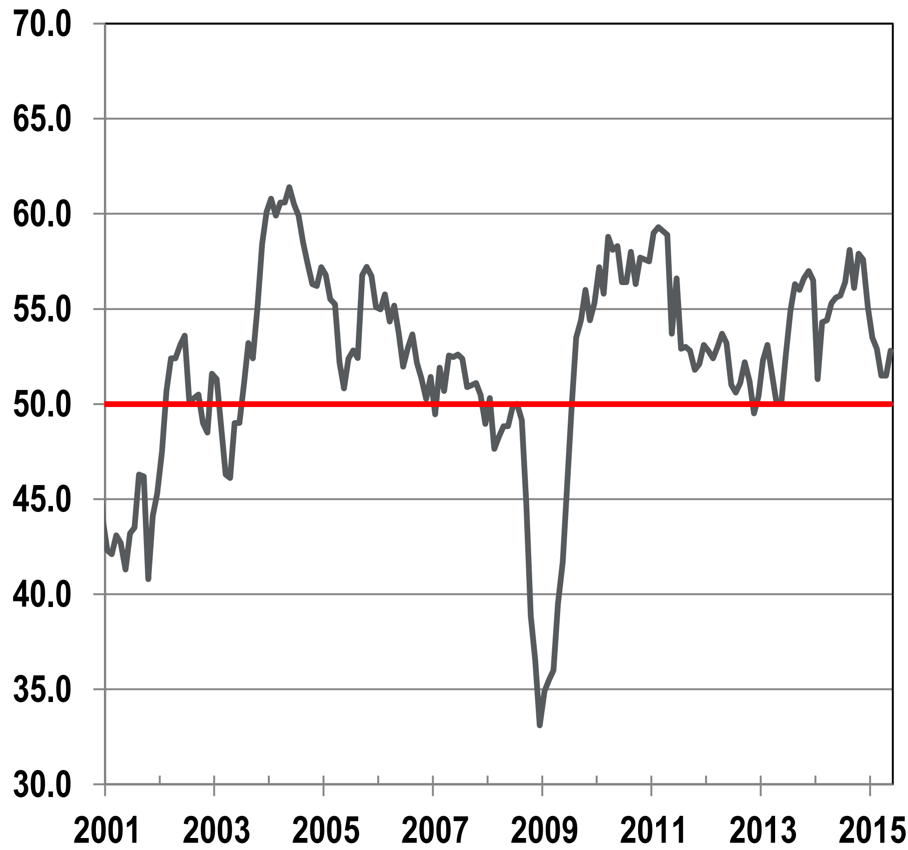
Source : U.S. Census Bureau, New Privately Owned Housing Units Authorized by Building Permits in Permit-Issuing Places (SAAR).

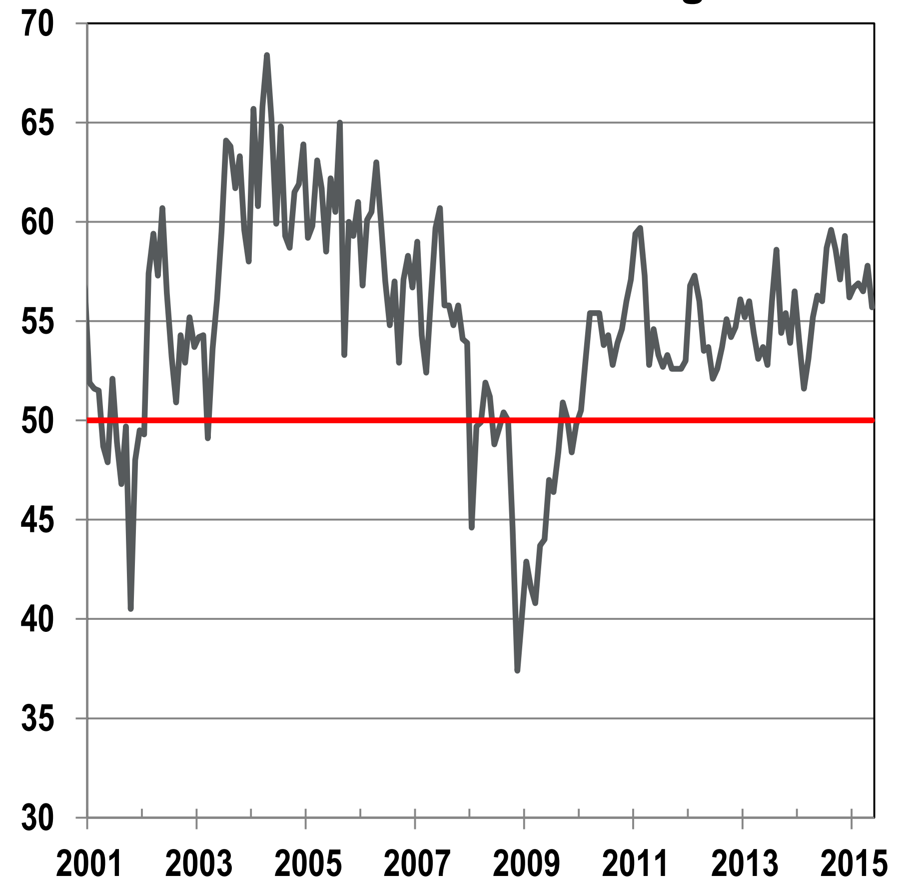
National Housing Starts



Sources: U.S. Census Bureau and Consensus Forecasts.

