

Economic Indicator — November 3, 2023

Service Sector Activity Is Slowing. Prices? Not So Much

Summary

The service sector is still expanding, but it is doing so at a slower rate. The moderation in activity has not yet been sufficient to cool prices as fast as policymakers at the Federal Reserve might like to see, although a sustained softening in the labor market might just do the trick.

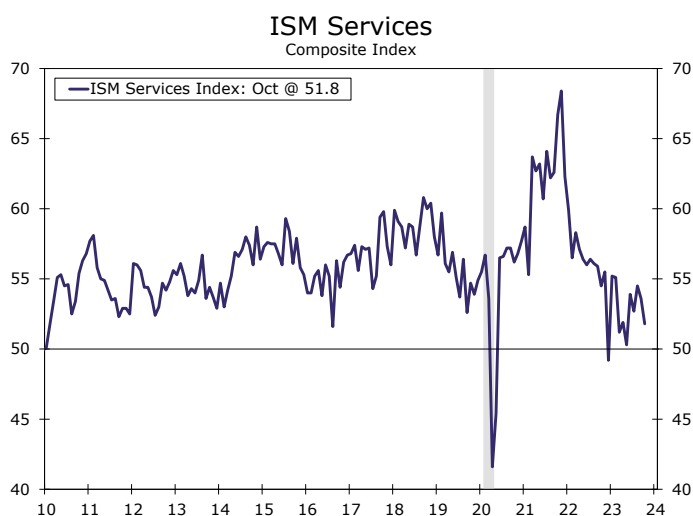
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Source: Institute for Supply Management and Wells Fargo Economics

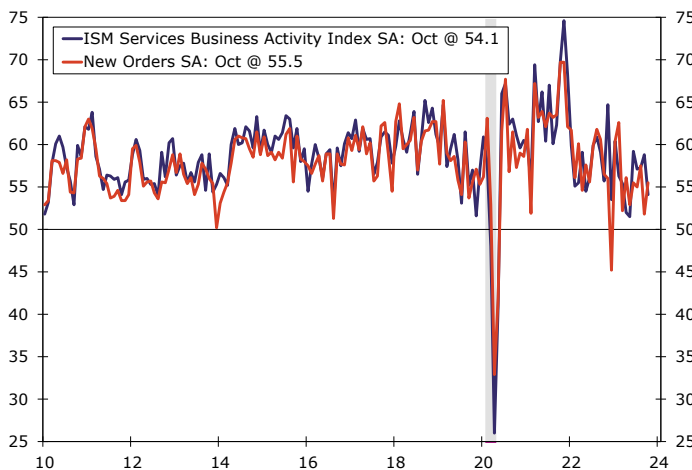
Loss of Momentum, but Still Growing

The ISM Services Index came in at 51.8 for October marking the second straight monthly decline in the index, while still remaining in expansion territory at the start of the fourth quarter ([chart](#)). Unlike the factory sector which is in outright decline, businesses in the service economy are merely dealing with a loss of momentum.

Details were mixed as the business activity component shed 4.7 points to come in at a five-month low of 54.1, while new orders rose 3.7 points to hit 55.5 ([chart](#)).

The impact of the UAW strikes appeared at various points throughout the excerpted comments ranging from being a source of “risk and caution [with]...customers who have pulled back” (Wholesale Trade) to “having no impact so far” (Retail Trade).

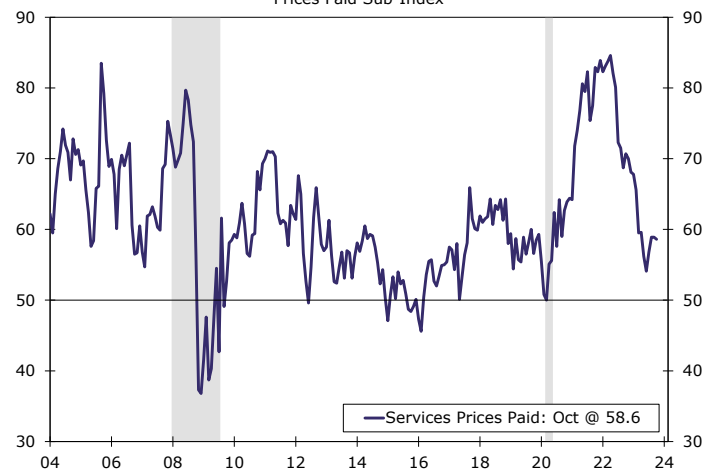
ISM Services Business Activity vs. New Orders



Source: Institute for Supply Management and Wells Fargo Economics

ISM Services Prices

Prices Paid Sub-Index



Source: Institute for Supply Management and Wells Fargo Economics

Supply Bottlenecks No Longer to Blame for Prices, It's All About Labor

Price pressure remains elevated in the service sector. The prices paid measure declined incrementally to 58.6 from 58.9 a month earlier, which is still consistent with a broad expansion in prices. Ten industries reported paying higher prices during the month, with evidence of labor being a primary contributor to cost pressure. In a bit of an under-appreciated bright spot, the supply chain problems that still exist in manufacturing are practically non-existent among service providers. The supplier deliveries component came in at 47.5, the second lowest reading of the past 13 years.

A respondent in the Accommodation & Food Services industry, for example, mentioned suppliers passing through increased labor costs specifically. Labor competition also remains a challenge in the Health Care & Social Assistance industry: “Labor pressures continue, particularly in areas that are hard to recruit. Filling front-line and lower-skill labor positions has gotten very expensive because of competition from large companies and logistics providers. Also, middle management roles are harder to recruit for than they have been in some years.” The employment component was barely in expansion at 50.2 in October. We expect the weakness in the ISM employment reading reflects continued tightness rather than imminent weakness, particularly in the context of the separately released nonfarm payroll report out this morning that showed a slower but still solid pace of hiring during the month of October.

While the ISM services report is a bit more mixed than the pullback in the headline ISM suggests, it doesn't change much in terms of our expectations for Fed policy. The pause in the downward trend of prices paid and evidence of labor costs somewhat feeding services inflation does not come as a large surprise. We've long said the road to 2% will be bumpy, a view FOMC Chair Jerome Powell echoed in this week's post-meeting press conference. While price pressure continues to expand, the breadth of expansion is well-below the highs that prevailed in the initial run up in inflation ([chart](#)).

Further, as our colleagues noted in the employment [report](#) this morning, lower growth in average hourly earnings in October suggests the demand and supply of workers are coming back into balance

and easing upward pressure on inflation. While the moderation in activity has ultimately not yet been sufficient to cool prices as fast as policymakers at the Federal Reserve might like to see, there has been improvement, and we continue to anticipate the FOMC has come to the end of its tightening cycle.

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