

Forecasting: principles and practice

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2.3 Stationarity and differencing

Outline

- 1 Stationarity
- 2 Differencing
- 3 Unit root tests
- 4 Lab session 14
- 5 Backshift notation

Stationarity

Definition

If $\{y_t\}$ is a stationary time series, then for all s , the distribution of (y_t, \dots, y_{t+s}) does not depend on t .

Stationarity

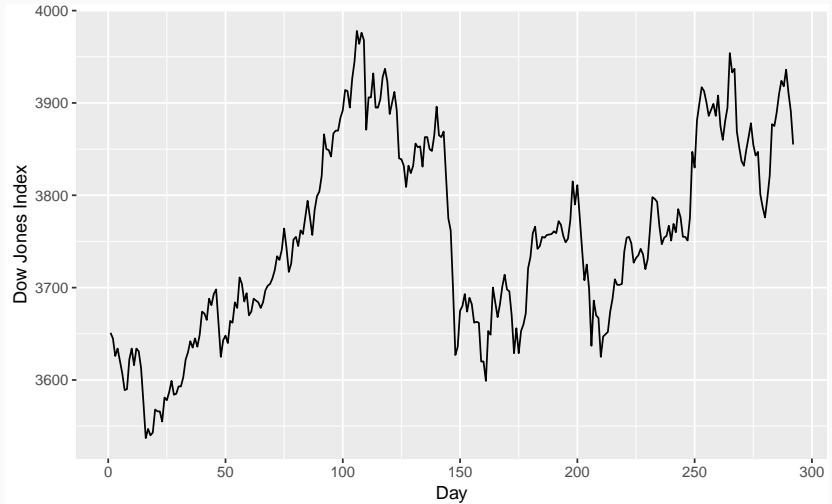
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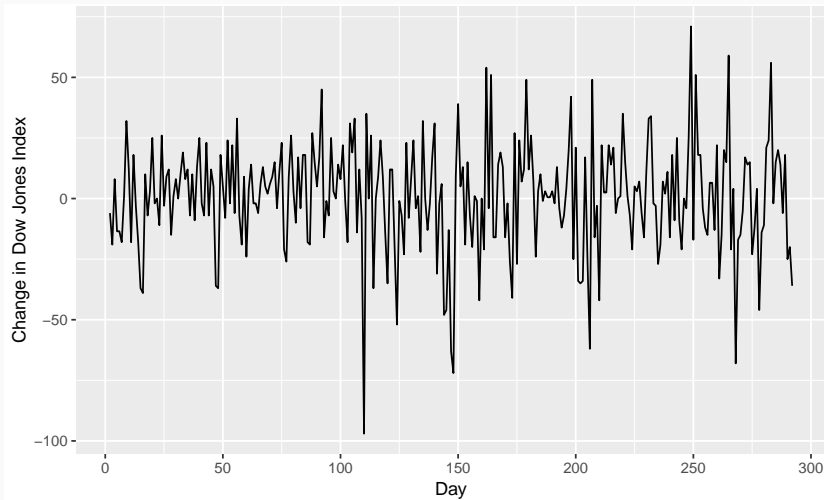
A stationary series is:

- roughly horizontal
- constant variance
- no patterns predictable in the long-term

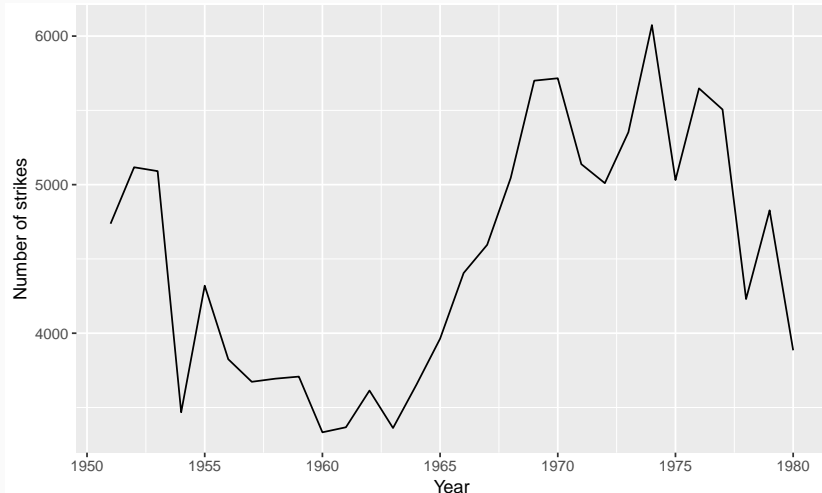
Stationary?