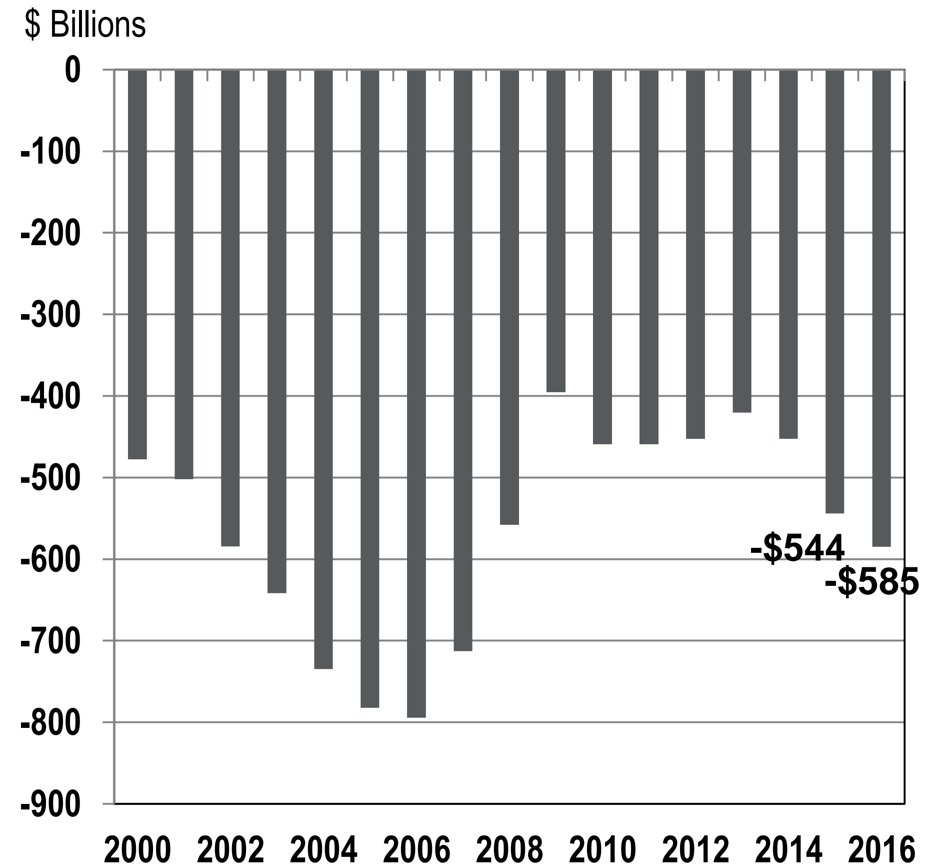
ISM Indices





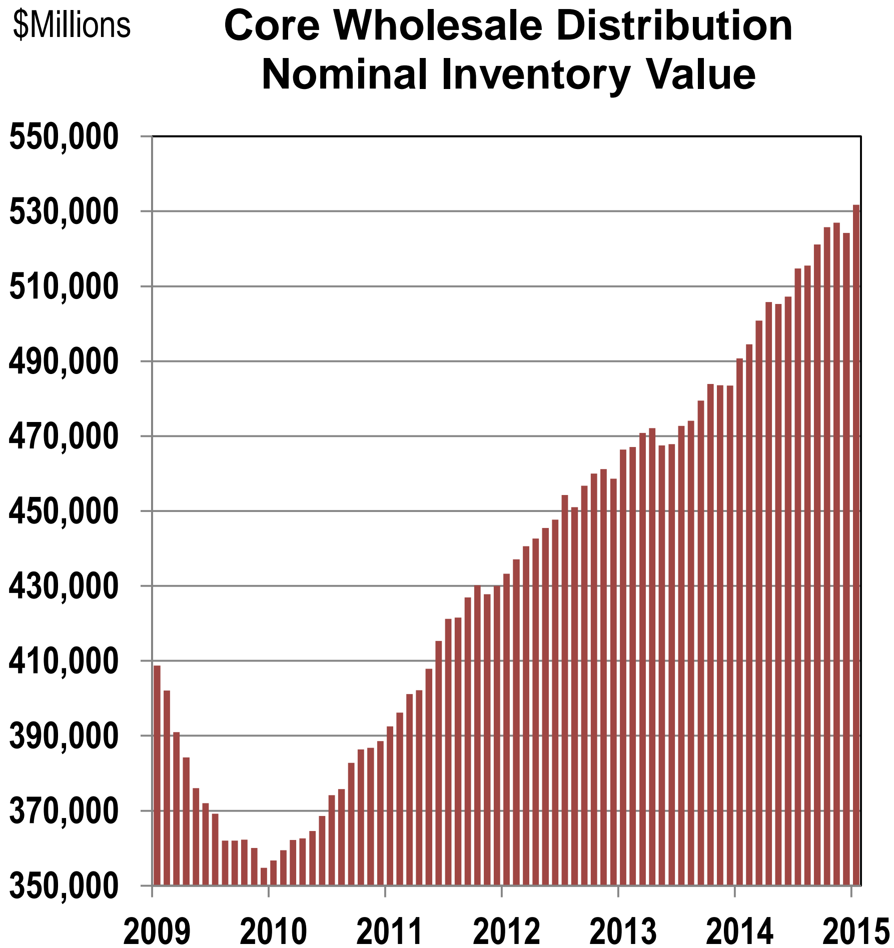
Source: Institute for Supply Management (ISM).

