Conversations with Commerce Trust

2026 Economic and Market Outlook

Recorded December 17, 2025

David Hagee: Hello, and welcome to Conversations with Commerce Trust, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust.

Today I'm joined by Scott Colbert, our Chief Economist and Director of Fixed Income, and KC Mathews, our Chief Market Strategist, to recap 2025 and to discuss our outlook for 2026. Welcome back to the podcast, gentlemen.

KC Mathews: Hey, David.

Scott Colbert: Hi, Dave. How are you?

David: Great to have both of you here to go through ’25 (2025), but really to talk about where we're headed for 2026. Let's start with the economy first.

Scott, it's been an interesting year. We have a new administration in place. We've had a new paradigm in terms of tariffs really being thrust onto the stage here. What happened in 2025, and then also as we look forward, where do we anticipate the economy headed in 2026?

Scott: Well, you know, the administration got off to a rip-roaring start with a lot of policy thrown at the market. Most people focused on the tariffs, but of course, we had the loss of government jobs, probably some reduction, of course, in regulation. And let's not forget the Federal Reserve was cutting interest rates, not only last year, but this year.

So economic growth this past year was probably, and we don't know, of course, because of the government shutdowns, somewhere around 1.5%. Next year, we actually think things will pick up again, probably for two reasons. Number one, those lower short-term interest rates work with a lag, and of course, the Fed (Federal Reserve) has been cutting rates since September of 2024, and we're only now beginning to feel that impact.

And then secondly, while job growth this past year was exceptionally anemic, driven largely by two things, number one, a lack of immigration, and number two, a slowdown in government hiring, in fact, net negative government job creation. We won't have that repeat again next year, and so we expect to see a modest rebound in job growth.

So, the combination of lower interest rates, a rebound in job growth, and then I will say give the administration credit with the One Big Beautiful Bill Act. There's a little front-loaded stimulus coming on early next year. So, we wouldn't doubt that economic growth beats last year's economic growth by maybe 0.5% or so.

David: So as we look at that situation where we have, you know, stimulus coming from the One Big Beautiful Bill Act, and this jobs environment where we have a smaller labor force here, what do we anticipate for inflation moving forward, and how will that affect the Fed's rates?

Scott: Yes, this, of course, has slowed the Fed's rate cutting despite the fact that there was a clear slowdown in economic activity this past year, as well as job growth, because inflation has remained stubbornly sticky at 3%.

When you break the inflation into two components, goods, which is about 35% of the CPI (Consumer Price Index), and services, which is 65% of the CPI, we can see that there has been some acceleration on the goods side. Effectively, from about 0% increases year-over-year to about 1.9%. We would attribute most of that to the tariff policy that, of course, was brand new this year.

On the other hand, the services side continues to cool, housing, in particular. And we think that as the year progresses next year, while there will still be some follow-through from the tariffs likely pushing up short-term inflation for a period of time, perhaps peaking as early as the first quarter, we'll start to see the service side begin to pull inflation down. We wouldn't doubt that inflation ends the year next year lower than it is this year by maybe 0.3%, 0.4%, even 0.5%.

So, inflation today is about 3% as measured by the CPI. We wouldn't doubt that inflation could fall next year to something closer to 2.5%, which probably also means that the Federal Reserve will come along with at least one or two interest rate cuts as they see inflation peak and roll over.

David: So, as we transition from an economy that's been clicking along at a fairly nice pace and that looks to continue at that somewhat muted pace, we move over to the equity markets.

KC, we've had three exceptional years here, you know, up mid-20s for '23 and '24 (2023 and 2024), and then here in 2025 looks like we're going to end solidly in the mid-teens here in terms of market returns as measured by the S&P 500 (Index). Looking at the markets, what has surprised you most, and where have that where have those market returns come from?

KC: Yeah, it's been a great run, hasn't it? But to answer your question, the surprise, I might suggest that the surprise was the magnitude of the volatility. We always expect volatility in the marketplace.

