ISM Non-Man Signals Broadening Slowdown in U.S. Economy

At 52.6, the ISM non-manufacturing index fell to a three-year low and suggests weakening in the U.S. is no longer isolated to the factory sector. The odds of an October rate cut have increased.

Amid Broad Pullback, Drop in Hiring Most Worrisome

The ISM non-manufacturing index plunged 3.8 points in September, putting the index at a three-year low of 52.6. A drop seemed almost inevitable after last month’s surprisingly strong report. Despite a sharp escalation in the trade war in August and ubiquitous headlines about recession risk rising as a widely watched portion of the yield curve temporarily inverted, the ISM non-man also jumped 2.7 points. The August increase stood in stark contrast to multi-point declines in the Markit Services Survey and regional Fed service sector PMIs.

Today’s drop, however, was steeper than even our below-consensus forecast (and the entire consensus for that matter). At 52.6, the ISM non-man is now more closely in line with other service-focused PMI measures, and corroborates signals that economic activity is moderating beyond the factory sector.

Among sub-components, the biggest retrenchments were in business activity (down 6.3 points to 55.2) and the more forward-looking new orders component (down 6.6 points to 53.7). Most troubling, however, was the further decline in the hiring index. At 50.4, the employment index is at its lowest level since early 2014 and dangerously close to a contractionary reading. The pullback in the employment component makes the consensus estimate for Friday’s payroll report, currently just shy of 150K, look high. More generally though, the slowdown in hiring inserts some fragility into the outlook for consumer spending as labor income looks at greater risk of slowing at the same time consumer confidence has wobbled.

Economy Still Growing, But Clearly at a Slower Pace

Notably, the ISM non-manufacturing index remains in expansion territory, but is down from an average of 56.7 in the first half of the year and 58.9 in 2018—consistent with a meaningful slowdown in growth. The gap between the manufacturing and non-manufacturing sides of the economy remains fairly wide, but there are growing signs of weakness spreading, and we believe the risk of factory weakness spilling over to consumer spending and the service sector is greater in today’s environment than during the last growth scare of 2015-16. Not only is hiring slowing, but consumers are facing higher inflation—versus the disinflationary tailwind to real consumer spending during the commodity price collapse earlier this decade.

We expect GDP growth to slow to a roughly 1.5% pace over the next few quarters, which is decidedly below FOMC members’ estimates of potential growth. With sustaining the expansion now an explicit goal of the committee, today’s report supports our outlook for another 25 bps cut before year-end, with the odds increasing that it comes as soon as this month, and that it won’t be the last of the Fed’s “mid-cycle adjustment.”

Source: ISM, U.S. Department of Labor, Federal Reserve System, Bloomberg LP and Wells Fargo Securities