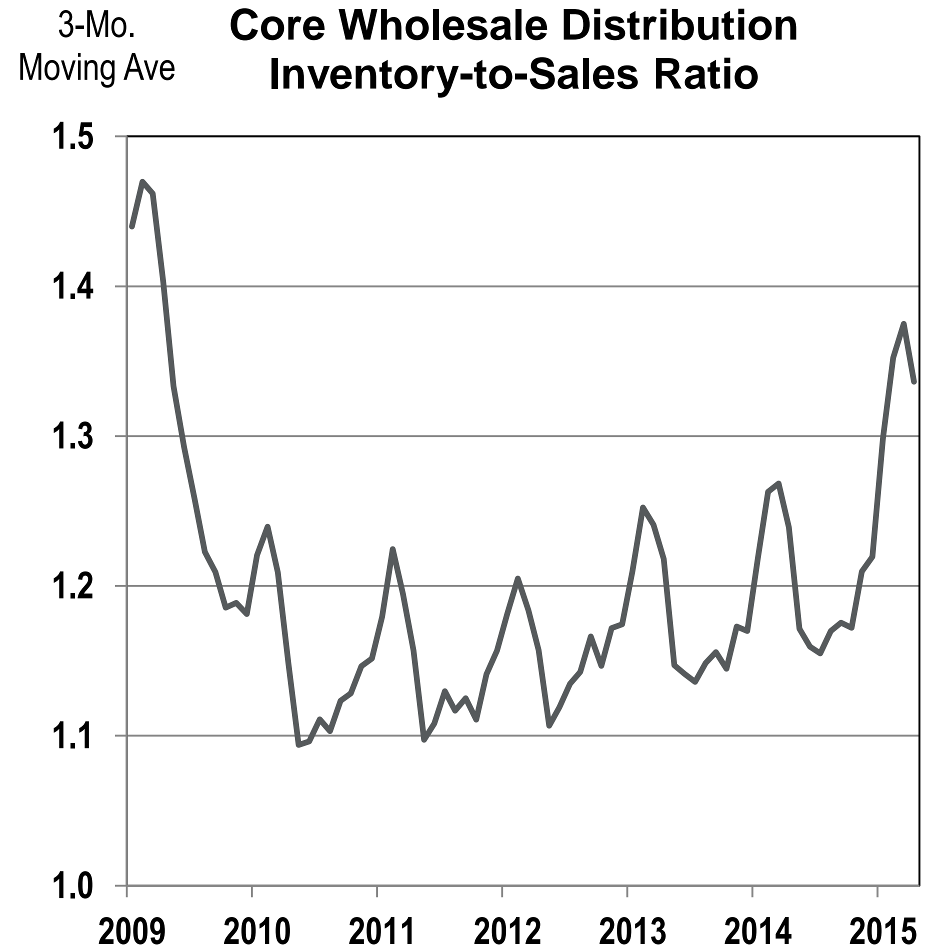
U.S. Nominal Broad Dollar Index and Real Net Exports



Sources: Federal Reserve, Bureau of Economic Analysis, and Consensus Forecasts.

