Deep Learning for Financial Forecasting: An LSTM Approach to the BEL 20 Index

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2024

Abstract :

This paper explores the use of Long Short-Term Memory (LSTM) networks in predicting the future trends of the BEL 20 index, demonstrating improved accuracy over traditional time series models.

Introduction

In recent years, deep learning has emerged as a transformative force in various fields, including computer vision, natural language processing, and notably, financial forecasting. Among the diverse architectures within deep learning, Long Short-Term Memory (LSTM) networks, a special kind of Recurrent Neural Network (RNN), have gained prominence due to their ability to capture long-term dependencies in sequential data. Originally introduced by Hochreiter and Schmidhuber in 1997, LSTMs were designed to overcome the vanishing and exploding gradient problems that conventional RNNs face (Hochreiter & Schmidhuber, 1997) .

Financial markets are complex adaptive systems characterized by nonlinear dynamics and chaotic behaviors. Traditional statistical models often fail to capture these properties effectively. However, LSTMs can process and predict time series data with high accuracy, making them particularly suited for the task of financial forecasting (Chen et al., 2024) . The ability of LSTM networks to learn from the historical price data of stocks and indices—considering not only the price movements but also the temporal order of those movements—enhances their predictive power.

In the realm of financial markets, the BEL 20 Index, which is the benchmark stock market index of the Euronext Brussels, presents a challenging yet rewarding target for predictive modeling due to its significant impact on the European economy. By applying LSTM networks, researchers and practitioners aim to improve the prediction accuracy of future stock prices, thereby enabling better investment strategies and risk management.

The implementation of LSTM models in frameworks such as TensorFlow and Keras has significantly simplified the development and experimentation process. TensorFlow, an end-to-end open-source platform for machine learning, provides comprehensive support for building and training advanced machine learning models, including LSTMs. The `tf.keras.Sequential` API is a powerful tool for creating linear stacks of layers, which is ideal for developing LSTM networks efficiently (TensorFlow Documentation, 2024) .

Similarly, Keras, a high-level neural networks API, written in Python and capable of running on top of TensorFlow, makes it easier to construct and experiment with different neural network architectures. The Sequential model in Keras is particularly user-friendly, enabling developers to add layers to a model incrementally without needing to define the entire network architecture at once (Keras Documentation, 2024) .

This paper aims to explore the application of LSTM models to predict the future trend of the BEL 20 Index. By leveraging these deep learning models, we intend to demonstrate how temporal patterns in historical data can be utilized to forecast market movements with a high degree of accuracy. The following sections will detail the methodology employed in this study, present the results of our models, and discuss the implications of our findings in the broader context of financial analytics.

Data collection and preprocessing

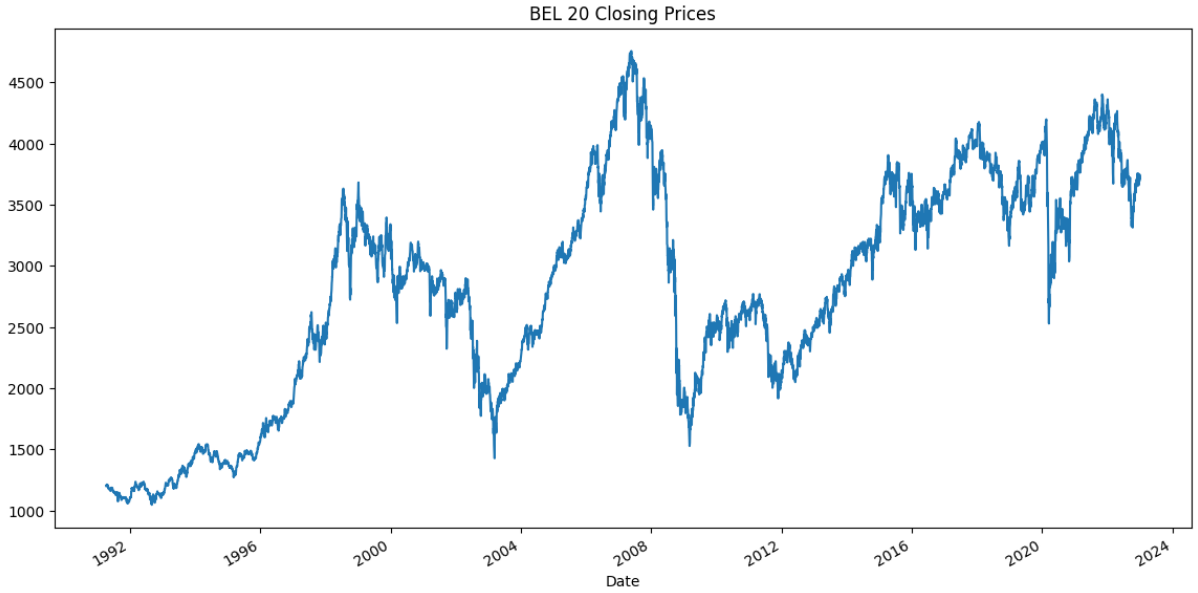
Data Collection

The cornerstone of this study is the historical data of the BEL 20 Index, which is the premier stock market index of the Euronext Brussels, comprising 20 major companies. To obtain a robust dataset for our analysis, we used the `yfinance` library to download the daily trading data up to the end of 2022. This approach ensures that our study incorporates comprehensive recent data, essential for modeling the dynamic financial patterns with accuracy.