Stationary?

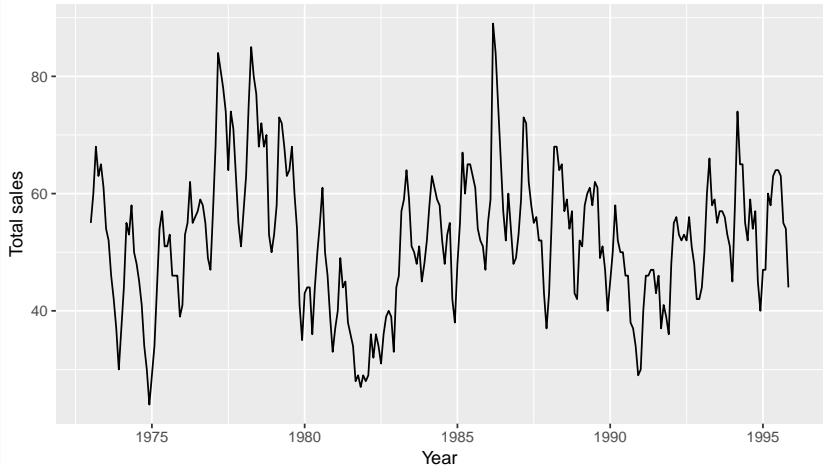


Stationary?

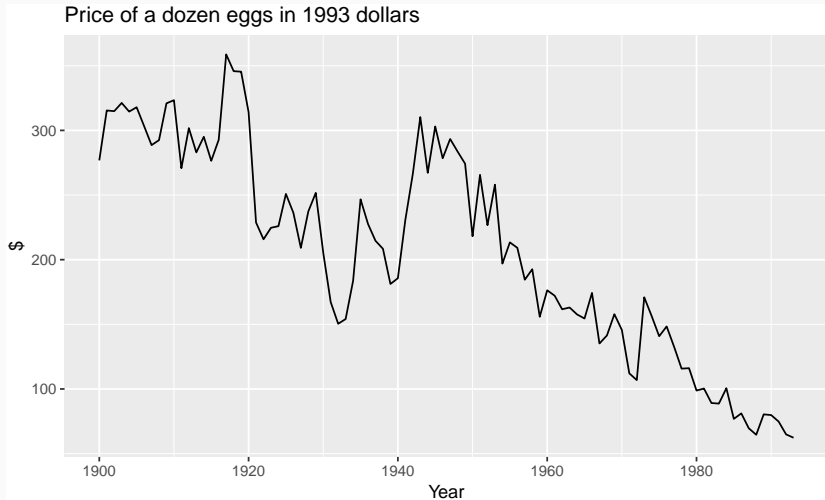


Stationary?

