

# Growth Is Holding. Inflation Repriced the Hurdle.

Resilient demand, renewed price pressure, and the higher proof threshold for risk assets

September data show an economy producing more, spending more, and paying more. The result is not a clean recession signal or a clean soft-landing signal. It is a regime in which earnings quality, balance-sheet resilience, cash conversion, and entry valuation matter more.

OCTOBER 20, 2026 | 9-MINUTE READ | MARKET & PORTFOLIO STRATEGY

|                               |                                        |                                     |                                                |
|-------------------------------|----------------------------------------|-------------------------------------|------------------------------------------------|
| +0.8%                         | +0.7%                                  | 3.7%                                | 3.75-4.00%                                     |
| RETAIL SALES<br>September M/M | INDUSTRIAL PRODUCTION<br>September M/M | CONSUMER INFLATION<br>September Y/Y | FEDERAL FUNDS TARGET<br>Effective September 17 |

INDEPENDENT RESEARCH ON MARKETS, STRATEGY, RISK, AND CAPITAL ALLOCATION

## EXECUTIVE VIEW

# The economy is not giving investors the relief of a single narrative.

The September data combine firm nominal demand and improving production with a material acceleration in consumer and producer prices. Growth has not disappeared. Inflation risk has not disappeared either. That collision raises the required return on every investment thesis.

**WATSON CAPITAL  
THESIS**

Resilient activity can support earnings, but persistent inflation and tighter policy increase the penalty for weak pricing power, external financing dependence, poor cash conversion, and excessive valuation. We favor businesses that can convert nominal growth into durable per-share cash economics.

## Five conclusions

- bullet** Demand remains active. September retail sales increased 0.8% from August and 6.3% from a year earlier, while industrial production increased 0.7% during the month.
- bullet** The price signal strengthened materially. Consumer prices increased 0.6% in September and 3.7% over 12 months. Producer prices increased 1.3% during the month and 6.3% over 12 months.
- bullet** Household purchasing power deserves attention. Real average hourly earnings decreased 0.5% from August to September as consumer prices rose faster than nominal hourly earnings.
- bullet** Policy is responding to inflation. The Federal Reserve raised the federal-funds target range to 3.75-4.00% in September. The next FOMC meeting is scheduled for October 27-28.
- bullet** The investment implication is selectivity, not paralysis. A firm economy can reward operational strength. A higher hurdle rate makes the quality of that strength decisive.

## THE DASHBOARD

# Four releases describe one demanding regime.

| Release               | Reported evidence                          | What it can support                      | What it cannot prove                           |
|-----------------------|--------------------------------------------|------------------------------------------|------------------------------------------------|
| Retail sales          | +0.8% M/M; +6.3% Y/Y                       | Nominal consumer demand remains active   | Real unit growth or household financial health |
| Industrial production | +0.7% in September; +2.8% annualized in Q3 | Production momentum improved             | Uniform strength across manufacturing          |
| Consumer prices       | +0.6% in September; +3.7% Y/Y              | Household inflation pressure accelerated | That every category faces the same pressure    |
| Producer prices       | +1.3% in September; +6.3% Y/Y              | Pipeline cost pressure intensified       | Automatic pass-through into prices or margins  |

Interpretation standard: Retail sales are reported in current dollars and are not adjusted for price changes. Producer prices measure selling prices received by domestic producers, not the exact input-cost experience of every company. The dashboard is a decision framework, not a mechanical forecast.

**Inflation signal**

## Energy explains part of the acceleration, but not the entire issue.

The September Consumer Price Index increased 0.6%, with gasoline up 9.1% and accounting for more than half of the monthly increase. Over 12 months, the all-items index rose 3.7% and the energy index rose 20.4%. Food increased 2.5% over the same period.

Producer prices show pressure earlier in the economic chain. Final-demand goods increased 2.6% in September and services increased 0.8%. The 1.3% increase in the overall index was the largest monthly advance since March 2022. Energy volatility can reverse, but broad producer-price pressure can also reach margins, working capital, and final prices with different lags.

