

Economic Indicator — June 5, 2023

# Service Sector Slows to a Crawl in May Amid Hiring Contraction

## Summary

The third decline in four months for the ISM services index points to a trend decline in service sector activity, which slowed to a crawl of just 50.3 in May. In direct contradiction to Friday's jobs report, employment was in contraction with seven industries reporting a decrease in payrolls.

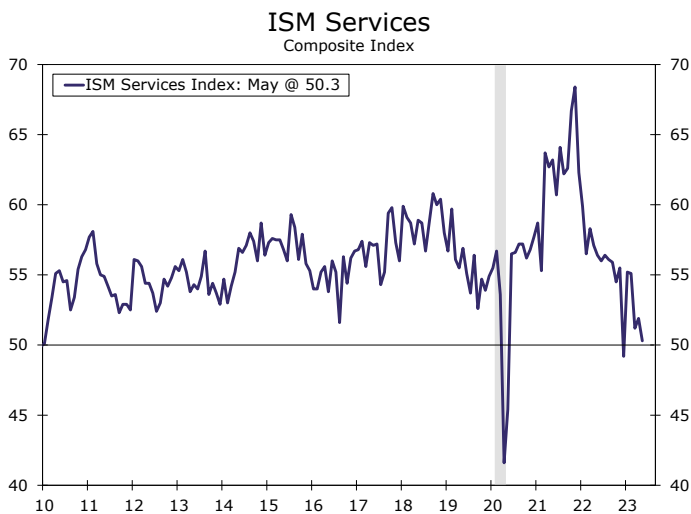
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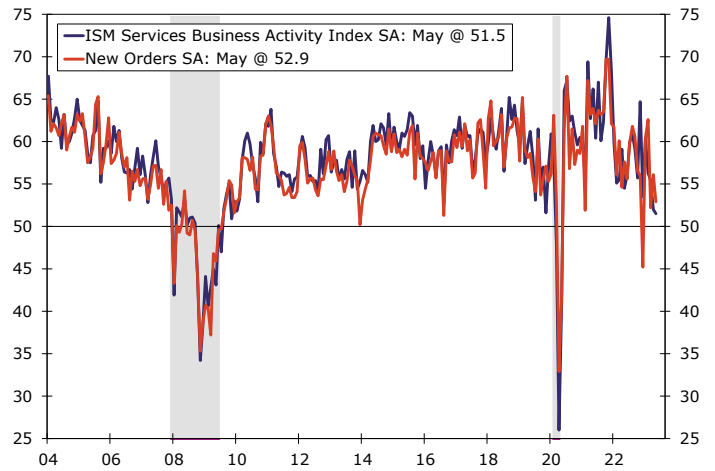
Source: Institute for Supply Management and Wells Fargo Economics

### Slowing Toward Stall Speed

The ISM services component fell for the third time in four months to come within a whisker of the 50.0 line of demarcation that separates expansion and contraction ([chart](#)). Since the re-opening of the economy in June 2020 after the COVID shutdowns, the ISM services index was below 50 only once in December 2022.

The business activity index continued its trend decline with May's 51.5 reading marking the fourth consecutive monthly decline ([chart](#)). Every non-inventory sub-component was lower in May reflecting a clear shift into a lower gear. To the extent that there was good news in today's report, the fact that new orders are still in expansion is encouraging. Although the fact that this measure fell to 52.9 from 56.1 in April, shows a clear slowdown. Worse, the prospects for orders are not at all good. Order backlogs plunged 8.8 points to hit a low of 40.9, a reading not seen since the financial crisis in 2009.

ISM Services Business Activity vs. New Orders



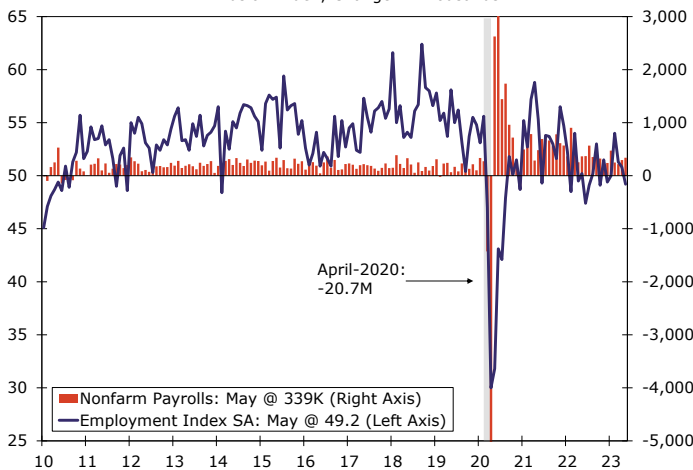
Source: Institute for Supply Management and Wells Fargo Economics

### Contraction in the Labor Market?

In the wake of last week's better-than-expected jobs report, it may be surprising to see that the employment component came in at 49.2, notching its first month in contraction territory since December ([chart](#)). Comments referred to a hiring freeze and seven industries reported reductions in headcount.

To some extent, there this is not a complete surprise, a dynamic that was widely overlooked in last week's jobs report was that the household survey which showed the number of people employed actually fell by 310K. As we wrote last week, this decline offers a cautionary note that despite the impressive payroll print, job growth might not be quite as strong as the establishment nonfarm payroll figures suggest.

ISM Services Employment vs. Nonfarm Payrolls  
Diffusion Index; Change in Thousands



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

ISM Services Prices Paid  
Diffusion Index



Source: Institute for Supply Management and Wells Fargo Economics

## Inflation and the Fed

In addition to negative news in other subcomponents, the prices paid component of the services ISM shows that inflation remains far too high for the Fed's liking. At 56.2, the sub-index is a few points lower than it was in April, but still consistent with a broad expansion in prices across the service sector ([chart](#)). We have not yet seen consumers materially shying away from higher prices, likely in part due to the fact that slowing inflation amid continued wage growth has given way to a meaningful rise in real household income. While 56.2 is still comfortably in expansion territory, the prices index is trending toward equilibrium. More plainly, prices are still rising, but rising much more modestly.

This will likely be a topic for discussion the FOMC meeting on Tuesday and Wednesday of next week. Some Fed officials believe further tightening is necessary while others believe it makes more sense to be patient given the lagged effects of monetary policy. We expect the most likely outcome will be no change to the main policy rate; although we expect policymakers to make it clear that another hike at its July 26 meeting remains a distinct possibility.

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