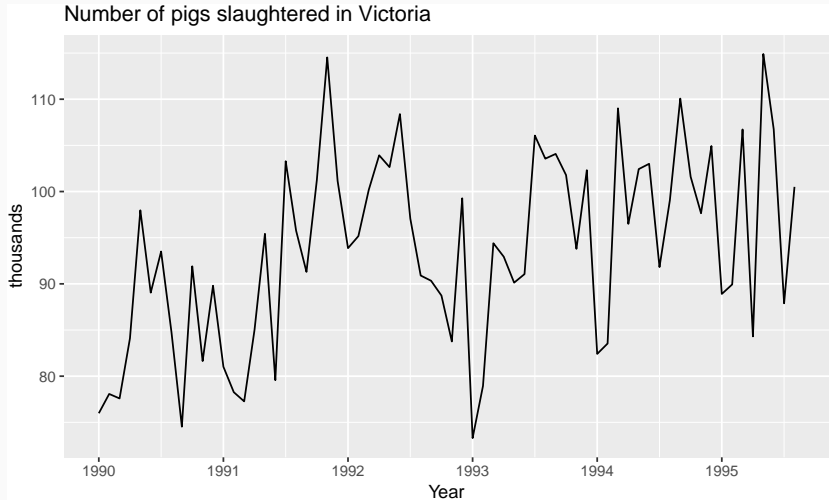
Sales of new one-family houses, USA



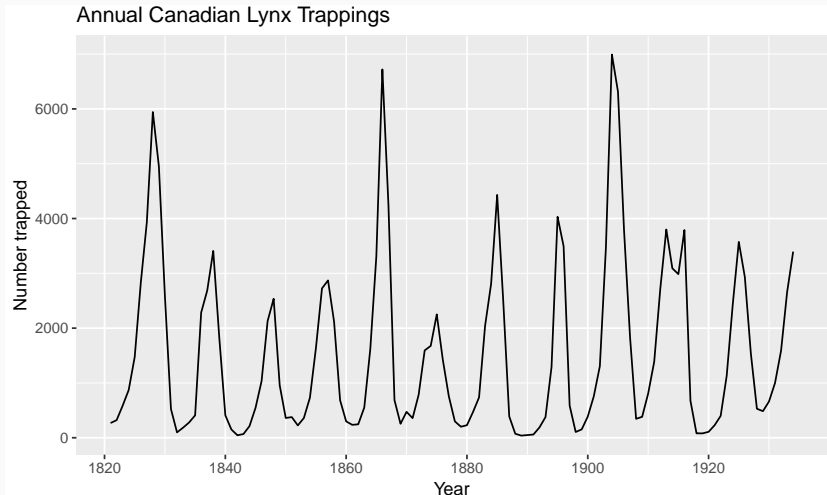
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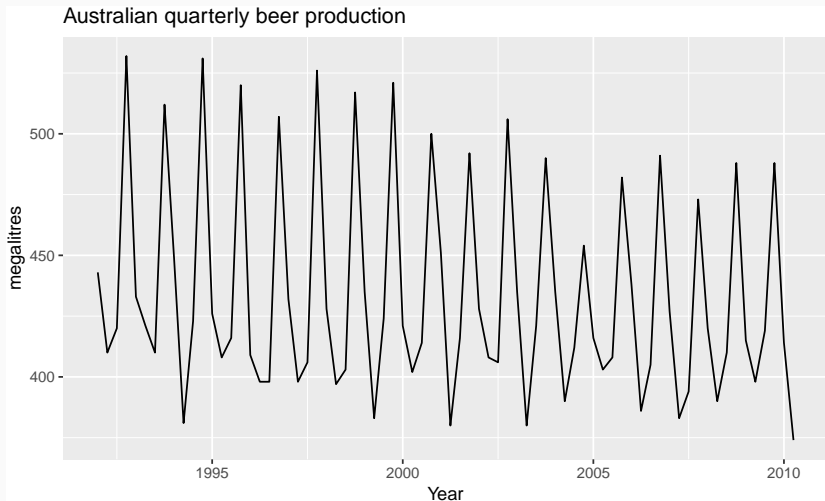
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Transformations help to **stabilize the variance**.

For ARIMA modelling, we also need to **stabilize the mean**.

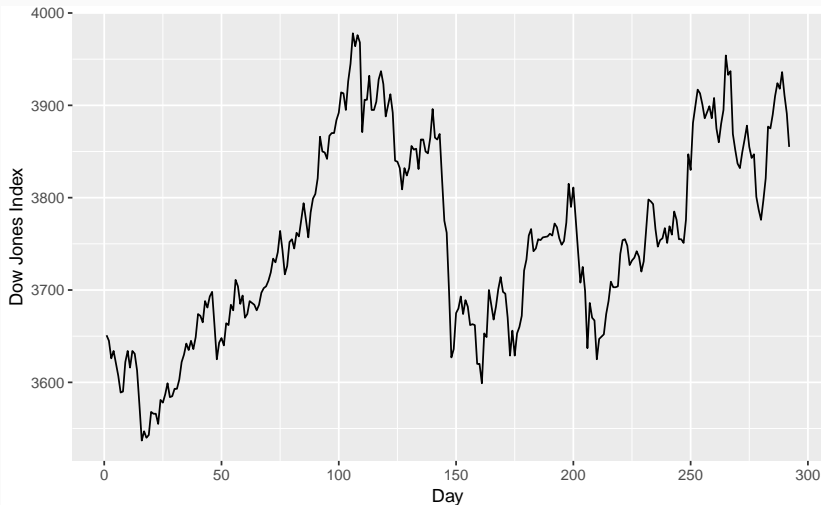
Non-stationarity in the mean

Identifying non-stationary series

- time plot.
- The ACF of stationary data drops to zero relatively quickly
- The ACF of non-stationary data decreases slowly.
- For non-stationary data, the value of r_1 is often large and positive.

