Did The USD and Rates Get ISM-Services Wrong?

- ISM non-manufacturing surprised to the upside…
- ...but the underlying details were mixed
- Hiring confidence continues to wane
- Heavy distortions could have been at work…
- ...including an unusual month of August and tariff effects

ISM non-manufacturing, balance/diffusion index, August, SA:
Actual: 56.4
Scotia: 54.0
Consensus: 54.0
Prior: 53.7

While the headline ISM non-manufacturing reading surpassed expectations and increased from the month before, there were mixed underlying drivers that were bullish for production and ordering but bearish for jobs. The overall report might have been unusually distorted for at least a couple of reasons. Because of the mixed details and distortions, I wouldn't get too carried away with any indication of resilience that is indicated by the headline number. As a result, in my view, the reaction in the USD that appreciated and the almost 4bps rise in the 2 year Treasury yield post-data exaggerates if not totally misinterprets the report.

Before turning to the details, why could the upside result have been distorted?

1. An unusual August: There were five glorious weekends in August and the earlier than typical Labor Day weekend mostly fell in August this year. What an August to remember as partial recompense for the market turbulence and crazy headline risk. The result was that activity in several service sectors could have been greater than usual for a month of August. Seasonal adjustment factors are adjusted once per year by ISM and so the typical August seasonal adjustment factor probably didn't compensate enough against these effects. The result was probably more consumer spending and more housing activity than normal for a month of August. This was a factor in yesterday's upside surprise to vehicle sales in that the greater number of weekends and the industry's accounting practices that compress all of this year's Labor Day weekend sales into being recorded in August artificially boosted sales. Also, since most ISM responses tend to come in later in the month, it's conceivable that much of the long weekend effect that mostly fell in August had a particularly distorting effect on the responses.

2. Tariffs: It's plausible that the August 1st announcement of additional tariffs on China led to front-loading of orders ahead of the implementation on September 1st. Against this assertion is that new export orders fell back to 50.5 (53.5 prior), indicating little if any growth. Therefore, the pick-up in overall new orders came through domestic sources. Is that how tariff front-running worked? Did retailers and others in the non-manufacturing sphere ramp up orders from domestic supply chains in order to secure prices before any tariff pass-through effects?

Now for the underlying details:

- **Employment decelerated in the key services sector** to 53.1 (56.2 prior). Over time, ISM-services employment is highly correlated to nonfarm changes

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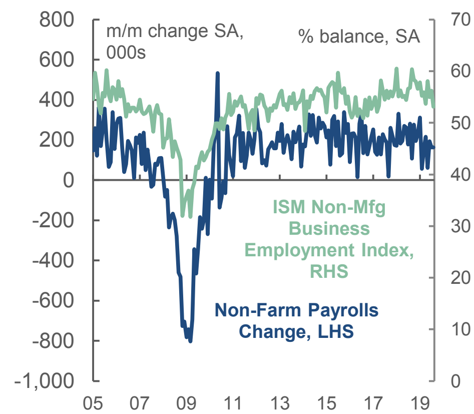
Nonfarm Vs. ISM-Employment



Sources: Scotiabank Economics, ISM, BLS.

(see chart), but there is enormous noise in the shorter term intervals. That said, ISM-services employment has fallen from 60.4 a year ago to 53.1 now and the trend isn't letting up. **It suggests considerably less hiring confidence by services related employers that make up the vast bulk of overall employment in the United States**. I didn't really care about the ISM-mfrg employment gauge, given the light share of employment, but the deterioration in services hiring sentiment is disturbing and weighs against arguments that tariffs and other risks may be only impacting a small portion of the US economy.

- New orders accelerated to 60.3 (54.1 prior) entirely on domestic orders as new export orders fell to 50.5 (53.5 prior);
- The order backlog decelerated and is shrinking now at 49;
- Prices paid accelerated to 58.2 from 56.5 the month before. Again, this might have reflected rising concern about tariffs after this subcomponent slipped during the relative calm of July.