The Federal Reserve's preferred PCE measure had already shown inflation above target before the September CPI report. August headline PCE was 3.4% higher than a year earlier and core PCE was 3.0% higher. The latest CPI and PPI releases strengthen an existing inflation concern rather than create an entirely new one.

## DEMAND QUALITY

# Nominal strength must be reconciled with units, mix, and real income.

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The September retail report shows broad nominal spending resilience. It should not be translated directly into a conclusion about real consumption because the data are not adjusted for price changes. The real-earnings release adds an important counterweight: real average hourly earnings for all employees decreased 0.5% in September as prices rose 0.6% and nominal average hourly earnings rose 0.1%.

For consumer businesses, the correct bridge is traffic or transactions, units, price, promotions, product mix, credit behavior, and cash collection. Revenue that rises because customers pay more for fewer units can support near-term results while weakening the longer-term relationship.

Production data are constructive but uneven. Industrial production increased 0.7% in September, manufacturing output rose 0.3%, and total production increased at a 2.8% annualized rate during the third quarter. Within manufacturing, motor vehicles and parts declined 3.0% during the month while primary metals, machinery, and electrical equipment recorded stronger gains.

## Policy constraint

## The Federal Reserve has less room to look through renewed inflation.

On September 16, the Federal Open Market Committee raised the federal-funds target range by 25 basis points to 3.75-4.00%. The next meeting is scheduled for October 27-28, one week after this publication.

The latest releases create a difficult combination for policy. Stronger activity reduces the urgency of supporting demand, while faster inflation increases the cost of easing prematurely. That does not predetermine the next decision. It does mean that rate-sensitive assets and financing-dependent business models should be evaluated under a wider range of policy outcomes.

For investors, the policy channel operates through more than discount rates. It affects interest expense, refinancing capacity, housing and durable-goods demand, inventory finance, acquisition economics, private-market valuations, and the relative attraction of cash and fixed income.

## PORTFOLIO FRAMEWORK

# Raise the proof threshold in five places.

|                                                                                                                                                                                                |                                                                                                                                                                                                     |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>01 Pricing quality</p> <p>Look for stable units, retention, and market share alongside realized price. Price without durable customer value is a temporary bridge.</p>                      | <p>02 Cash conversion</p> <p>Reconcile reported earnings with receivables, inventory, capital expenditure, and free cash flow per share.</p>                                                        |
| <p>03 Balance-sheet resilience</p> <p>Test floating-rate exposure, maturities, liquidity, and the amount of external capital required to execute the plan.</p>                                 | <p>04 Incremental margin</p> <p>Measure how much additional operating profit each additional dollar of revenue produces after current labor, energy, and financing costs.</p>                       |
| <p>05 Valuation discipline</p> <p>Separate a strong enterprise from an attractive security. Growth deserves a premium only when its duration, funding, and per-share economics support it.</p> | <p>The discipline</p> <p>No single metric is sufficient. The thesis strengthens when operating evidence, cash economics, balance-sheet capacity, and valuation all point in the same direction.</p> |

## Evidence that strengthens a thesis

- bullet Positive real unit or transaction growth alongside price.
- bullet Free-cash-flow growth that confirms reported earnings.
- bullet Stable or improving interest coverage and liquidity.
- bullet Broad estimate revisions rather than one-time upside.
- bullet Capital spending linked to utilization and measurable returns.

## Evidence that weakens a thesis

- bullet Price-led revenue with falling volume and rising promotions.
- bullet Inventory and receivables growing faster than sales.
- bullet Adjusted profit that requires continued external financing.
- bullet Margin guidance that assumes immediate cost relief.
- bullet Valuation dependent on rapid policy easing.

