Economics

Economic Indicator — July 6, 2022

Service Sector Activity Is Cooling, Not Buckling

Summary

The message from the June ISM report is that service activity is cooling rather than buckling. Business activity rose during the month and while new orders declined, the index remains above the 50-threshold designating expansion from contraction. Service-providers continue to contend with an array of supply issues, which are limiting capacity and keeping the heat turned up on prices.

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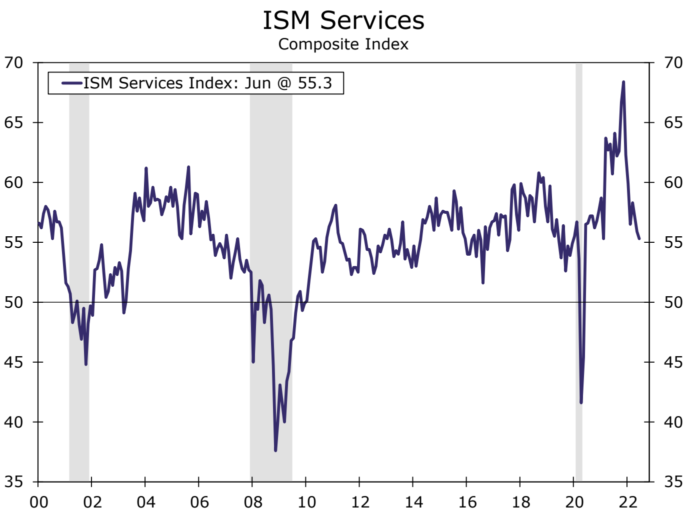


Source: Institute for Supply Management and Wells Fargo Economics

Service Activity Cools Amid Persistent Supply Shortages

The ISM services index slipped 0.6 points to a two-year low of 55.3. The decline, however, was less than expected and the underlying details of the report were a bit more mixed than implied by the headline reading.

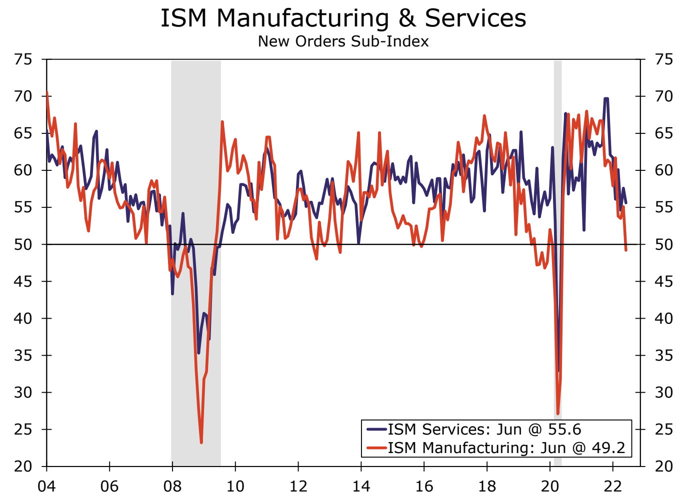
For starters, business activity held up reasonably well with 15 of the 18 service industries reporting an increase in activity for the month of June. Overall business activity was up 1.6 points to 56.1, which should help quell some fear that an economic downturn is imminent. New orders did decline 2.0 points to 55.6, but with the reading still notably above the 50-breakeven point designating expansion from contraction, demand is cooling rather than buckling. The same cannot be said for the ISM manufacturing report, released last week, where new orders slipped into contraction-territory. The divergence in the two sectors emphasizes what we are seeing from a demand perspective in consumer purchasing habits and is consistent with our overall forecast of service activity holding up well, particularly through the summer months.

Despite current activity holding up, service-providers' order backlog leaped 8.5 points last month. The sharp move higher in backlogs can likely be tied to persistent supply problems which continue to weigh on activity and drive up prices.

Supplier delivery times got a bit longer last month, and higher prices paid were reported by *all* 18 service industries in the ISM survey, an indication of just how widespread services inflation is today. That said, one modest bright spot is that the prices paid component declined 2.0 points to 80.1, a move consistent with prices rising *at a slower pace* last month.

While we have seen some cooling in commodity prices more recently, continued shortages may keep upward pressure on an array of inputs. Further the short supply of labor will continue to keep upward pressure on labor costs for some time. With labor demand still strong, we suspect shortages were the cause of the employment component slipping back into contraction territory last month at a reading of 47.4. We still expect to see employers added 240K net new jobs in June when data is released on Friday. Our forecast is below the consensus expectation for 265K jobs added during the month, and is a step down from the 390K jobs added in May.

The services ISM for June continues to be consistent with a sector that is struggling with a demand and supply imbalance. Service-sector activity is notoriously more stable than manufacturing, even in the toughest of times, and we expect service activity to hold up reasonably well through the summer months. Real consumer spending on services rose for the fifteenth straight month in May, and there is still plenty of slack in many discretionary recreation categories of spending. High-frequency data indicate consumers are taking the vacation or attending the function no matter the cost. But with consumers' staying power showing initial signs of running out, once the summer is through the boost from services may not be enough to keep overall consumer spending in the black.



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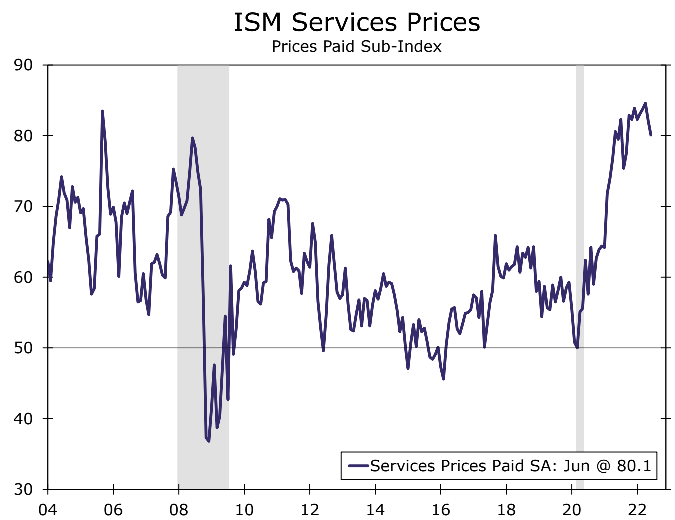

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