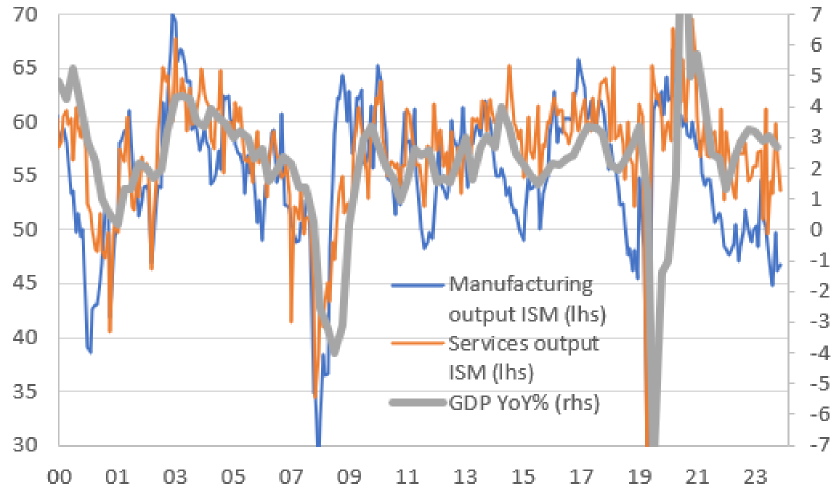
Softer US services growth favours further Fed rate cuts

Commentary from Fed officials has leaned dovish over the past week, suggesting subdued data will give them greater confidence to cut rates at a third consecutive meeting on 18 December. This week's ISM reports have ticked that box and a soft jobs number on Friday would likely seal the deal even if next week's inflation data remains sticky

The November reading of the US ISM services index is quite a bit weaker than predicted. The headline balance dropped to 52.1 from 56.0 versus a consensus forecast of 55.7. This is the weakest reading for three months, but at least it remains above the break-even 50 reading. Business activity declined 3.5 points to 53.7 while new orders fell 3.7 points, also to 53.7. This is a disappointing outcome with the ISM attributing the softening to "election ramifications and tariffs... with cautionary outlooks related to the potential impact on respondents' specific industries".

On balance it is supportive of the rate cut narrative at the December FOMC meeting and suggests a cooling in economic growth in the fourth quarter, especially with the manufacturing ISM index remaining in contraction (sub 50) territory. The chart below shows the relationship between the output series for the services and manufacturing ISM reports versus GDP growth.

ISM business surveys' output components versus GDP growth



Source: Macrobond

The employment component dropped to 51.5 from 53.0 while the prices paid component was little changed at 58.2. The relationship with non-farm payrolls and the ISM employment components has broken down in recent years and so we don't expect this outcome to seriously shift the consensus for Friday's jobs report. Remember that 53.0 is historically consistent with decent increases in employment, yet we know the outcome last month was for private payrolls to fall 28k. Likewise the private ADP series released earlier (146k versus the 150k consensus) is in our view a poor guide for non-farm payrolls. As such the current consensus of 215k looks about right to us. But remember that we will get 44k or so formerly striking workers returning and roughly 65k employees returning that were not included last month due to Hurricane Milton effects. Therefore the "true" payrolls expectation of actual jobs growth is 215k-44k-65k=106k.

The Fed commentary this week has generally leaned dovish and if we do get a jobs report indicating roughly 100k of net job creation and the unemployment rate ticks up to 4.2%, as we expect, then a 25bp rate cut on 18 December looks probable.

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