## SCENARIO MAP

# Use observable combinations instead of one macro forecast.

| DISINFLATION RESUMES                                                                                                                                                                                                                                                                                                                               | STICKY NOMINAL GROWTH                                                                                                                                                                                                                                                                                                  | MARGIN AND DEMAND BREAK                                                                                                                                                                                                                                                                            |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Energy pressure fades while activity remains firm</p> <p>Signals: October price data cool, real income stabilizes, production and earnings breadth hold, and policy expectations stop moving higher.</p> <p>Implication: Operating resilience becomes more valuable and the duration penalty can ease, but valuation still governs returns.</p> | <p>Demand holds and inflation remains elevated</p> <p>Signals: Sales and production remain positive, price measures stay above target, and the Federal Reserve maintains or tightens policy.</p> <p>Implication: Favor pricing quality, cash generation, shorter-duration earnings, and balance-sheet flexibility.</p> | <p>Producer pressure reaches customers as real demand slows</p> <p>Signals: Volume declines, promotions rise, inventories build, credit weakens, and earnings estimates fall.</p> <p>Implication: Capital preservation, liquidity, and explicit downside analysis become the first priorities.</p> |

## Evidence calendar

## The next two weeks can clarify the regime.

|                  |                                                                                                                                                                                                         |
|------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| OCT. 27-28       | Federal Reserve: The FOMC decision and press conference will show how policymakers weigh September inflation against still-resilient activity.                                                          |
| OCT. 29          | GDP and PCE: The advance third-quarter GDP estimate and September personal income and outlays will add evidence on real growth, consumption, income, and the Fed's preferred inflation measure.         |
| REPORTING SEASON | Company evidence: Unit demand, pricing, incremental margin, working capital, capital spending, and estimate revisions will test whether nominal economic strength converts into per-share cash returns. |

Bottom line: Growth has not disappeared, but the hurdle rate has moved higher. The appropriate response is neither a blanket risk-on conclusion nor a blanket retreat. It is more demanding underwriting.

## SOURCE NOTES

# Primary evidence reviewed October 20, 2026.

Reported facts are attributed below. Watson Capital analysis and investment implications are identified as interpretation. Data may be revised after publication.

1. U.S. Census Bureau - Advance Monthly Sales for Retail and Food Services, September 2026  
Nominal retail-sales levels and monthly and annual changes; released October 15, 2026.  
<https://www.census.gov/retail/sales.html>
2. Federal Reserve - Industrial Production and Capacity Utilization, September 2026  
Industrial production, manufacturing, sector detail, and third-quarter annualized change; released October 16, 2026.  
<https://www.federalreserve.gov/releases/g17/20261016/>
3. U.S. Bureau of Labor Statistics - Consumer Price Index, September 2026  
Monthly and annual consumer-price changes and energy detail; released October 14, 2026.  
<https://www.bls.gov/news.release/cpi.nr0.htm>
4. U.S. Bureau of Labor Statistics - Producer Price Index, September 2026  
Final-demand, goods, and services price changes; released October 15, 2026.  
<https://www.bls.gov/news.release/ppi.nr0.htm>
5. U.S. Bureau of Labor Statistics - Real Earnings, September 2026  
Inflation-adjusted hourly and weekly earnings; released October 14, 2026.  
<https://www.bls.gov/news.release/realer.nr0.htm>
6. Federal Reserve - FOMC Statement, September 16, 2026  
Federal-funds target range and policy decision.  
<https://www.federalreserve.gov/newsevents/pressreleases/monetary20260916a.htm>
7. Federal Reserve - Monetary Policy Calendar  
October 27-28 FOMC meeting schedule and current policy materials.  
<https://www.federalreserve.gov/monetarypolicy.htm>
8. U.S. Bureau of Economic Analysis - Personal Income and Outlays, August 2026  
Headline and core PCE inflation; released September 30, 2026.  
<https://www.bea.gov/news/2026/personal-income-and-outlays-august-2026>

## IMPORTANT INFORMATION

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