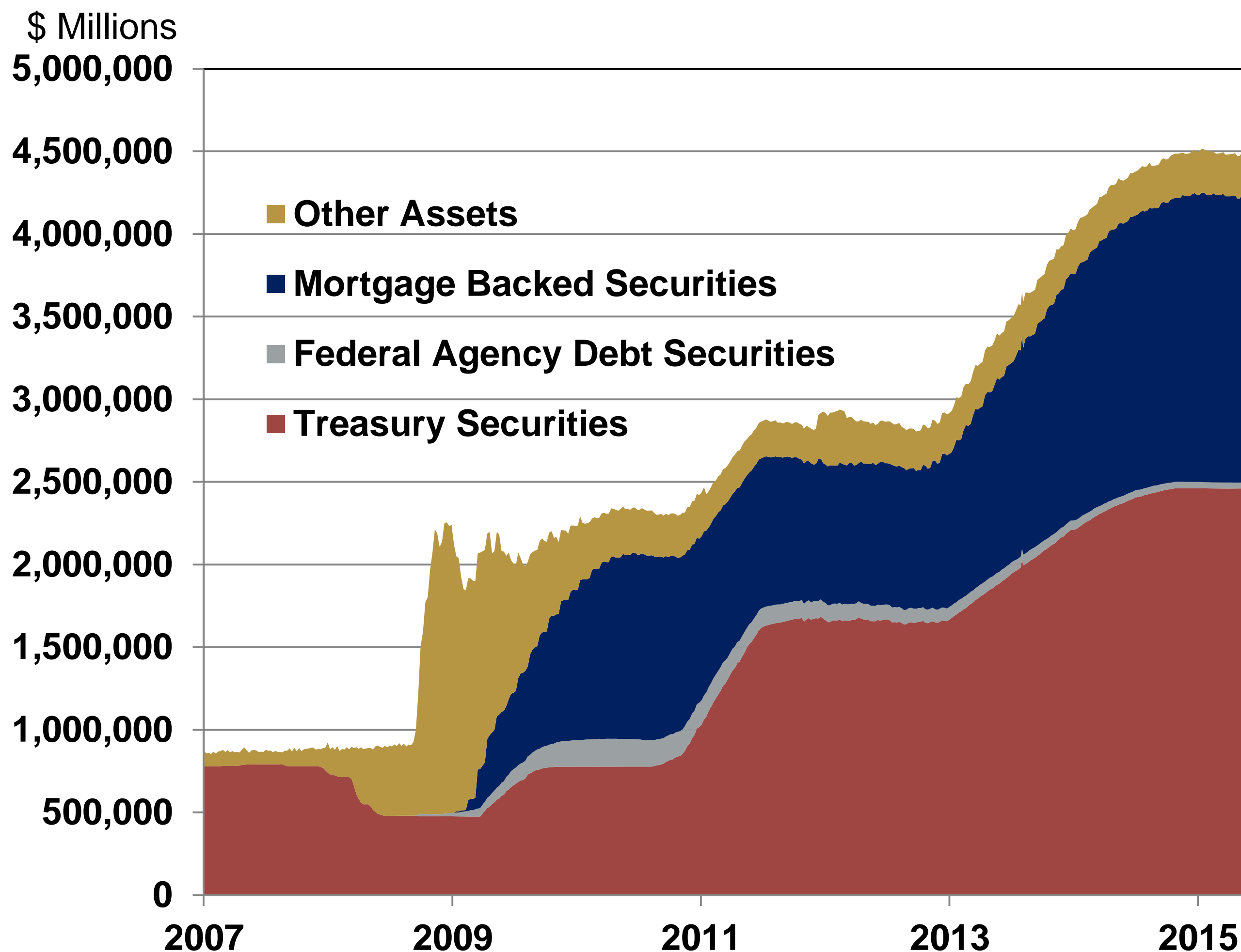
Inventory





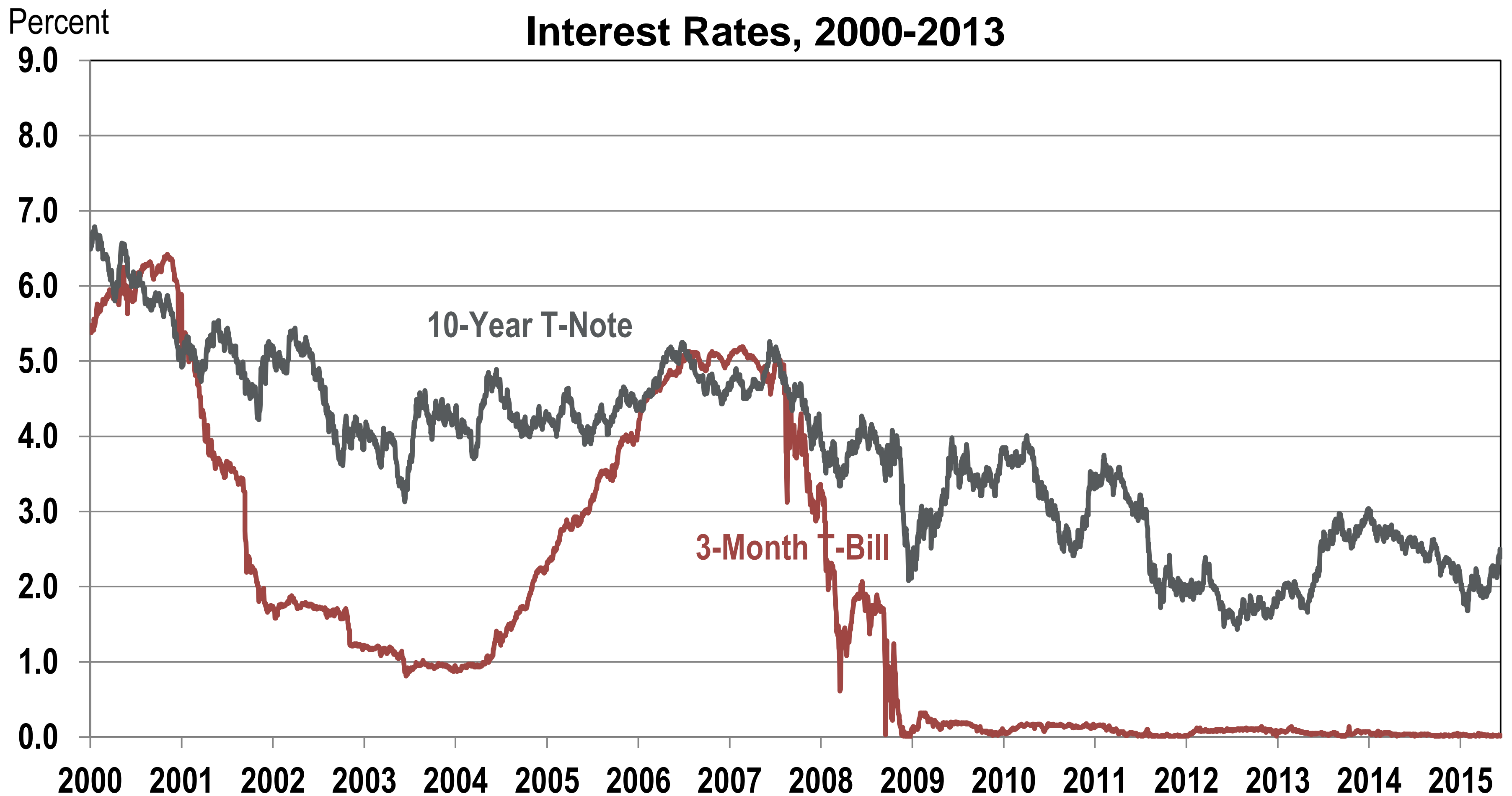
The FED

- QE 1
- QE 2
- Fed promises near zero interest rates until mid-2013, 2014,
- 2015, 2016?
- Operation Twist
- Swaps
- Tapering



