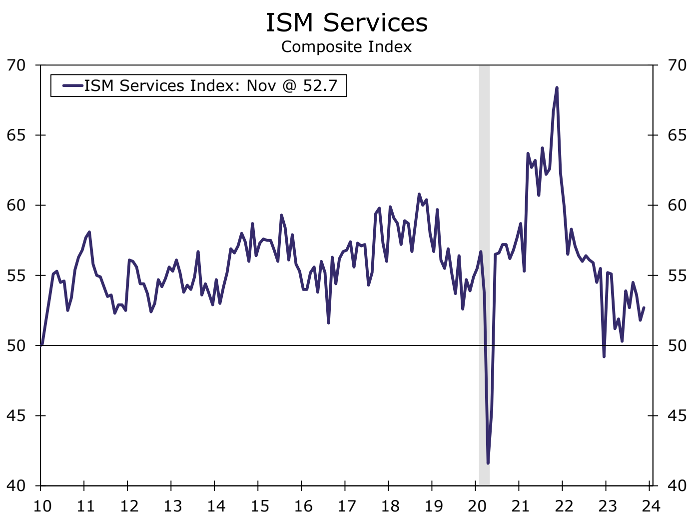
Economics

Economic Indicator — December 5, 2023

Hot Service Sector Might Be Cold Water on Swift Rate Cut Hopes

Summary

Not only is the services sector still expanding, it picked up steam in November with the ISM coming in at 52.7. With prices still firmly in expansion and employment rising slightly, it suggests that recent expectations for rate cuts might have been pulled too far forward.



Source: Institute for Supply Management and Wells Fargo Economics

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Two Years Before the Mast

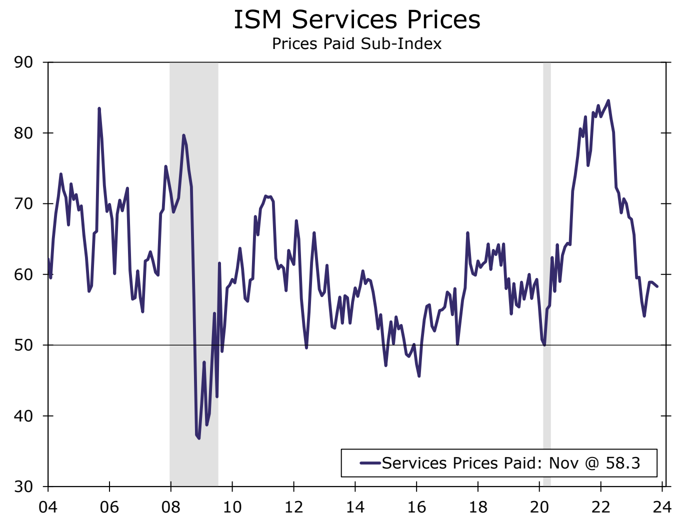
It's been quite a journey the past two years. In November 2021, the ISM services index reached its zenith, not just for this cycle, but in records dating back to the 1990s. The fed funds rate two years ago was still at the zero lower bound and inflation was still ascendant. In the ensuing 24-months, the Fed embarked on a rate-tightening campaign for the ages, yet despite a fed funds rate now higher than any point in more than 20 years, the Fed's job is not quite finished. Yes, inflation is coming down, but is still above the Fed's 2.0% target and the ISM services index is still in expansion territory, even if unconvincingly so at 52.7 (chart).

The trouble is that while the service economy may be able to withstand higher capital costs, big-ticket durable goods spending is more vulnerable to higher rates. But as long as services outlays remain robust, there is little incentive for service providers to lower prices. This complicates the Fed's efforts to get inflation fully in check. To the extent that the service sector keeps humming along, it could dash the rising hope in financial markets that rate cuts are just beyond the horizon. It is tough to justify cutting rates when the prices paid component is still consistent with rising prices (chart).

Both sides of the Fed's mandate are gradually moving toward their longer-run estimated levels. While prices are still rising, they're doing so at a slower clip. The labor market is also becoming less tight and thus exerting less upward pressure on wages. In separately released data this morning, the quits rate held steady at 2.3% in October, which is consistent with pre-pandemic levels and indicates a loosening labor market and less need to raise wages to attract talent.

The employment component of the ISM services index rose modestly to 50.7, consistent with a faster expansion in jobs last month, though the gain was slightly smaller than expected and presents some downside to our estimate for November job growth (chart). When we get the full employment situation release on Friday, we expect to see employers continued to add jobs at a robust clip in November. Specifically we forecast about 230,000 jobs were added during the month, as the conclusions of the United Autoworkers and Hollywood strikes lead to a pickup in payroll growth. Despite the rise, the overall trend in hiring has downshifted since earlier in the year.

We anticipate the fed funds rate probably has reached its terminal level of this cycle. But we still expect the Fed to keep the door open to the possibility for additional tightening at its policy meeting next week, particularly in the context of the recent loosening in financial conditions. Ultimately the Fed will need to see more progress on inflation before it begins to outright ease policy.



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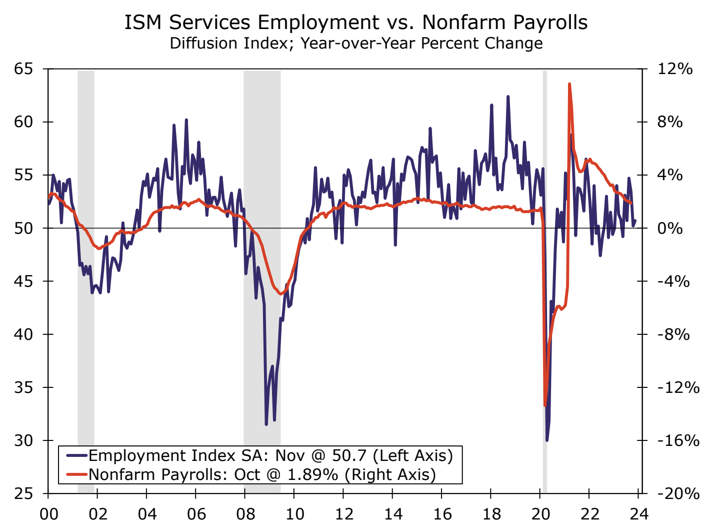

Source: Institute for Supply Management, U.S. Department of Labor and Wells Fargo Economics

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