US slowdown fears heighten the odds of Fed rate cuts

Business surveys are not looking good. Today's manufacturing ISM looks particularly soft with the employment metrics looking especially poor. The Fed signalled the potential for a September rate cut, but today's data has given the market even greater faith the Fed will loosen monetary policy with the pricing now in excess of 75bp of cuts this year

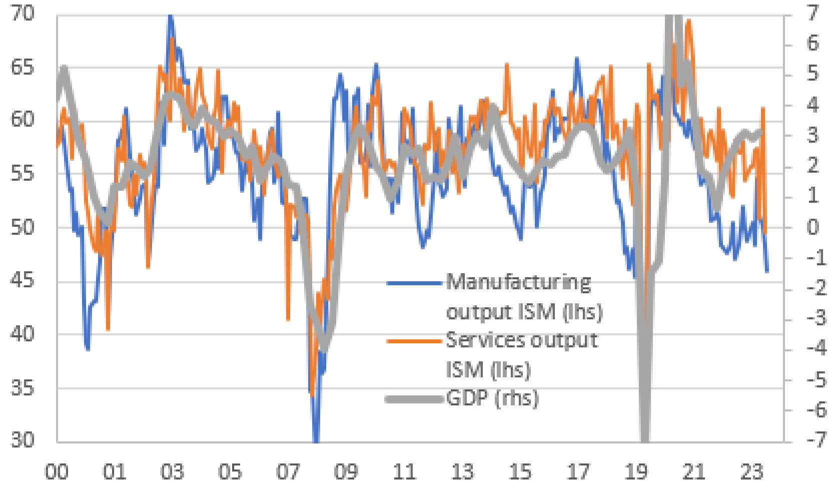
US manufacturing ISM fell, which indicates the Fed is likely to cut rates starting in September

Manufacturing worries mount

Today's US ISM manufacturing index for July was very soft. The headline balance dropped to 46.8 from 48.5 (consensus 48.8), meaning it has been below the break-even 50 level for 20 out of the past 21 months. Employment was very weak, plunging to 43.4 from 49.3, which is the worst outcome since the pandemic (June 2020) and sets us up for a potentially very disappointing non-farm payrolls number tomorrow. Meanwhile, new orders dropped to 47.4 from 49.3 with output dropping to 45.9 from 48.5. Anything below 50 is a contraction, so this is not good and has helped to help push the market to fully discount three cuts this year even though prices paid increased due to a pick-up in commodity prices.

The chart below shows how the ISM output indicators suggest a clear risk of a sharp slowdown with the non-manufacturing index dropping below 50 in June. We will get the July release early next week and the consensus is looking for a bit of a recovery, but it will still imply the threat of substantially weaker economic activity in coming quarters.

ISM reports suggests the risk of a rapid slowdown



Source: Macrobond, ING

Jobless claims point to the threat of a major pick-up in the unemployment rate

Earlier we had initial jobless claims, which jumped to 249k last week, up from 235k the previous week and above the consensus 236k expectation. Continuing claims also rose more than expected to 1877k from 1844k – the consensus forecast was 1855k. Auto maker retooling shutdowns always make predicting this number challenging in the summer months and there is the risk of greater than usual volatility, but we appear to be in a clear upward trend channel for both initial and continuing claims.

So far the move in the unemployment rate from 3.4% to 4.1% has been driven by rising worker supply rather than job losses. However, should these trends in claims continue it would mean growing upside risk to the unemployment rate. Remember the Fed only last month predicted that unemployment would end the year at 4%. We are already above that and the risks, we believe, are skewed towards the unemployment rate hitting 4.5% or higher by December. As such we see greater scope for Fed policy easing than they are currently admitting.

Note too that we also had second quarter productivity and unit labour costs data. Productivity was stronger than expected (2.3% versus 1.8% consensus) and this meant unit labour costs cooled significantly to just 0.9% (consensus 1.7%). Coupled with the softer employment cost index from yesterday, this should really boost the Fed's confidence that inflation pressures emanating from the jobs market are cooling fast and that we are on a path to achieving 2% inflation.

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