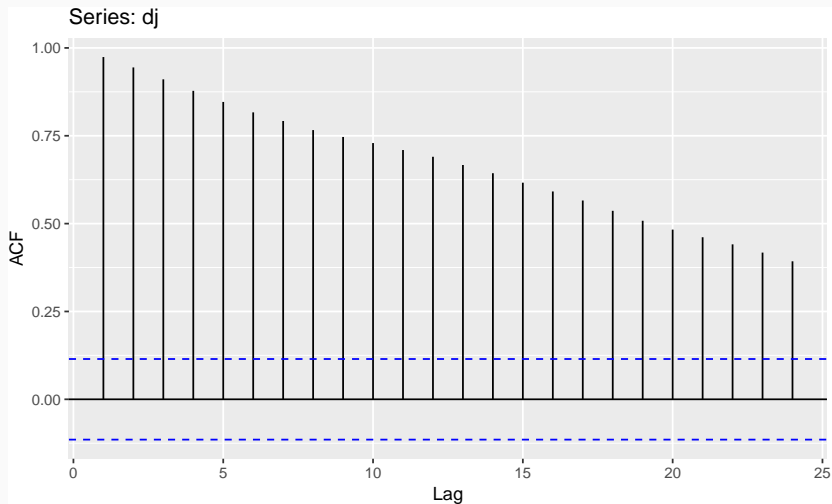
Example: Dow-Jones index

```
autoplot(dj) + ylab("Dow Jones Index") + xlab("Day")
```



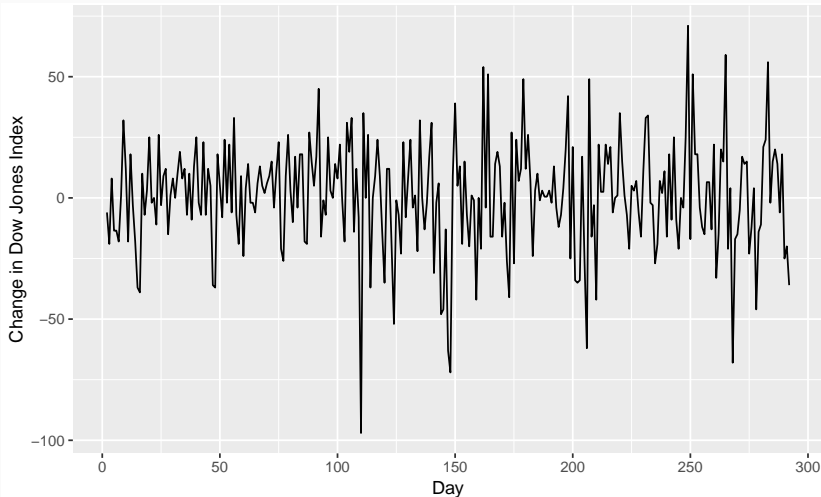
Example: Dow-Jones index

```
ggAcf(dj)
```



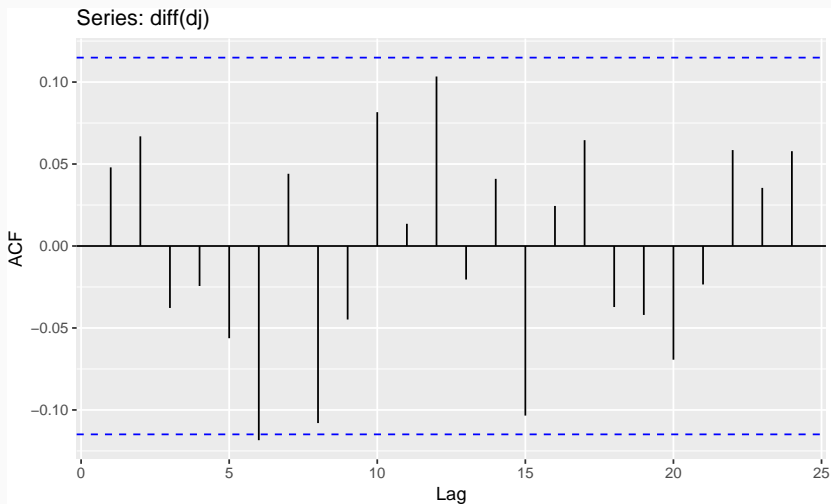
Example: Dow-Jones index

```
autoplot(diff(dj)) +  
  ylab("Change in Dow Jones Index") + xlab("Day")
```



Example: Dow-Jones index

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ggAcf(diff(dj))
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Differencing

- Differencing helps to **stabilize the mean**.
- The differenced series is the *change* between each observation in the original series:
$$y'_t = y_t - y_{t-1}.$$
- The differenced series will have only $T - 1$ values since it is not possible to calculate a difference y'_1 for the first observation.