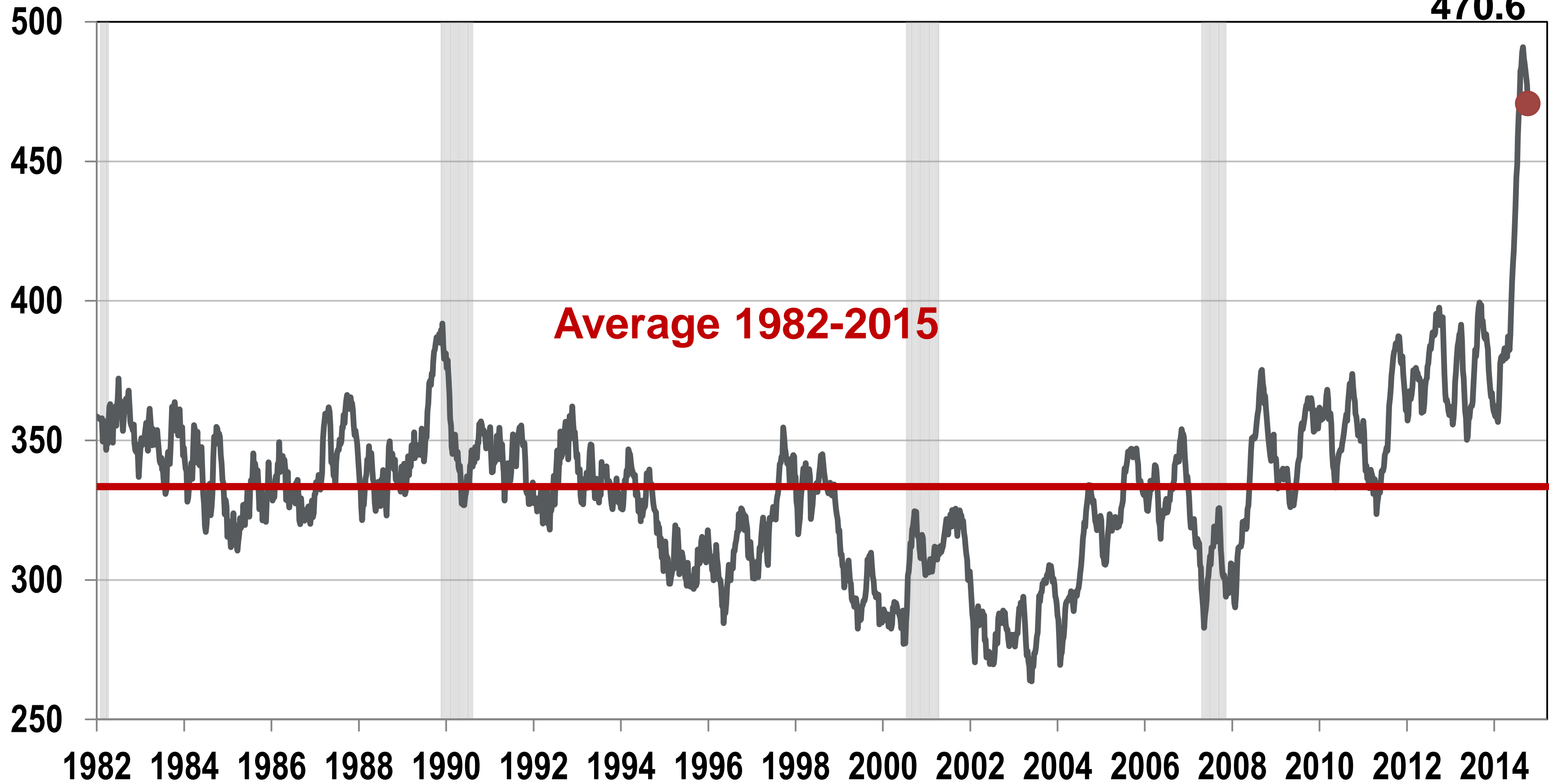
Source: Federal Reserve Balance Sheet.

Interest Rates



Sources: U.S. Treasury.