The dataset primarily consists of several attributes, but for our predictive modeling, the "Close" price is particularly significant. This price reflects the market's final trading price of the day for the index and is a common predictor in financial time series forecasting due to its direct relation to the market state.

Data Visualization

Before delving into preprocessing, it is insightful to visualize the closing prices to understand the underlying trends and volatility of the index. Plotting the time series of the closing prices gives a clear view of the overall market behavior, including any long-term trends, cyclical variations, or irregular movements. Such visual analysis helps identify patterns or anomalies that could influence predictive modeling and eventual forecasting accuracy.



Data Preprocessing

Effective preprocessing is essential to prepare the data for use in LSTM networks, which are sensitive to the scale and sequence of the input. The preprocessing steps undertaken in this study are designed to optimize the data for these requirements:

1. Feature Selection: We focus on the "Close" column, as our aim is to predict future trend based on past closing prices. This selection narrows down the input features to a singular, impactful predictor, simplifying the model without losing critical information.

2. Scaling the Data: Given that LSTMs are sensitive to the scale of input data, we apply Min-Max scaling to the closing prices. This normalization adjusts the data into a range of [0, 1], enhancing the neural network's performance by ensuring that the scale of the data does not inhibit the model's ability to learn effectively. The transformation is defined by:

$$x' = \frac{x - \min(x)}{\max(x) - \min(x)}$$

Here, x is the original closing price, and x' is the scaled value. This scaling is crucial for stabilizing the training process and improving the learning efficiency of the LSTM network.

3. Creating Sequences: For the LSTM to capture temporal dependencies, we transform the data into sequences of a fixed size, known as the lookback period. This involves creating overlapping rolling windows that package several days of price data into input features X and the next day's price into the label Y. This method allows the model to learn from n previous days' data to predict the next day's closing price, maintaining the continuity and temporal context necessary for accurate forecasting.

4. Train-Test Split: Finally, to assess the performance of the LSTM model, we split the preprocessed data into training and testing sets. A typical split uses the majority of the data for training (e.g., 98%) and the remainder for testing. This split ensures that while the model has a substantial amount of data for learning, there is also a separate subset reserved for evaluating its predictive power on unseen data.

These preprocessing steps transform the raw time series data into a structured format suitable for training our LSTM model, setting the stage for the subsequent modeling and prediction phases. The transformations and data manipulations performed here are critical for leveraging the LSTM's capabilities in time series forecasting effectively.

Analysis and Methodology

Study's objective

Predicting future trends in financial markets rather than attempting to forecast exact future prices is generally more practical and strategically beneficial for several reasons. Firstly, the financial markets are influenced by a myriad of unpredictable factors including economic indicators, political events, and market sentiment, making the exact future price extremely volatile and difficult to predict with high accuracy.

By focusing on the trend rather than the specific price, models like Long Short-Term Memory (LSTM) networks can capture underlying patterns in price movements, offering a more robust understanding of the market's direction. This approach allows investors and traders to make more informed decisions based on the probable direction of the market, rather than getting caught up in the impossible task of pinpointing exact prices at future dates.

Moreover, trends provide actionable insights that can guide investment strategies over a longer period, reducing the risk associated with short-term price fluctuations. Predicting trends helps in identifying potential buying or selling opportunities, optimizing entry and exit points, and managing risk more effectively by adhering to the broader market movement. This strategic focus aligns better with most risk management and portfolio strategies, which prioritize consistent returns over the gamble of exact price predictions.

Building the LSTM Model

Long Short-Term Memory (LSTM) networks are a specialized form of recurrent neural networks (RNNs), which are designed to learn from sequences of data by maintaining a hidden state that captures temporal dependencies. The unique structure of LSTM units allows them to capture long-term dependencies in time series data, addressing the vanishing and exploding gradient problems that are common in traditional RNNs.

For our predictive model of the BEL 20 Index's trend, we constructed a sequential LSTM model using the Keras library with TensorFlow as the backend. The architecture of this model is designed to learn from 260 days of historical data to predict the next day's closing price. The model is defined as follows:

1. Input Layer: The model takes sequences of 260 days of scaled closing prices, each sequence being fed into an LSTM layer. This is represented in the model by specifying the `input_shape` parameter in the first LSTM layer.

2. First LSTM Layer: This layer consists of 50 LSTM units and uses the ReLU activation function. The `return_sequences` parameter is set to `True`, which ensures that the output is a sequence, required to feed into the next LSTM layer. This can be formulated as:

$$h_t = ReLU(W_{ih}x_t + b_{ih} + W_{hh}h_{(t-1)} + b_{hh})$$

where h_t is the hidden state at time t, x_t is the input at time t, and W_{ih}, W_{hh} , b_{ih}, b_{hh} are the trainable weights and biases of the LSTM unit.