You know, listening to Scott a year ago, he suggested that there be sources of volatility from the trade policy and tariffs, the labor market, immigration, fiscal and monetary policies, and perhaps a pause in the AI (artificial intelligence) boom. We expected those, but maybe to answer your question, the surprise was from February to April, the S&P 500 had a drawdown of 19%, you know, 20% is called a bear market. That was a bit surprising.

And then perhaps the second surprise was the recovery. So, from April to mid-December here we saw a 36% rally in the S&P 500. So, it's been a good year up the S&P year-to-date, you know, 15-16%, and around the globe, positive returns in risk-based assets. But to answer your question, I think that would be the surprise was the magnitude of the volatility. And those drivers of volatility will still be present in 2026, causing some volatility in the markets.

David: So, as we look forward, we've had, as we mentioned earlier, an exceptional year inside the U.S. stock market. International stocks have responded with, if you look at the broad world index (MSCI World Index), that's up about 21% (year-to-date). The more you know, focused MSCI EAFE Index, representative of developed economies at 30% up this year. What are we anticipating the sources of returns and how are markets going to be powered moving into 2026?

KC: Well, we're fundamentalists, so we feel the power is going to come from corporate earnings growth. So here domestically, you've seen, over a number of years, very substantial and material earnings growth.

In 2024, we saw 9% earnings growth. This year, 2025, now we haven't closed the books on the year, but it looks like it's going to be 12% to 14% earnings growth. And the expectation right now, analyst expectations for 2026, is like another 15% earnings growth, which is the highest growth rate expectation that we've seen in four years. So, we expect another year, 2026, of positive returns domestically.

You also asked about internationally. International stocks have done very, very well, the first time in like a decade, and a lot of that was driven by the weak (U.S.) dollar. If the dollar is weak, you don't want to be in domestic investments; you want to be in international investments. The dollar index was down approximately 10% in 2025, and that was a big contribution driver to international stock returns.

Our forecast for the dollar is probably stable, so you won't have that tailwind driving international stocks. We still have an exposure to international stocks, but we're still a fan of domestic stocks. U.S. exceptionalism and all the things that the macro landscape that Scott just painted for us should support earnings growth and positive returns in domestic stocks.

David: So, Scott, transitioning over to fixed income, again closing out another great year on the fixed income side with returns of the Bloomberg U.S. Aggregate Index closer to about 6.75% to 7% for 2025. What are we anticipating for sources of return for the fixed income market, as well as, you know, our overall positioning inside fixed income right now?

Scott: Well, you know, last year, of course, you mentioned the nearly 7% return. That, of course, didn't entirely come from the coupon because we saw interest rates decline with the Federal Reserve cutting short-term rates. All that decline kind of came in the short end of the market. The 10-year Treasury is basically unchanged on a year-over-year basis.

So, some of the extra return was also not only just driven by capital appreciation, but a compression in credit spreads. Corporate bond spreads, the amount of extra yield that a corporate bond offers you to take on the credit risk, is about as low as it ever was. So that's also helped to drive returns.

Next year, it's unlikely that you'll get any improvement at all in terms of credit spreads because we're already kind of at rock bottom levels. But that doesn't mean that incremental spread is likely to disappear because if we have positive economic growth, particularly if we have positive economic growth that is better than it was this past year, you know, we think it pays to take on a bit of credit risk.

Where we are taking it on is in the mortgage space. Mortgages were very, very inexpensive for a while. They become more, more, you know, relatively fairly valued. We still like that. We still like the corporate bond market. That was the big winner last year as you both mentioned how well international stocks have done, international bonds did exceptionally well.

We like the preferred and trust preferred markets. The bank and financial system which issues these is in very, very healthy shape. And then the one thing we're shying away from is deep credit, largely because these credit spreads are so tight.

But we think you can take on modest amounts of credit risk to pick up a modest amount of extra return over and above Treasuries. The nominal return for the year though, isn't likely to be as big as this past year because we're not going to get the fall on of even a further interest rate decline like we did this past year. Basically, over the last 15-16 months, as we mentioned, the Fed’s cut rates 1.75%.

