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Economic Indicator — March 5, 2024

ISM Services Signals Less Runway for Patience

Summary

The ISM services index slipped to 52.6 in February as prices paid cooled more than five points. For the second time in three months, the employment component was in contraction territory. Attention now shifts to Friday's employment report for confirmation that job growth is indeed cooling.

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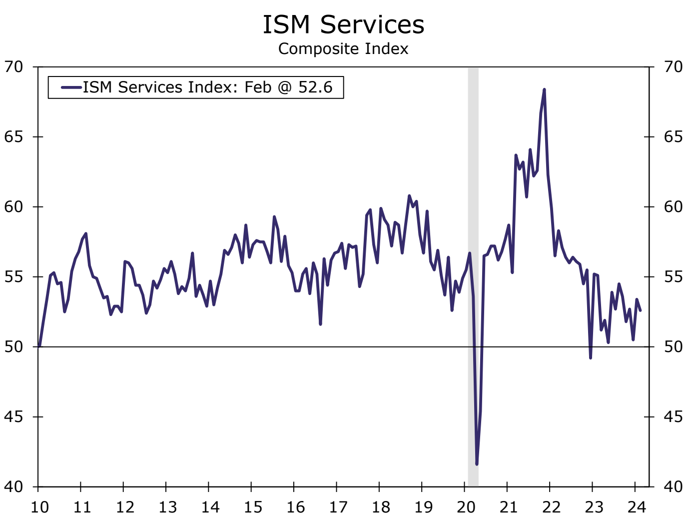


Source: Institute for Supply Management and Wells Fargo Economics

January Jump in Prices Proves Temporary

The ISM services index came in just a bit cooler than expected at 52.6 (chart). The prices paid component fell more than five points to 58.6, that is still consistent with rising prices, but at least higher prices are becoming less widespread. Between that and an employment reading that was in contraction for the second time in three months, the upshot is a bit less complacency around the timing of rate cuts.

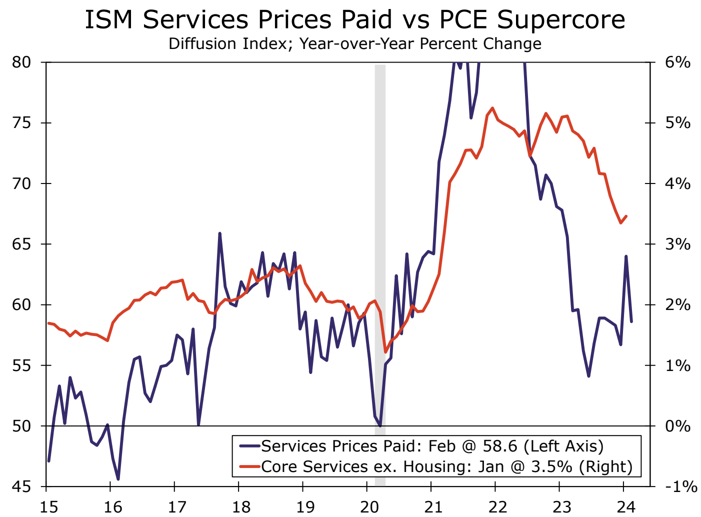
Throughout the past year, the ISM services index has been swimming against a current of pessimistic readings from other key bellwethers. Even as its manufacturing ISM counterpart and the Leading Economic Index both signaled contraction, the services ISM kept its chin up, remaining above 50 for each month of the year. We all should have been listening more attentively. Amid the hand-wringing over potential for recession, this indicator got it right.

Yet, to some extent this resilience is problematic to Fed policymakers because to the extent that the service sector continues to thrive, there is diminished incentive for service providers to lower prices. To punctuate that point, consider the fact that the prices paid component came in hot at 64.0 in January, an 11-month-high. The fact that this leading indicator for inflation came down more than five points in February is a welcome sign that price pressures are not getting worse. As the nearby chart shows, ISM service prices paid tends to lead "supercore" inflation, a key barometer to policymakers in this cycle in particular.

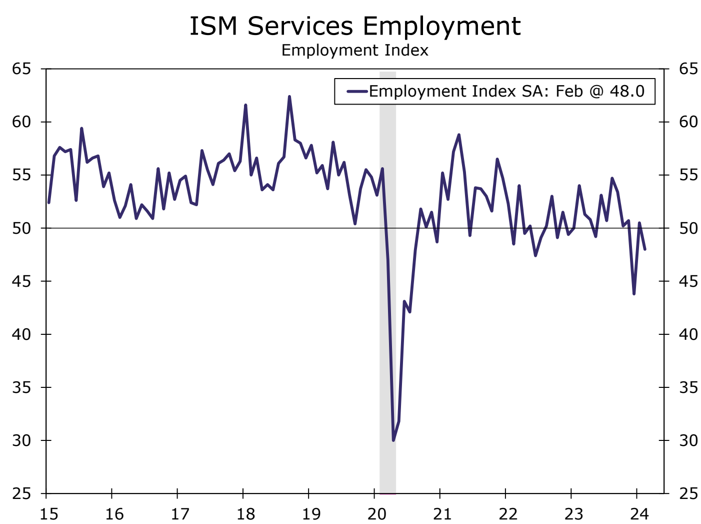
Service sector hiring is also easing. The employment component slipped back into contraction last month, at 48.0 (chart). When we combine this development with the low reading from the ISM manufacturing survey, where the employment component hit its second-lowest level since coming out of the pandemic, the data suggest some downside risk to the February nonfarm payroll report, out Friday. Employer caution is showing up in their hiring plans. A respondent from the Management of Companies & Support Services industry said, “Employers remain cautious about hiring direct employees and are considering utilizing contract labor to cover project and interim work demands as concerns about the economy continue to be front of mind.”

Although the Fed's focus is still on inflation, a deteriorating labor market leaves the Fed with less runway to be patient. The fire is also still not yet out in terms of service-sector activity, and we are not out of the woods yet. Services demand remains strong as evidenced by the jump in new orders to 56.1, marking the highest in six months. Note that Entertainment was the only industry to report a decline in new orders in February. Current activity also held up exhibited by the improvement in the business activity component.

While the easing of price pressure and moderation in hiring tilt this report in a dovish direction, the Fed will ultimately want to see these developments translate to the hard data on inflation and job growth. The challenge will be to quell demand enough to cool pricing pressure without significant disruption to the rest of the economy. This report is largely a step in the right direction.



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



Source: Institute for Supply Management and Wells Fargo Economics

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