Commerce Trust Market Brief with Scott Colbert

Economic News and Data Ahead of the September Federal Reserve Meeting

Recorded August 24, 2026

Scott Colbert: Good morning. It's Monday, August 24th, and the markets are open. Stock returns remain exceptionally resilient, despite the Iranian war, and the elevated energy prices, and the higher Treasury yields. The total return of the S&P 500 (Index) so far year-to-date is 12.93%, and it gets better as you move down in market cap (capitalization), with the average stock returning 16.8% year-to-date (as measured by the S&P 500 Equal Weight Index).

Mid-cap stocks doing about the same (as measured by the S&P 400 Midcap Index). And the small-cap stocks, the clear winners, the Russell 2000 (Index) up 22.61% so far year-to-date. International stocks have followed suit with the American stock market. Large-cap international stocks up about 14% (as measured by the MSCI EAFE Index). And the big winners being the emerging market stocks, driven by all the technology exposure in the South Korean and Taiwan markets, up a whopping 24.22% so far year-to-date (as measured by the MSCI Emerging Market Index).

The big laggard, of course, has been the bond market. As interest rates have pushed up, this pushes bond prices down, basically taking away all the yield that the bond provides you. So far this year, the Bloomberg Aggregate (Index), the broadest measure of the investment grade bond market, remains slightly negative, down about 34 basis points. Whereas munis (municipal bonds) haven't been damaged quite as much by these higher interest rates, still up a positive 65 basis points of tax-free return on a year-to-date basis (as measured by the Bloomberg Municipal Index).

And with the higher inflation and higher energy prices, interest rates have gone up as well. The 2-year Treasury is about 4.25% today. The 10-year Treasury is about 4.75%. And the long bond (30-year Treasury) has snuck to a 19-year record high yield of 5.27% as we sit here today.

And it's not only inflation that's driving the yields up in the long end of the bond market, but it's also the amount of public debt that we've accumulated as we continue to run deficits. As we sit here today, total marketable debt is about one times the size of our economy. That compares to about half as big as our economy on a long-term basis. In fact, the only time we've really had more accumulated debt was at the end of World War II.

So clients are asking us, is a 5.25% 30-year Treasury a reasonable yield? And would you expect that to be going up or down? To get a sense for that, we can look at history. Over the last 19 years, the 30-year Treasury has averaged something like CPI (Consumer Price Index) plus about 1%. Trailing CPI today is 3.4%. Add 1% to that, and you might expect to see a 30-year Treasury yield of about 4.4%.

But when we go back over longer periods of time, and the 30-year Treasury was issued in 1977, so we have quite a bit of data here, the 30-year Treasury yield has averaged something closer to inflation, plus better than even 2.5%. So 3.4% plus 2.5% gets you something much closer to 6%. So the long bond at 5.25% today is sitting somewhere between the middle of its short-term average and its long-term averages, a pretty reasonable outcome on a relative basis.

Fortunately, most of the debt is not issued out in the 10-plus-year part of the market. In fact, only 17.5% of U.S. Treasury debt is longer than ten years of maturity, with most of it financed inside the 10-year and almost $7 trillion of our deficit financed inside of a 12-month bill.

The average maturity of the average Treasury bond today is about 5.9 years, or 71 months of maturity. The longest it's ever been has been 75 months. And you can see that the U.S. Treasury is trying to bring in the average maturity, as yields on the shorter end of the market are much lower than yields on the longer end of the market.

Ultimately, though, to bring interest rates down, we need to bring inflation down. And of course, inflation has been rather sticky on the upside. The average core inflation rate when you average the CPI and the PCE (Personal Consumption Expenditures Index) is about 2.9% as we sit here today, and the average top line inflation rate, when you average the CPI and the personal consumption expenditure[s] index is about 3.5%. These inflation rates have been trending lower the last several months, but are still well in excess of that so-called 2% Fed (Federal Reserve) target.

Which brings us to the next Fed meeting that occurs on September 16th. The market is only about 40% certain that the Fed will raise rates this September, but they're very certain that there will be at least one rate hike by the end of the year to combat these higher oil prices. And, of course, the relatively sticky, higher inflation. The market is giving the Fed a pass at the next meeting, largely because the recent labor report was so modest and the inflation trend has been coming down.

But there will be quite a bit of news between now and that September 16th meeting. We think the key drivers to the market and probably the interest rate level, will start with NVIDIA's (Nvidia Corporation) earnings this Wednesday after the market closes, with NVIDIA being so much at the heart of the AI (artificial intelligence) data center buildout.

In addition, this Friday, we might get some insight into the Federal Reserve, with Chairman Warsh scheduled to give a big speech out in Jackson Hole, Wyoming. On September 4th, we’re going to get an employment report. The most recent employment report was relatively cool. Another cool employment report would give the Fed an opportunity to pause and not raise rates at the next meeting.

Finally, just before the Fed meets, we're going to get August's inflation report. We think it's important that inflation continue to trend down. Otherwise, those hawkish members of the FOMC (Federal Open Market Committee) may carry the day and push interest rates up a nudge if the trend doesn't continue.

Well, that's a lot of financial and market-moving information to digest. And we'll keep you up to speed on all the news three weeks from now as we return with a new video.

August 24, 2026
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