

ISM-Services Sinks, Triggering Nonfarm Bets With Implications For The Fed & BoC

- ISM-services fell to about a three year low...
- ...fanning recession bets in markets...
- ...but we're not quite there yet
- Underlying details were weak, but stagflationary
- The employment gauge points to a poor payrolls report tomorrow...
- ...but markets may be too confident in such an outcome
- Souring US data buoys our forecast for the BoC to cut before year-end

ISM non-manufacturing, balance/diffusion index, September 2019:

Actual: 52.6

Scotia: 55.5

Consensus: 55.0

Prior: 56.4

The Trump administration's tariffs are dragging everything down and it simply lacks credibility to argue that the US economy is not being harmed by the trade wars it started. After ISM-manufacturing fell sharply on Tuesday, the services gauge followed suit this morning. **The headline ISM-services gauge fell by more than anyone anticipated to the lowest reading since August 2016** (chart 1) and hence just a few months before the election of that year.

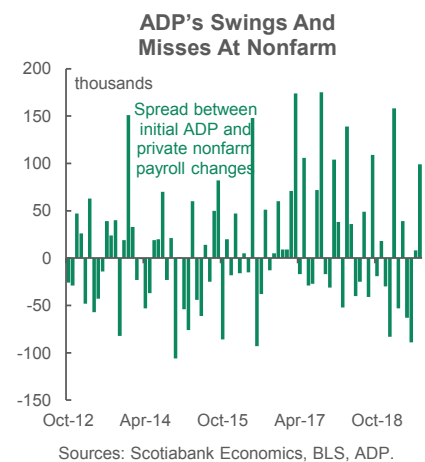
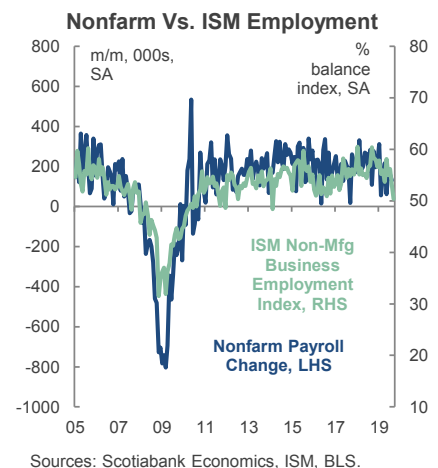
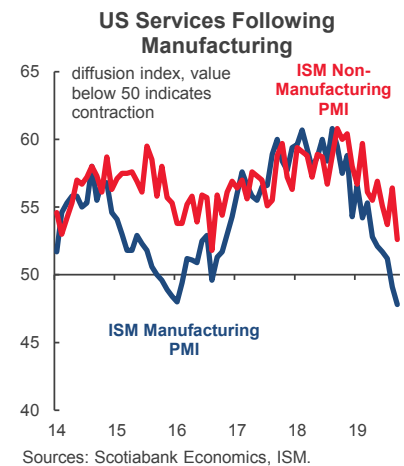
Should everyone pile on the recession bandwagon? There have been five other times since 2010 when ISM-services has fallen to this level or a little lower. Each of those prior times was not marked by recession and the readings improved thereafter and so we need further weakening and for ISM-services to contract for a period of time to raise recession calls. This may well be different in that those prior times were not characterized by destabilizing trade wars. **If Trump wants, he still has time to right this ship—and his approval ratings—with key trade deadlines over the weeks ahead.**

Markets responded in largely predictable fashion by heaping on correlated recession bets. The bottom fell out of the Treasury curve immediately after the release with the 2 year yield down 10bps on the day and bull steepening with 10s down by a little less. The S&P500 initially tanked but has since clawed back much of the reaction perhaps on Fed bets. On the latter note, futures markets swiftly moved to price in near-certain probability of a rate cut on October 30th. The USD also abruptly weakened against all crosses except CAD where markets are underpricing

The most important detail ahead of nonfarm tomorrow is the employment subcomponent. It also fell to 50.1, down three points from the prior month. A roughly 50 reading suggests no growth in service sector hiring. This is important because a) services do most hiring, and b) there is a reasonable correlation between the employment subcomponent and monthly changes in nonfarm payrolls (chart 2).

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Having said that, while there is correlation over time, the individual months along that path are very noisy. An example of the noise to the pattern that worked in the opposite direction is that when we got some pretty low nonfarm readings earlier this year to date, it didn't show up so much in the ISM-services employment gauge.

In fact, **there are three reasons why I wouldn't change my 150k estimate for the change in total nonfarm payrolls.** Indeed, markets may be braced on one side of a nonfarm bet with greater conviction than may be justified.

1. ISM-services employment is a loose guide to monthly changes in nonfarm payrolls as noted.
2. ADP's tracking of the private nonfarm payrolls change is marked by an average difference between the initial (pre-revision) estimates of about 50k when estimated in absolute terms. The largest overestimation of nonfarm by ADP was 175,000 in September 2017 and the largest undershoot by ADP was 106,000 in November 2014. See chart 3.
3. Nonfarm's 90% confidence interval is +/- 110,000 jobs. It's statistically noisy. In repeated sampling 90 times out of 100 you'd say payroll growth was somewhere between what they say tomorrow and +/- 110k. It's kind of like throwing darts after a few tequila shots.
4. As for the household survey from which the UR is derived, take the above points and multiply them. Its 90% CI is much bigger. For example, the +/- 90% CI for the change in the number of unemployed is about +/- 300k.

Across other components:

- **new orders** decelerated to 53.7 from 60.3;
- **this one is about domestic weakness.** That's because new export orders improved to 52 (50.5 prior) suggesting that the weakness came through the domestic services side
- **prices paid increased** to 60 from 58.2 and the strongest since November of last year. Weaker activity and rising inflation signals puts the risks to the Fed's dual mandate in somewhat of a jam.
- **breadth isn't as bad across industries as it was for the manufacturing ISM report.** 72% of industries reported growth (89% prior). 67% of industries recorded higher new orders (down from 83%). 83% of industries say prices paid increased (67% prior). 61% of industries say they are hiring (56% prior) and so a few more industries hiring must be offset by a slower pace of hiring to jive with the employment subcomponent to ISM.

Our first and still off-consensus and markets forecast for the Bank of Canada to cut in Q4 unfortunately got a boost with such poor US data of late. That may be reflected a bit more in currency markets this morning in that CAD is in the minority of major or semi-major currencies holding its own by being flat to a depreciating dollar (ie: following it lower against other crosses). The rates complex, however, only has about a quarter of a cut priced for the end of this month and is also underpriced for December in my view even with the post-ISM rally in Canadian rates.

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