Second-order differencing

Occasionally the differenced data will not appear stationary and it may be necessary to difference the data a second time:

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- y_t'' will have $T - 2$ values.
- In practice, it is almost never necessary to go beyond second-order differences.

Seasonal differencing

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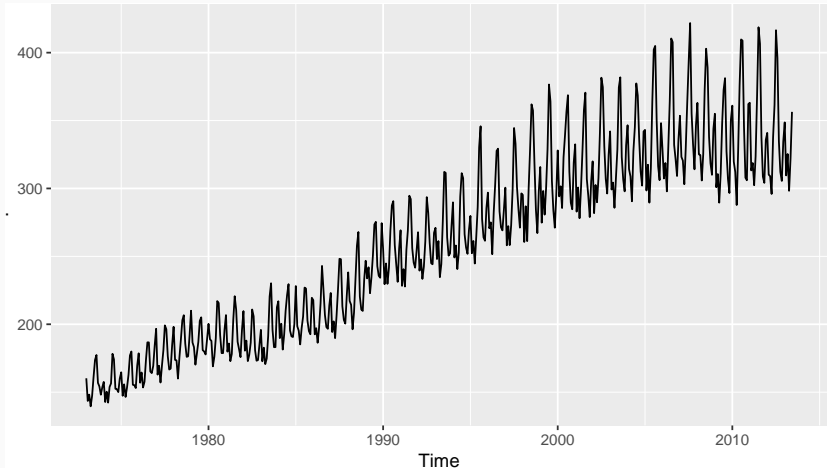
$$y'_t = y_t - y_{t-m}$$

where m = number of seasons.

- For monthly data $m = 12$.
- For quarterly data $m = 4$.

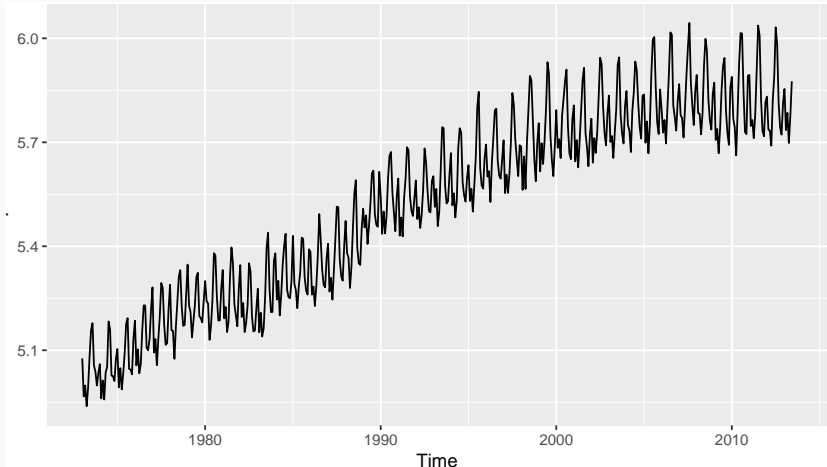
Electricity production

```
usmelec %>% autoplot()
```



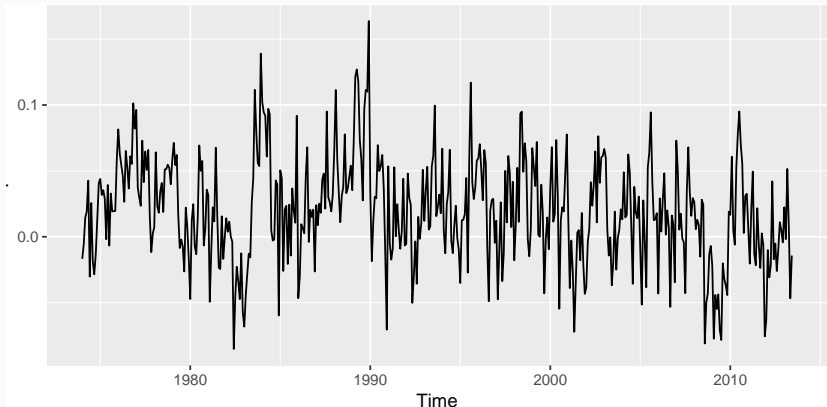
Electricity production

```
usmelec %>% log() %>% autoplot()
```



