Comerica Economic Alert

Comerica Bank

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ISM PMIs Softer Than Expected in May, and Inflation Is Slowing

- **The ISM Services PMI was softer than expected in May and input price pressures cooled. Trends were similar in the ISM Manufacturing PMI, which was released last week.**

- **The ISM Services PMI reported lower employment, corroborating the uptick of the unemployment rate in the May jobs report.**

- **Real GDP will likely be slower in the second quarter of 2023. Comerica's below-consensus forecast is for a modestly negative GDP print; the consensus forecast is for modest but still positive growth.**

- **The ISM surveys provide reasons for the Fed to hold interest rates steady at their next decision June 14.**

The ISM Services PMI pulled back to 50.3 in May from 51.9 in April and was below the 52.4 consensus forecast; Comerica forecast 52.0. The reading was the second lowest since May 2020. Before the pandemic, the last time the Services PMI was this low was January 2010, when the economy was flat on its back and the unemployment rate nearly 10%.

Forward-looking components of the Services PMI survey point to further slowdown in economic activity ahead. New orders fell to 52.9 from 56.1; customers reported higher inventories (58.3 after 47.2—this sub-index is most relevant for the goods-producing sub-sectors included in the survey: Mining, agriculture, and real estate). The backlog of orders index fell to 40.9 from 49.7 and was the lowest since May 2009, a sign that service-providing businesses are rapidly working through their order books as business activity outpaces forward-looking measures of demand. The employment index pulled back to 49.2 from 50.8 in April. Contradicting the Bureau of Labor Statistics' payrolls report, the ISM Services PMI has reported flat or falling employment in service-providing sectors in four of the last eight months.

The Prices Paid component receded to 56.2 in May from 59.6 in April and was the lowest since May 2020. It soared to a record high in late 2021, but has now come back to near its average between 2015 and 2019, a period when core PCE inflation (one measure of inflation's underlying trend) averaged just 1.6%.

By industry, ISM reported growth in accommodation and food services; management of companies and support services; professional, scientific and technical services; utilities; retail; arts, entertainment and recreation; construction; other services; transportation and warehousing; public administration; and educational services.

Industries that contracted in May were mining; agriculture, forestry, fishing and hunting; real estate, rental and leasing; wholesale; information; health care and social assistance; and finance and insurance.

The ISM Services PMI rounds out the releases of the U.S. economy's three most closely watched privately-produced economic indicators, all of which moved lower in May. The ISM Manufacturing PMI released last week slipped to 46.9 from 47.1 and has reported a contracting manufacturing sector each month since last November;

the sub-index for prices paid by manufacturers fell to 44.2 from 53.2, indicating more than half of surveyed businesses paid lower prices for inputs in May than in April. The third leg of the private survey tripod is The Conference Board's Consumer Confidence Index®, which was the weakest since last November, with consumers seeing the least abundant job opportunities since April 2021.

Lower readings from the ISM surveys suggest that economic activity is taking another step down in the second quarter after real GDP slowed to 1.3% annualized in the first quarter from 2.1% in 2022. Comerica's below-consensus forecast is for real GDP to modestly contract in the second quarter, by 0.5% annualized, as the Fed's interest rate hikes weigh on capital-intensive sectors. The consensus forecast in Bloomberg's May survey of economic forecasters was 0.6% annualized. As far as the job market goes, the PMI Surveys suggest that the labor market weakened in May, a judgement that was hard to determine from the mixed May jobs report—with higher payrolls but also a higher unemployment rate.

The Fed is still primarily focused on fighting inflation and will see the ISM's May PMI surveys as excellent news—purchasing prices are falling for manufacturers, and businesses outside the manufacturing sector are reporting price pressures similar to before the pandemic. The ISM surveys' price components led CPI inflation on the way up in 2021 and 2022. Their pullback in 2023 increases the odds that inflation continues to slow in the rest of this year and into 2024. The May CPI report, to be released on June 13, will likely show total CPI slowing to 4.2% in year-over-year terms from 4.9% in April, with CPI excluding food and energy slowing to 5.3% from 5.5%.

The ISM PMIs, and especially their prices paid components, make the Fed more likely to hold interest rates steady at their next decision June 14 than hike them further, and reduces the likelihood of rate hikes later this year, too. Comerica's draft interest rate forecast for June foresees the Fed holding its policy rate steady at the current target range of 5.00%-to-5.25% through December, at which time the Fed is forecast to cut the target a quarter percentage point as both inflation and the labor market soften. Additional rate cuts are likely in 2024, with their pace dependent on how much inflation's trend slows.