US services sector is growing, but job concerns are mounting

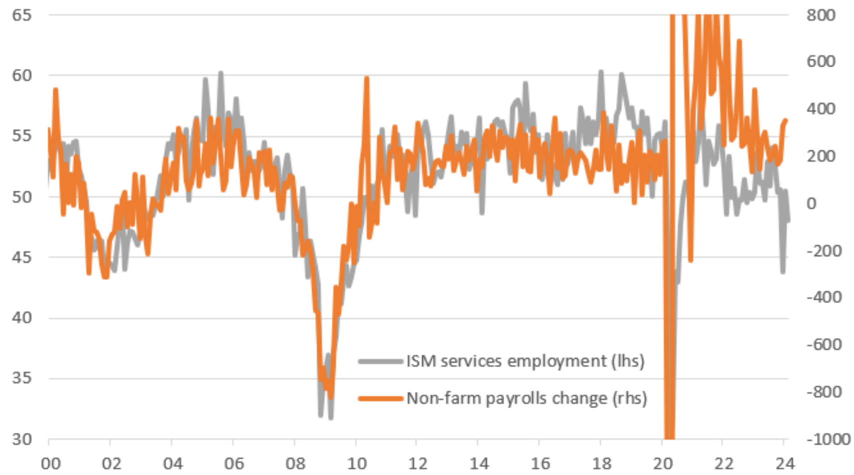
The US ISM services index shows that business activity and new orders are performing well, but companies are increasingly focused on trimming their workforce with the employment component hinting at the risk of outright job losses in coming months. However, with inflation pressures looking less worrying, the Fed should have the flexibility to respond

The US ISM services index for February paints a very mixed picture of the state of the biggest sector of the economy. The headline index was disappointing at 52.6 (versus 53.4 in January) coming in below the 53.0 consensus forecast, yet business activity and new orders improved nicely to 57.2 and 56.1, respectively, with both more than a full point higher than their six-month average, where a number above 50 represents expansion and anything below signals contraction.

However, employment was particularly soft, dropping into contraction territory at 48.0. This is the second sub-50 print in the past three months with the six-month moving average also now below the 50 line. Historically, there has been a very strong relationship between the ISM services employment index and the monthly change in nonfarm payrolls, but throughout 2023 and into

January 2024 they have had an inverse relationship.

ISM services employment and nonfarm payrolls changes (000s)



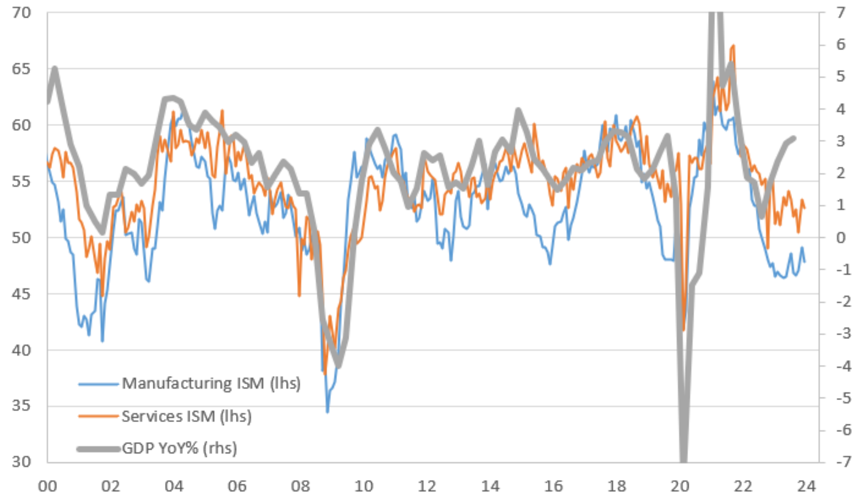
Source: ING, Macrobond

With job loss announcements seemingly picking up and the quit rate falling, it does appear that the jobs market is cooling. But to forecast a negative payrolls print for this coming Friday, as suggested by ISM, would be a very bold call given the tendency for official data to continually surprise on the upside. The ISM manufacturing employment component was also very weak, but it is doubtful that the consensus will move very much from the 200,000 figure currently anticipated.

We also see that prices paid thankfully fell back – this component was being closely eyed given the recent strength in core inflation readings. It spiked up to 64.0 in January from 56.7 in December, but we are now back down to 58.6, which is well below the 62.0 consensus figure.

The market has seemingly taken this report as a signal of weakness, with Treasury yields falling further and Federal Reserve rate cut expectations rising modestly. Nonetheless, it can also be spun as showing quite a nice combination of decent activity, not-so-hot prices and businesses looking at perhaps right-sizing their workforce after a period of firm hiring. There is little sign of employers taking an axe to jobs. Nonetheless, the chart below leaves us with a nagging doubt that the economy may not be as robust as GDP alone suggests and that we could see a broader slowing in coming quarters. We have US GDP growth up above 3% yet the ISM indices suggest the economy is performing more in line with 1% GDP growth.

ISM indices and GDP growth (YoY%)



Source: Macrobond, ING

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