Commercial Crude Oil Storage

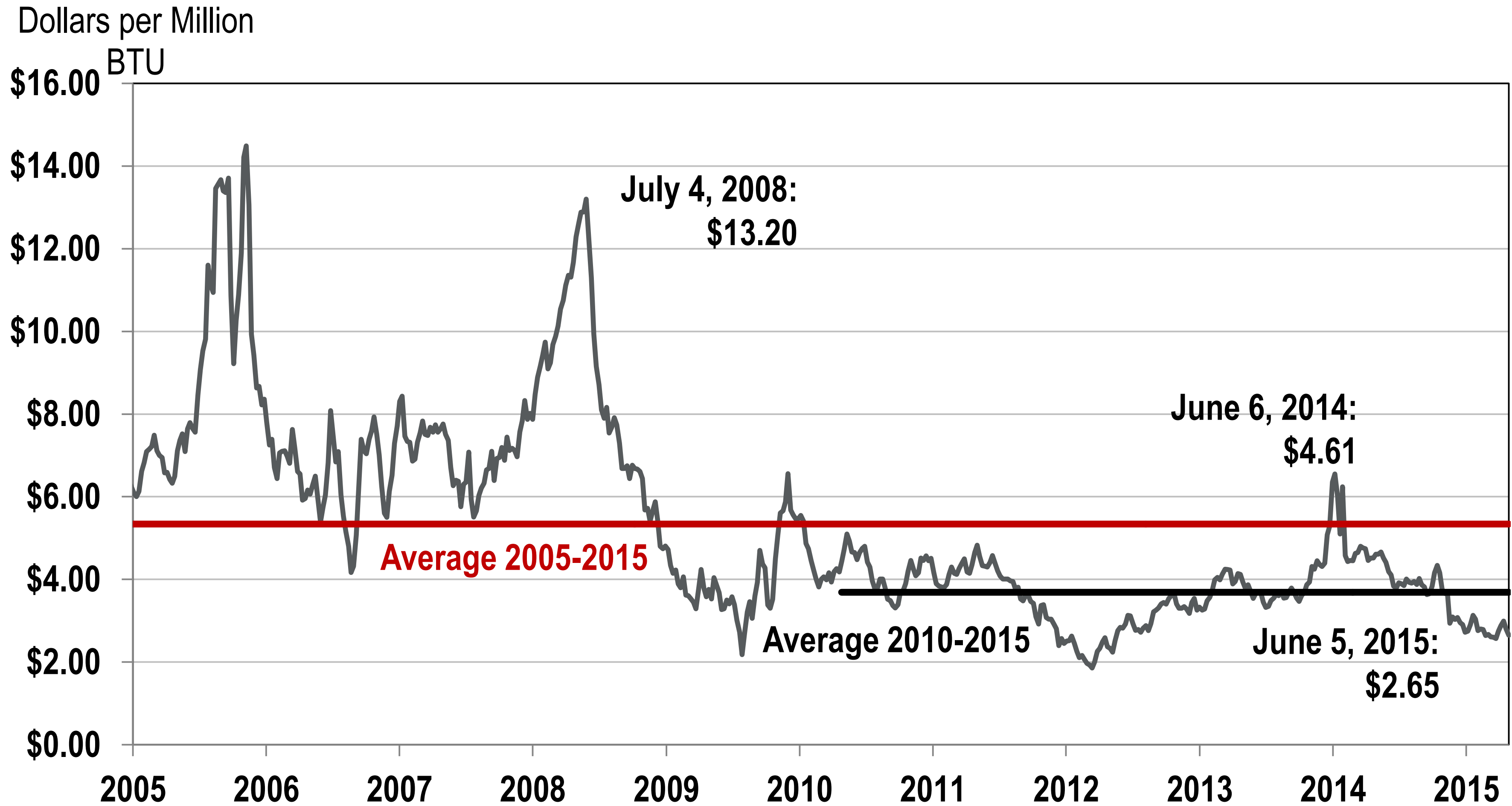


Source: Energy Information Association (EIA), Weekly U.S. Ending Stocks excluding SPR of Crude Oil.

WTI Oil Price

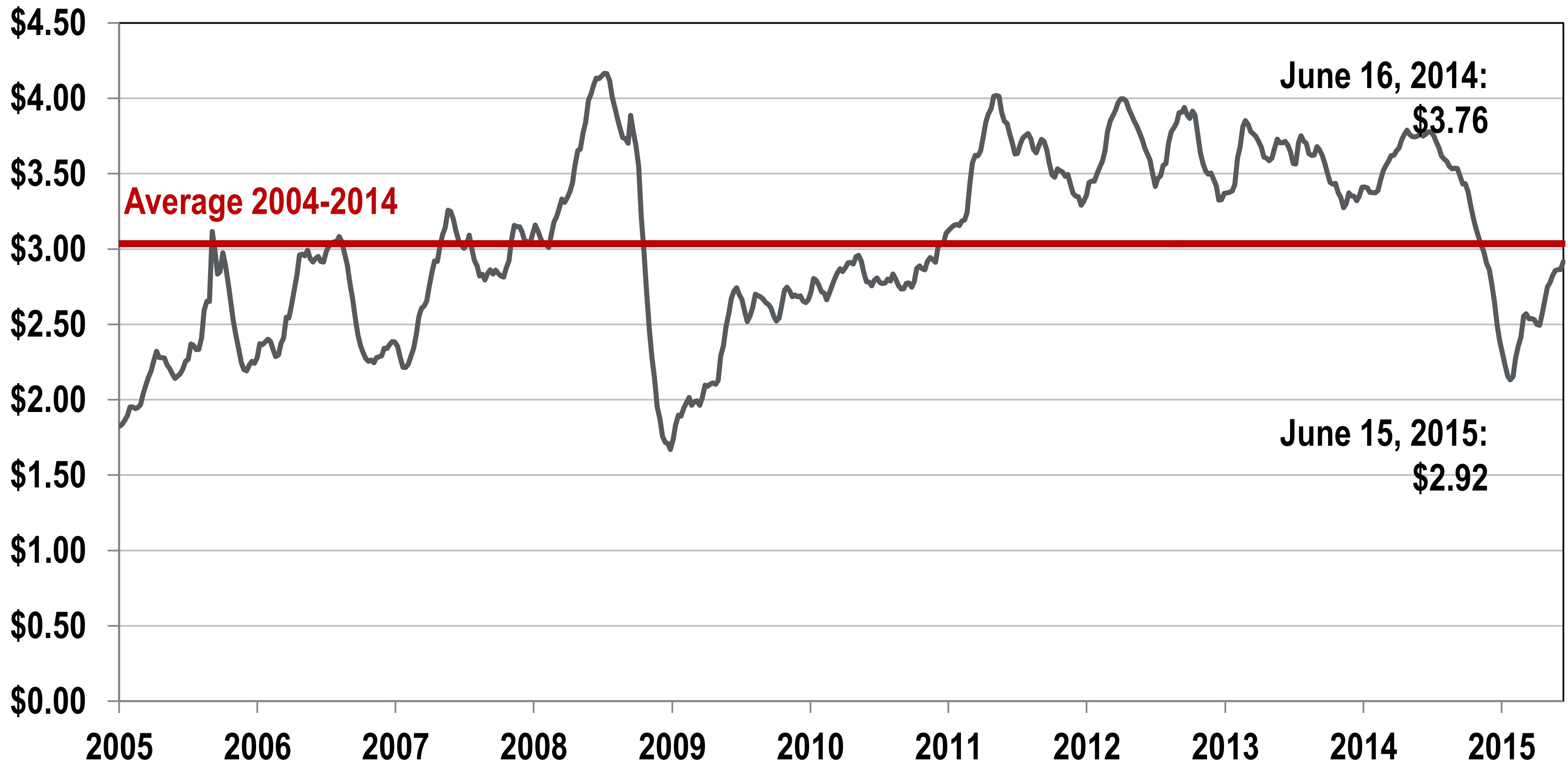
Source: Energy Information Association (EIA), Cushing, OK WTI Spot Price FOB.

