January 14, 2022

**Omicron Damage**

Damage assessment shows limited impact  
Liquidity unleashed after first rate hike  
iFlow EM shows large declines in Q4 2021

**Omicron Impairment Contained**

We estimate a weekly nowcast for the US economy, which so far is showing limited impact from the Omicron variant. As shown in the chart, the peak in activity was seen on December 10, 2021. In comparison, activity peak into Delta, according to the model, was May 7, 2021.

BNY Mellon nowcast estimates an annualized quarter activity growth, which we draw against a confidence band for reference. A month following the peak in Delta, nowcast was already adjusting by about 30-40% of the pace observed around the peak. Omicron data so far seems to present a slightly more gradual downward adjustment, but from a lower peak.

These findings are corroborated by additional real-time indicators. Facteus reports a daily consumer spend index as the spending change against last year for middle- and low-income households. The index searches for trends in retail, entertainment, and travel. The data shows a peak on December 8, primarily driven by the slowdown in air travel. The framework is tentatively showing a bottom on January 7. Much of the spending that is taking place is happening in idle sectors from a year ago, such as amusement parks, cruise travel and fitness. These are the main stabilizers of Omicron impairment.
Omicron data seems to present a more gradual adjustment

Nevertheless, we believe it might take longer before a full Omicron assessment can be made. The impact on office activity has been profound. According to the Kastle Back to Work Index, office usage dropped from 41% in the first week of December to as low as 18% on December 29 and is now at 28%. While overall activity suffered from the Delta variant, office usage improved throughout. This has not been the case with Omicron, which will likely have an impact on metropolitan areas at least until the end of the winter.

Looking further away from the US, UK London Underground data has not yet presented a clear bottom. The previous peak was on December 1, 2021 at 76% capacity. This metric is now at 56%, which is smaller than the prior correction seen between October 2020 and February 2021, from 40% to 14%.

Transport and Security Administration (TSA) data also corroborates a relatively contained downturn. We look at daily TSA throughput as a share of the same activity observed in 2019. The peak for this series was 91% on November 26, 2021. It now stands at 84%, against a post-Delta low of 70%, which followed a peak of 86% by July 3, 2021. So, a 6pp Omicron decline from the peak compared to 16pps back during the Delta wave.

BNY Mellon Nowcast
We do not believe liquidity will quickly drain for three reasons

Timing the Liquidity Flush

A few indicators show all-time high levels of liquidity in global money markets. This is the case for bank reserves at the Federal Reserve, cash on bank balance sheets, money market funds (MMFs) and the reverse repo facility at the Fed.

Bank reserves at the Fed are now at $4trl compared to $1.4trl in November 2019 and the previous cycle peak of $2.8trl in November 2014. This data mimics commercial banks' balance sheet cash assets data, now at $4.1trl against $1.6trl in November 2019.

Regulatory changes in MMFs attracted even more meaningful liquidity to these facilities. Government MMF balances are now at all-time highs of $4.2trl, compared to $2.7trl in
February 2020. Much of this increase has been about crowding out Prime MMFs, which remain at pre-lockdown lows around $500bn.

One frequently asked question is how quickly this liquidity may exit money markets as the Fed initiates its tightening cycle. Despite extraordinary inflation data - now at 7% y/y in the US – we do not believe liquidity will quickly drain for three reasons.

First, New York Fed Markets Group Executive Vice President Laurie Logan has been quite emphatic about taking appropriate steps to keep ample money market liquidity. This may imply that rate hikes will likely be approximately the same between Fed Funds (FF) and interest on reserve balances (IORB).

Second, we do expect a slightly smaller IORB hike than FF. This should be enough to initiate a long road that will end in a reduction in bank reserves by about one-third, like the reduction observed between 2018 and 2019, shown in the chart.

Third, and most importantly, headline inflation will likely decline somewhat. Consensus is for a decline from 7% to as low as 2.8%, while the Fed hikes to 1-1.25%. Even assuming a smaller drop in headline inflation, money market participants might be cautious to reduce balances too quickly until they have a better estimate of the 2023 outlook. A decline in realized inflation should be enough to cap concerns about an inflation tax paid by letting cash sit in money markets as the economy continues to reopen on the other side of the pandemic.

*Interest on Reserve Balances, Fed Funds and Bank Reserves*
In LatAm, high vaccination rates should trigger growth surprises

Anemic EM Portfolio Flows

iFlow EM shows a meaningful decline in EM flows toward the end of 2021. This was about global activity concerns, China outflows and a tighter stance not only in the US, but also across EM.

iFlow EM estimates portfolio flows into EM equity and bond markets. We run simple regressions to make the data consistent with that released by local statistical offices and central banks across the countries studied.

The yellow row marks our annual estimates for each region. Data dissects China flows showing the distortions observed in 2020. EM ex-China has recovered from a $4bn 12-month trailing outflow to a $97bn inflow now. Meanwhile, China flows dropped from $255bn last year to only $32bn now.

Flows across all regions outside China improved since the end of 2020 but remain anemic. Against peaks observed in the historical heydays, EM portfolio inflows are paltry. LatAm is at $26bn vs. the historical high at $164bn, Asia ex-China is at $36bn vs. $159bn and EMEA is at $37bn vs. $95bn.

Each region will face its own challenges in 2022 but we believe investors will overlook many of these issues. In LatAm, high vaccination rates will likely trigger higher-than-expected growth.

For EMEA, investors remain concerned about sanctions and capital controls in Russia and Turkey, but fundamentals are improving elsewhere, particularly in South Africa and the Middle East.

Asia may initiate its reopening sooner than expected as Omicron risks subside.

iFlow EM: Bond and Equity Portfolio Flows ($-mn)
<table>
<thead>
<tr>
<th>Year</th>
<th>LatAm</th>
<th>Asia ex-China</th>
<th>EMEA</th>
<th>China</th>
<th>EM ex-China</th>
<th>EM</th>
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<tbody>
<tr>
<td>2020</td>
<td>12,450</td>
<td>5,378</td>
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<td>254,661</td>
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<td>Jan-22</td>
<td>25,936</td>
<td>34,657</td>
<td>36,807</td>
<td>32,431</td>
<td>97,401</td>
<td>129,832</td>
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<td>-29,279</td>
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<tr>
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<td>158,838</td>
<td>94,883</td>
<td>331,516</td>
<td>417,401</td>
<td>748,917</td>
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</tbody>
</table>

| iFlow EM (April 2021) | 37,577 | 42,808 | 28,834 | 284,148 | 105,220 | 393,368 |

Source: BNY Mellon and Haver Analytics

Please direct questions or comments to: iFlow@BNYMellon.com

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