Next year, we only expect the Federal Reserve to probably cut rates twice, which will improve the returns for very, very short-term securities in terms of the total price performance, but it won't change the yield of the aggregate market in general much at all. So, think closer to 4% to 5% returns out of the taxable market. Probably 3% to 4% returns out of the tax-exempt market. And of course, a 3% to 4% tax-free return is frankly better than a 5% taxable return.

David: So, let's spend a minute talking about the risk that we see moving ahead inside 2026. Inside the equity market, it seems as though it's fairly valued at this point, maybe a little bit rich, but as you mentioned earnings. KC, what do you see as risks moving ahead or potential risks moving ahead for the equity markets in 2026?

KC: Well, one, I would suggest if the macro environment changes, but right now, given Scott's insights, it's definitely constructive for the equity markets in 2026. Another risk, as you cited, is valuations.

You know, we're around 22 times forward earnings, but I think I could make a pretty strong argument that again, if Scott's forecast is directionally correct and interest rates come down, can valuations expand? Can that P/E (price-to-earnings) multiple be at 22 times? Yes, definitely, at least using you know some historic, you know, trends that we've seen before.

So those are two main drivers, the macro environment and valuations. And the others are noise. I mean, you can have, you know, noise from Washington, noise geopolitical tensions that we've seen over and over again. Those are short-lived and noise, but I think the two that I cited are more longer-term risks to the market.

David: Thanks. And you know, as I look back on 2025, certainly I think even though The Economist claims that the word of the year is “slop,” I'm going to go ahead and say the word of the year is actually two words: AI, artificial intelligence.

As we're looking forward, that's been a decent driver for us in the economy. Scott, do you see any risks of AI falling off over the course of 2026?

Scott: You know, it's weird that in 2025, if you looked at fixed investment, which is basically what businesses, you know, build buildings, structures, add software, do research and development. Even with the AI boom, construction spending is still down on a year-over-year basis. This even includes all the construction spent, you know, at the utility space to beef up the electrical grid to provide all the power for those data centers.

So, to the extent that this AI boom is a bit overdone or a bit over its skis, that's likely to cool, you know, economic activity. I still think we're in the early innings of that. The biggest risk to the fixed income markets in general, though, probably is sticky inflation. One where it doesn't begin to roll over towards the end of the year, one where the Federal Reserve is unable to provide a little bit of additional interest rate help as the year progresses. I think that would certainly, you know, slow the stock market, you know, down, probably put pressures on those valuations.

The good news is globally we're still set to expand. While our economic activity here might increase at a 2% pace, global economic activity will still increase at a better than 3% pace, driven still by China, which is cooling but still growing, you know, at a faster rate than the average country.

So, you know, the backdrop is still fairly positive, but any blip in the AI story is likely to slow any market activity period, as much emphasis has been put into that sector.

David: KC, looking back at the returns we've experienced in 2025, how much of that has been driven by the technology and communication sectors?

KC: That's significant. Actually, those two sectors that you mentioned make up 44% of the S&P 500, and about half of the earnings in the S&P 500 came from the Mag Seven (Magnificent Seven), those seven largest companies that are technology and AI driven. And the Mag Seven, right now, year-to-date is up 24%.

David: So not only have they contributed from an earnings point of view, but really from a return point of view, they've been what's powered their markets for 2025.

KC: It was a significant driver, absolutely, and probably will be to some degree into 2026.

David: Yeah. No, that's a great recap of '25 and a good look forward into 2026. At Commerce, we still remain neutral in our overall mix of stocks, bonds, and alternatives inside of our portfolios. But that's a continuing conversation that we have throughout the course of the year as we look to position the portfolio to reflect the opportunities out there.

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Thank you for joining us on Conversations with Commerce Trust. I'm David Hagee. We'll talk again soon.

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December 17, 2025
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