Henry Hub Natural Gas Spot Price



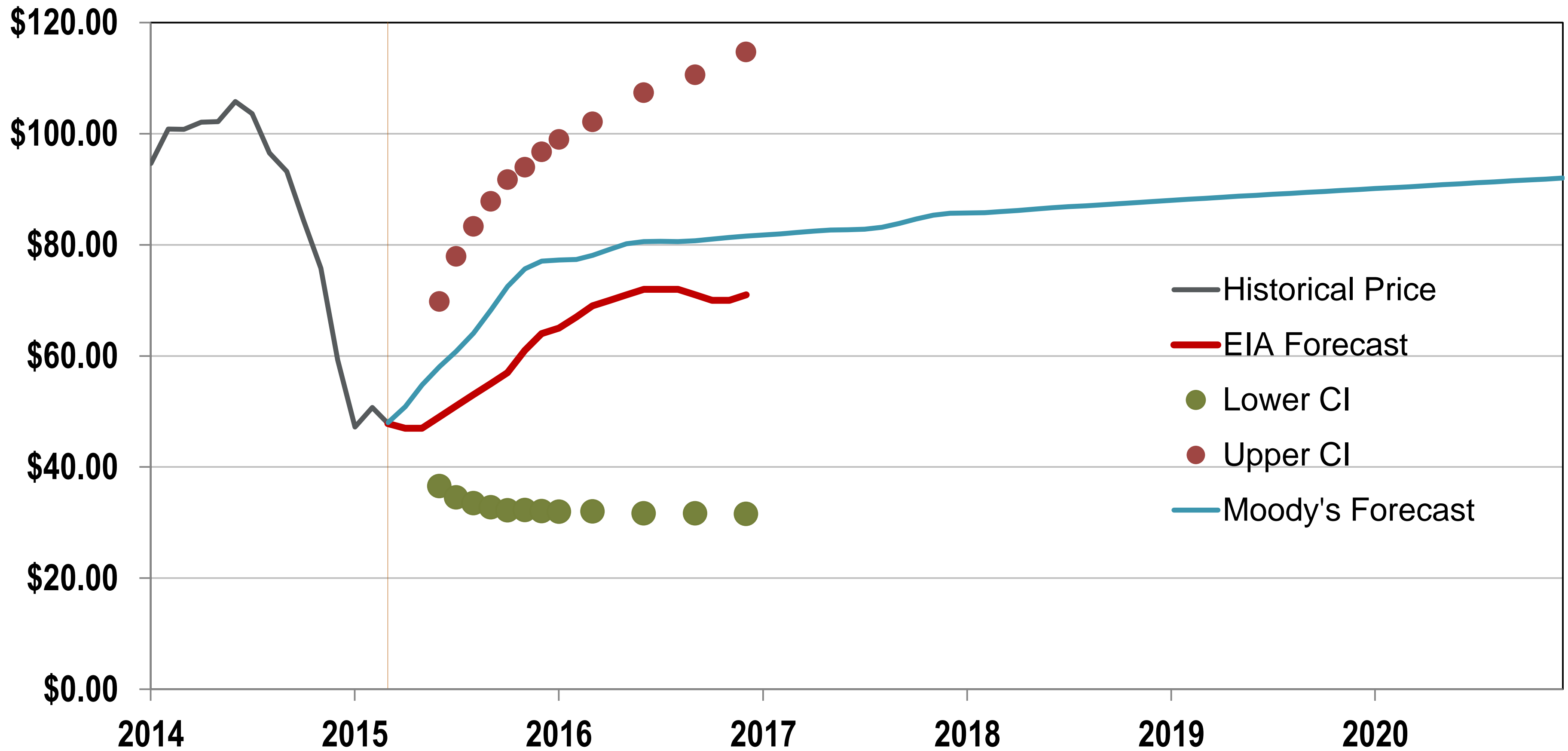
Source: Energy Information Association (EIA), Weekly Henry Hub Natural Gas Spot Price (Dollars per Million Btu).

National Gasoline Prices



Source: Weekly Colorado All Grades All Formulations Retail Gasoline Prices (Dollars per Gallon).

WTI Oil Price Forecast



Source: Energy Information Association (EIA), SPEO, Cushing, OK WTI, Moody's Analytics.

