

Economics Group

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ISM Non-Man: Don't Breathe Too Deep a Sigh of Relief

An improvement in the ISM non-man to 56.4 suggests broad activity is holding up. Slower hiring and falling backlogs, however, indicate the gap between manufacturing and the rest of the economy may not be sustained.

A Nice Headline Bounce, But Details Less Encouraging

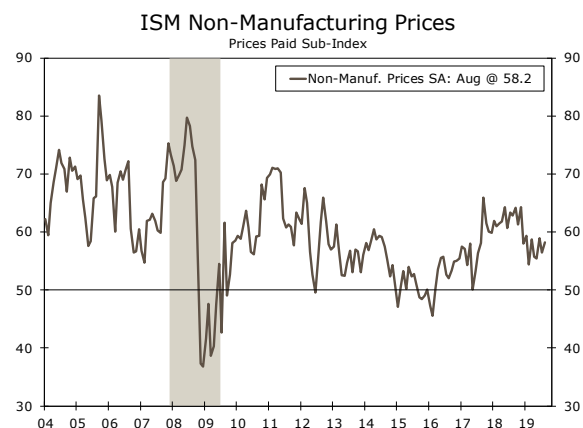
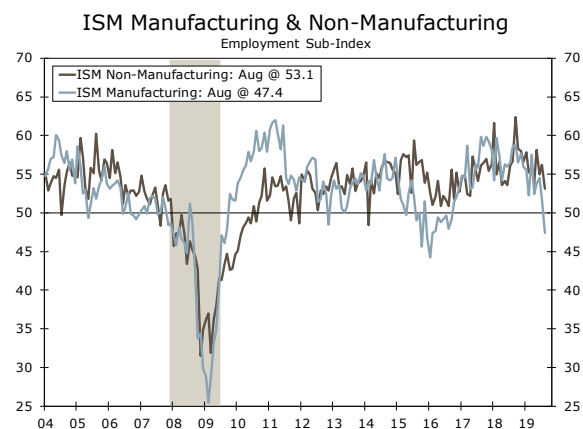
The 2.7-point jump in the ISM non-manufacturing index to 56.4 in August suggests that broad economic activity continues to hold up despite manufacturing activity contracting. We are not breathing too deep of a sigh of relief, however. The improvement contrasts with the slip in the Markit services index to a nearly three-and-a-half-year low and a 3.4-point drop in the average reading from regional Fed service sector surveys. Moreover, while the headline suggests that conditions remain OK at present, the details hint that businesses remain nervous about the outlook.

The index on current activity posted the largest increase among all sub-indexes, leaping 8.4 points. New orders was not far behind, increasing 6.2 points to move back above 60. But hiring, which gives an indication of how businesses view the outlook beyond the next couple months, slowed in August. At 53.1, the index is at its lowest level in more than two years, and has led us to downwardly revise our estimate for tomorrow's payroll report. We now expect to see payrolls rise by only 135K in August. Backlogs of orders also contracted, taking some of the shine off the improvement in new orders. Tariffs continue to cast a pall over the price environment. The prices paid sub-index rose to 58.2, with respondents from industries including accommodation & food services, construction and management noting an impact. Unfortunately for the FOMC, which is looking to offset some of the negative effects of tariffs and trade uncertainty via lower interest rates, one respondent also noted that "lower mortgage rates have not had a great effect on new residential construction sales."

Convergence with Manufacturing Still Likely to Come

While the spillover effects from weakness in the factory sector seem generally contained at the moment, we still see the current environment as more fragile than the last time manufacturing activity was contracting. During 2015-16, slowing global growth was also dragging down manufacturing activity here at home. Consumers were relied upon to carry growth, which they did with gusto; real consumer spending rose 3.7% in 2015, the strongest pace of this expansion.

The proposition of consumer spending carrying on undisturbed this time around, however, looks harder. Collapsing commodity prices in 2015-16 were a significant tailwind to real consumer spending via lower inflation. In contrast, today's global slowdown is closely tied to trade tumult and the imposition of tariffs. We expect tariffs, which have now been extended to finished consumer goods, to push up inflation 0.1-0.2 percentage points in the coming months. Although not massive, it will erode consumer purchasing power to an extent. As a result, we expect real consumer spending to slow in the coming months, rather than continue to diverge from the path of factory output.



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