US maintains growth momentum with warning signs of inflation

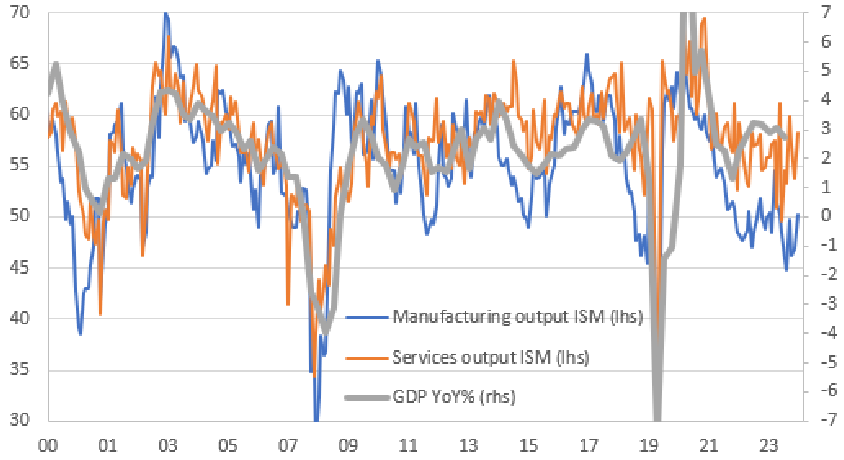
Markets have been re-pricing the prospect of Federal Reserve rate cuts this year in the wake of more hawkish Fed commentary. Today's data suggests that the economy is maintaining its strong momentum and that inflation continues to be sticky with concern over tariff implementation starting to impact corporate thinking and behaviour

Election clarity is helping to lift activity

We have been suggesting that that the clarity provided by the clean election outcome would lead companies that delayed investment and hiring on election/regulatory uncertainty to start putting money to work. That is seemingly the case based on the latest ISM purchasing managers' indices. Last week's manufacturing showed both output and news posting decent gains and today's services ISM index has also come in stronger than expected with the headline reading rising to 54.1 from 52.1, above the 53.5 consensus.

Business activity looks very strong at 58.2 relative to the break-even level of 50 that marks the boundary between expansion and contraction, while new orders strengthened to 54.2 from 53.7. The chart below showing the relationship between the ISM business activity series and GDP growth suggests the economy continues to maintain its strong momentum.

ISM activity indices versus GDP growth YoY%



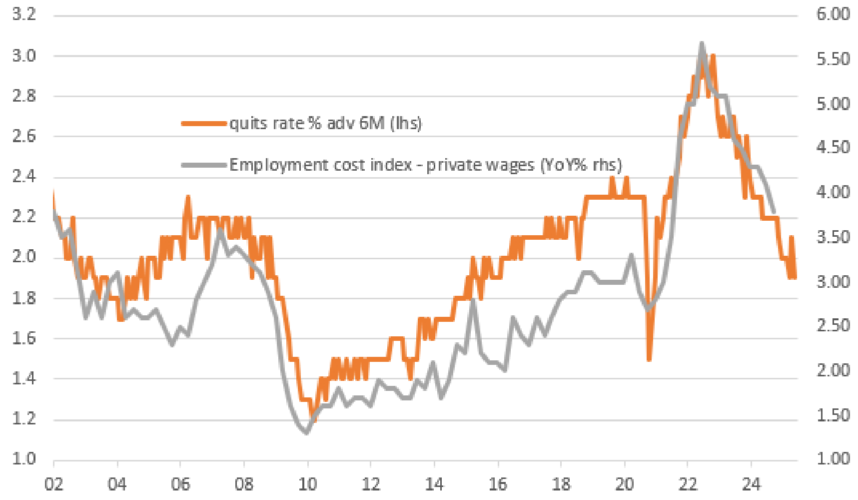
Source: Macrobond, ING

The main disappointment was that the backlog of orders is shrinking quite significantly while the employment component points to only modest growth in payrolls. At the same time, inflation pressures accelerated with the prices paid component up at 64.4, the highest since February 2023. Commentary within the report suggests that concern over tariffs is prompting businesses to accelerate activity. Some of the comments mentioned diversifying supply chains in anticipation of tariffs with others suggesting that prices were starting to shift in anticipation of the impact of tariffs, especially for longer term contracts.

Elevated inflation and a cooling, but not collapsing jobs market supports the Fed's more cautious positioning

Separately, the job opening numbers were also stronger than predicted with 8.098mn job postings in November, up from 7.839mn in October and above the 7.74mn consensus reading. However, the quits rate dropped back to 1.9% from 2.1%. This is the proportion of workers quitting their job to move to a new employer and suggests that while there may be more job availability, the jobs that are out there are not particularly attractive, either because of the money on offer or the roles available, and people are not moving job. This has historically had a strong lead relationship on employment costs – if you have fewer workers quitting there is less pressure to offer broad-based pay rises to your staff to retain them. This should help to ease inflation risks over the medium to longer term.

Quits rate versus employment cost growth



Source: Macrobond, ING

This tallies with the non-farm payrolls data that shows 78% of jobs added in the US over the past two years have been in just three sectors – leisure and hospitality, private education and healthcare services and government (predominantly local government) – all traditionally lower paid, more part time and less secure than the median job.

Looking towards Friday's jobs report both the ISM employment components have been subdued, suggesting a lack of hiring activity, but warmer weather in early December may mean that the usual seasonal temporary lay-offs in sectors such as construction may not have been as severe this year. There may also still be some catch-up coming through from the October hurricane effects. As such we are looking for something in the 150-175k range for net jobs added, but with the unemployment rate holding at 4.2%.

The combination of decent growth, elevated inflation concerns and a slowing, but not collapsing jobs market continues to see the market reducing the pricing on potential interest rate cuts this year. Only 35bp is priced with the first rate cut not fully discounted until July. The risk is that a stronger jobs number and yet another 0.3% month-on-month core CPI print next week sees that being scaled back even more.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

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