Economic Indicator — September 6, 2023

ISM Services: The Fire Isn't Out

Summary

The fastest pace of rate hikes in a generation temporarily slowed activity in the service sector, but the ISM Services Index rose to a six-month high in August as the prices-paid measure climbed for the second-straight month.

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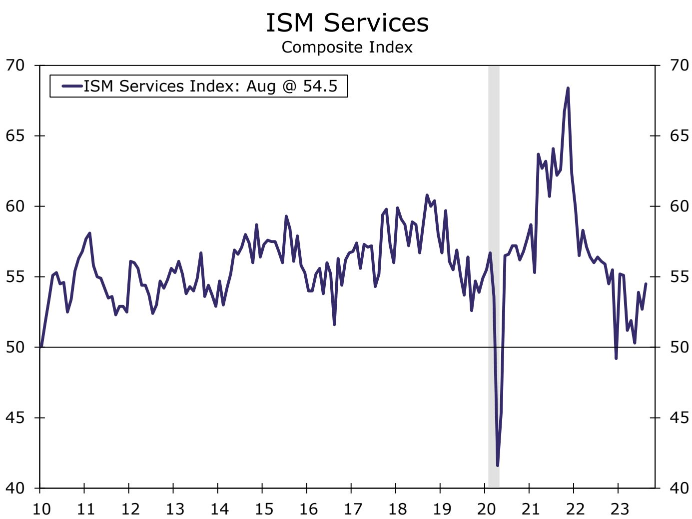


Source: Institute for Supply Management and Wells Fargo Economics

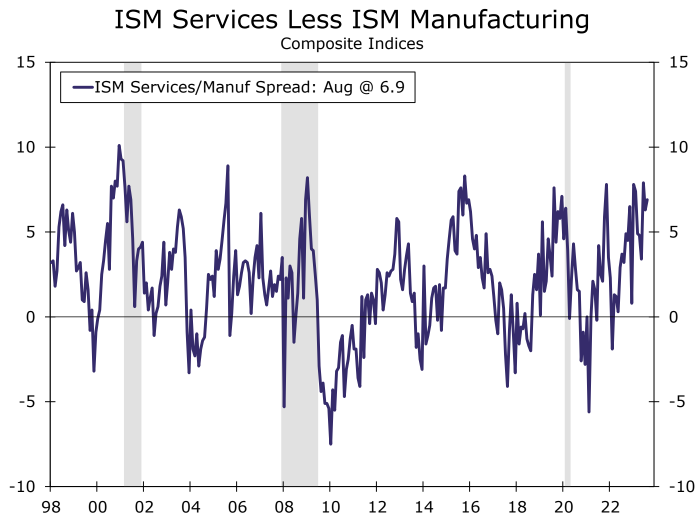
Word on the Street is Fire in Your Heart is Out

The fastest pace of rate hikes in a generation has yet to fully quell activity in the service sector. The ISM Service Index rose in August to 54.5, expanding at the fastest pace since the 55.1 reading in February (chart). Gains were broadly based; new orders, employment, prices, and production ALL expanded at a faster pace in August.

Order backlogs slipped into contraction territory, but that was the only item with a minus sign in the "percent point change" column. Import orders were unchanged and everything else posted an increase in August.

This is in stark contrast to what is happening in the factory sector. Last week we learned the Manufacturing ISM came in below 50 yet again, bringing the total number of months in contraction territory to ten, a run never before seen outside a recession. An argument could be made that manufacturing has been in recession most of this year, particularly in some harder hit sectors.

Yet the Services ISM spent just one single month in purgatory with a 49.2 headline print in December 2022 before rebounding back into expansion and remaining there every month thus far in 2023. In the nearby chart we plot the difference between the Manufacturing and Services ISM, which shows the present gap is near the top end of its range.



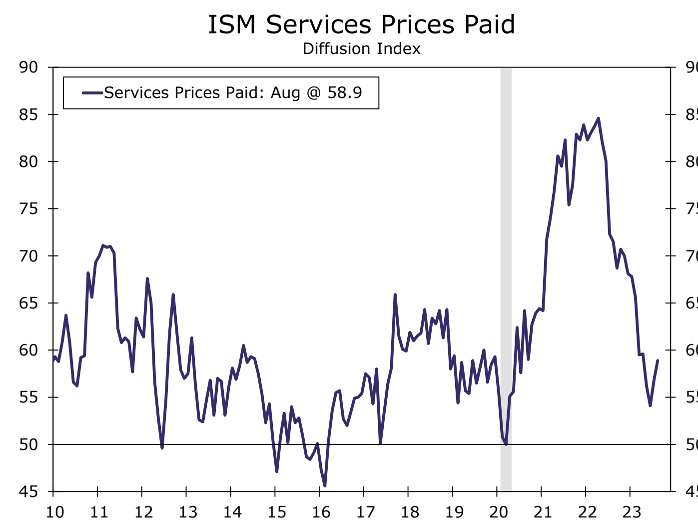
Source: Institute for Supply Management and Wells Fargo Economics

All the Roads We Have to Walk are Winding

The Services ISM also adds evidence that the road to 2% inflation is going to be bumpy. The prices paid index rose for the second consecutive month, consistent with an expansion in prices in August as 12 of 18 industries reported an increase in prices paid. At 58.9, prices paid are now back above their past six-month average and ahead of the average that prevailed pre-pandemic (57.9) (chart). In short, this indicates services prices moved in the wrong direction.

These data come as we see signs of inflation progress elsewhere. While the core CPI rose at a 4.7% annual pace in July, the three-month annualized rate was much lower at 3.1%, marking the slowest since September 2021 and indicating further progress to come. But the largest question mark remains around the services portion of inflation, which tends to be sticky and more-dependent on the labor market. Select industry comments from purchasing managers referenced still-high material, commodity and supply costs, which are likely keeping pressure on prices.

In addition to stable inflation, the Fed seeks maximum employment and the Goldilocks scenario for the Fed is to cool inflation while maintaining a sturdy labor market. So far, the jobs market appears to be cooling in all the right ways. Job openings have come down, labor supply has improved and wage growth has slowed.



Source: Institute for Supply Management and Wells Fargo Economics

Services purchasing managers, however, continue to cite a tight labor market saying "The labor market remains very competitive," indicating we're not necessarily yet out of the woods in terms of high costs. The employment component of the Services ISM would have been a whole lot cooler ahead of Friday's August nonfarm payroll release, but in rising to 54.7, it's consistent with continued expansion in hiring.

The Services ISM indicates the sector continues to broadly expand. But while consumers are not going into hiding, we may have seen the last of the all-go, no-quit, pay-any-price consumer. Pandemic era savings are running out, credit card rates are north of 20% and the job market is no longer white-hot as it was earlier this year.

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