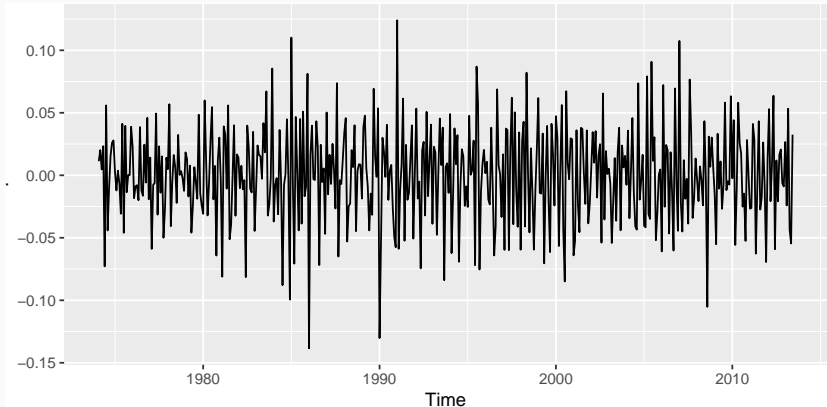
Electricity production

```
usmelec %>% log() %>% diff(lag=12) %>%  
autoplot()
```



Electricity production

```
usmelec %>% log() %>% diff(lag=12) %>%  
diff(lag=1) %>% autoplot()
```



Electricity production

- Seasonally differenced series is closer to being stationary.
- Remaining non-stationarity can be removed with further first difference.

If $y'_t = y_t - y_{t-12}$ denotes seasonally differenced series, then twice-differenced series is

$$\begin{aligned}y_t^* &= y'_t - y'_{t-1} \\&= (y_t - y_{t-12}) - (y_{t-1} - y_{t-13}) \\&= y_t - y_{t-1} - y_{t-12} + y_{t-13} .\end{aligned}$$

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It is important that if differencing is used, the differences are interpretable.

Interpretation of differencing

- first differences are the change between **one observation and the next**;
- seasonal differences are the change between **one year to the next**.

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But taking lag 3 differences for yearly data, for example, results in a model which cannot be sensibly interpreted.

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Statistical tests to determine the required order of differencing.

- 1 Augmented Dickey Fuller test: null hypothesis is that the data are non-stationary and non-seasonal.
- 2 Kwiatkowski-Phillips-Schmidt-Shin (KPSS) test: null hypothesis is that the data are stationary and non-seasonal.
- 3 Other tests available for seasonal data.

KPSS test

```
library(urca)
summary(ur.kpss(goog))
```

```
##
## #####
## # KPSS Unit Root Test #
## #####
##
## Test is of type: mu with 7 lags.
##
## Value of test-statistic is: 10.72
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## Critical value for a significance level of:
##           10pct  5pct 2.5pct  1pct
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```
ndiffs(goog)
```

```
## [1] 1
```

Automatically selecting differences

STL decomposition: $y_t = T_t + S_t + R_t$

Seasonal strength $F_s = \max \left(0, 1 - \frac{\text{Var}(R_t)}{\text{Var}(S_t + R_t)} \right)$

If $F_s > 0.64$, do one seasonal difference.

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If $F_s > 0.64$, do one seasonal difference.

```
usmelec %>% log() %>% nsdiffs()
```

```
## [1] 1
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```
usmelec %>% log() %>% diff(lag=12) %>% ndiffs()
```

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$$B(By_t) = B^2y_t = y_{t-2} .$$

For monthly data, if we wish to shift attention to “the same month last year,” then B^{12} is used, and the notation is $B^{12}y_t = y_{t-12}$.

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Note that a first difference is represented by $(1 - B)$.

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Similarly, if second-order differences (i.e., first differences of first differences) have to be computed, then:

$$y''_t = y_t - 2y_{t-1} + y_{t-2} = (1 - B)^2 y_t .$$

Backshift notation

- Second-order difference is denoted $(1 - B)^2$.
- *Second-order difference* is not the same as a *second difference*, which would be denoted $1 - B^2$;
- In general, a d th-order difference can be written as

$$(1 - B)^d y_t.$$

- A seasonal difference followed by a first difference can be written as

$$(1 - B)(1 - B^m)y_t.$$

Backshift notation

The “backshift” notation is convenient because the terms can be multiplied together to see the combined effect.

$$\begin{aligned}(1 - B)(1 - B^m)y_t &= (1 - B - B^m + B^{m+1})y_t \\ &= y_t - y_{t-1} - y_{t-m} + y_{t-m-1}.\end{aligned}$$

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For monthly data, $m = 12$ and we obtain the same result as earlier.