Thank You

2014 Wholesale Distribution Industry Performance

Measure	Value	% chng
Industry revenues ($B), 2014:Q4	$1,368	2.7%
Industry revenues ($B), 2014	$5,396	5.1%
Total Employment, 2014:Q4	4,963,167	1.9%
Avg. annual revenues per emp.	$1,095,000	3.2%

% change vs. previous year

Source: 2015 Economic Benchmarks for Wholesale Distribution

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Select Sector Performance/Forecast

% change vs. previous year

Major Sector	2014 Actual Revenue	2015 Forecast	2016 Forecast
Industrial	10.7%	8.3%	9.0%
Electrical/Electronics	5.2%	7.0%	9.0%
Oil & Gas	6.3%	-22.4%	24.8%
Bldg Material/Construction	6.2%	9.9%	14.7%
Hardware, Plumbing & HVAC	5.1%	8.6%	10.2%

Source: 2015 Economic Benchmarks for Wholesale Distribution

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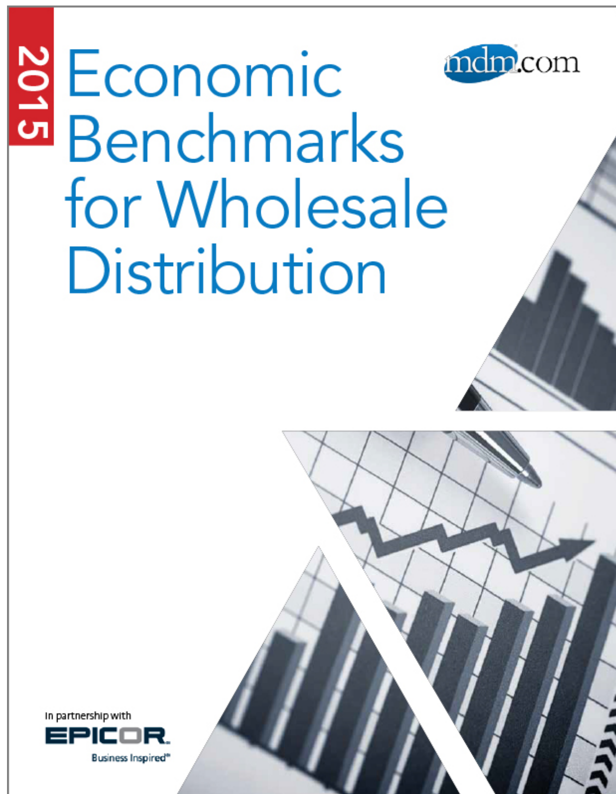
2015 Economic Benchmarks for Wholesale Distribution



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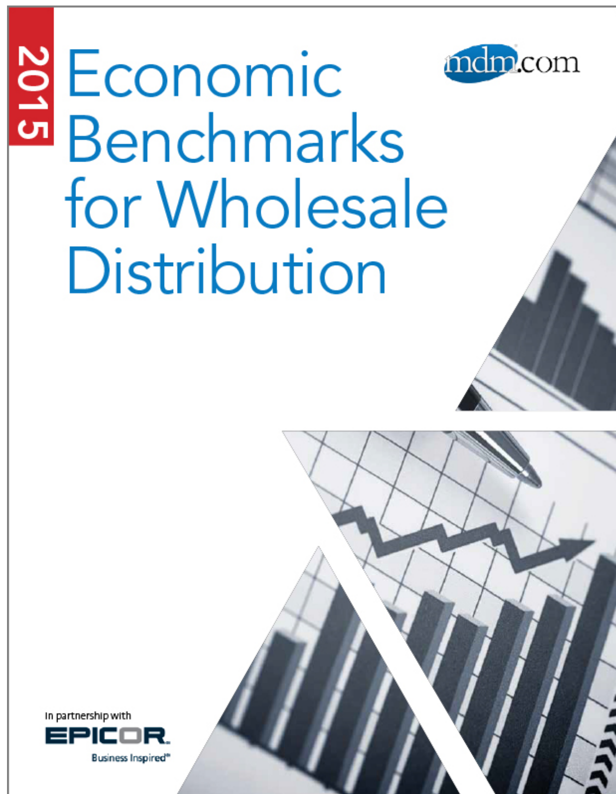
Analysis of 18 sectors (available for individual sale)

- Apparel & Piece Goods
- Agricultural Products
- Beer, Wine & Liquor
- Building Materials & Construction
- Chemicals & Plastics
- Commercial Equipment & Supplies
- Computer Equipment & Software
- Electrical & Electronics
- Furniture & Home Furnishings
- Grocery & Foodservice
- Hardware, Plumbing & Heating Equipment/Supplies
- Industrial
- Metal Service Centers
- Miscellaneous Durable Goods
- Motor Vehicle & Motor Vehicle Parts
- Office Products
- Oil & Gas
- Other Consumer Products

2015 Economic Benchmarks for Wholesale Distribution



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Analysis of 18 sectors (available for individual sale)

- **Trend Data**

Revenues, Inventories, Inventory-to-Sales Ratio, Total Employment, Average Annual Revenues per Employee and Average Weekly Earnings

- **Sector Summary**

2014 Revenues, Percent of Industry Revenues, No. of Companies and Average Gross Margin

- **Summary Trend Data**

2014 Actual Revenues, 2014 Real Revenues, Revenue Gap and 2014 Q4 Employment

- **Revenue Forecasts** for 2015 & 2016
- **Sector Growth vs. U.S. GDP Growth** - 2004:Q1 to 2014:Q4
- **Employment Size Distribution**
- **Actual Revenue Growth** – Quarterly 2004 to Present
- **Real Revenue Growth** – Quarterly 2004 to Present
- **Employment Growth** – Quarterly 2004 to Present
- **Inventory-to-Sales Ratio** – 3-Month Moving Average with Trendline

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Thank you!

Questions?

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The 2015 Mid-Year Economic Update

Brian Lewandowski and Tom Gale

June 18, 2015

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