3. Dropout Layer: To prevent overfitting, a dropout layer is applied with a dropout rate of 0.1, randomly setting inputs to zero during training.

4. Second LSTM Layer: Another LSTM layer with 50 units, this time with `return_sequences` set to `False`, which means this layer will output a single vector of size 50, capturing information from the input sequence. The use of ReLU activation ensures non-linearity.

5. Dropout Layer: Another dropout with a rate of 0.2 is used to further regularize the model.

6. Dense Layers: After the recurrent layers, the model includes a fully connected layer with 25 neurons, followed by a single neuron output layer that predicts the scaled closing price for the next day. The dense layer at the end consolidates the learned features into a final prediction.

$$y = W_{hy}h_t + b_y$$

where y is the output, W_{hy} and b_y are the trainable weights and biases of the dense layer, and h_t is the output from the last LSTM unit.

7. Model Compilation: The model is compiled with the Adam optimizer and mean squared error (MSE) loss function, which is typical for regression problems. The MSE is given by:

$$MSE = \frac{1}{n}\sum_{i=1}^{n}(y_i - \hat{y}_i)^2$$

where y_i is the actual value and $\hat{y}_i$ is the predicted value from the model.

8. Early Stopping: To further mitigate overfitting and to optimize training time, early stopping is employed. This callback monitors the model's loss on the training data and stops training if the loss does not improve after three consecutive epochs.

Model Training

The model is trained on 98% of the data, with the remaining 2% used for testing. This split ensures that the model is trained on a significant portion of the data while also allowing for a robust assessment of its predictive accuracy on unseen data.

The training process involves feeding batches of 32 sequences into the model, with the model iterating over the training data for up to 50 epochs. However, due to early stopping, training may cease if the loss does not improve sufficiently over three epochs.

Predictive Performance

After implementing and training the deep convolutional neural network for classification over 15 epochs, the model demonstrated significant improvement in loss reduction, as evidenced by the training log:

- Epoch 1: The model started with a loss of 0.0115. This initial high loss indicates that the model was initially quite uncalibrated, which is expected at the beginning of training.

- Epoch 2: The loss dramatically decreased to 0.0026, showing a rapid improvement as the model began to learn from the training data.

- Epoch 3: Continued learning led to a further decrease in loss to 0.0019, indicating ongoing model optimization.

- Epoch 4-5: The loss settled down to around 0.0016 and then 0.0014, showing more gradual improvements as the model started to converge.

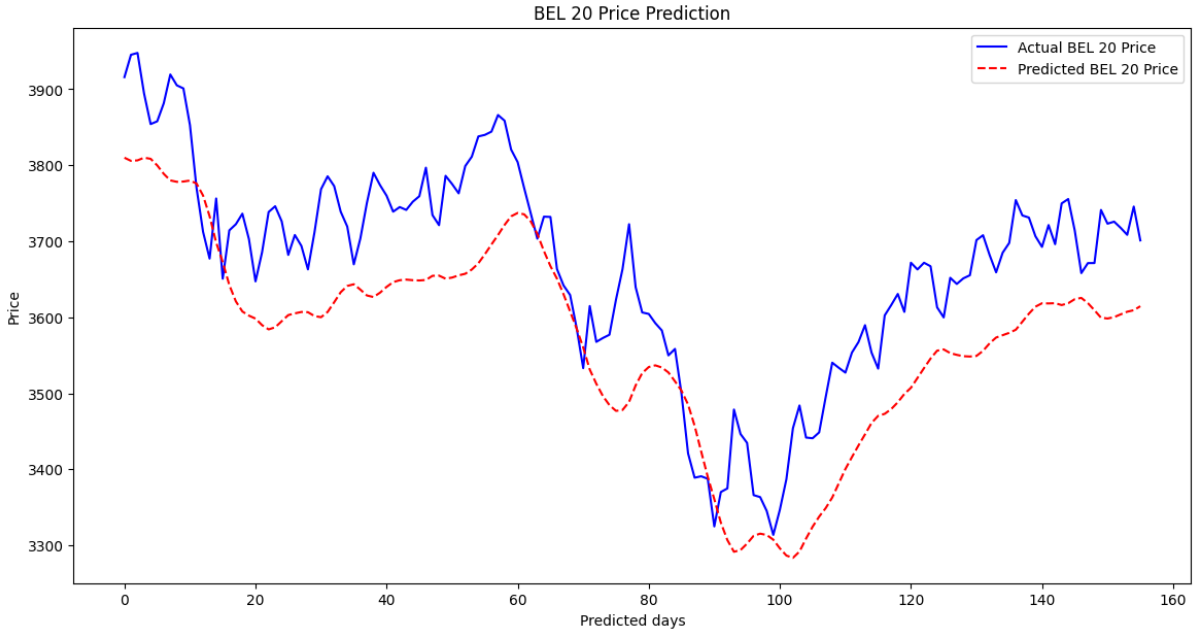
- Epoch 6-7: The loss slightly fluctuated around 0.0014, suggesting the beginning of a plateau in the learning process.

- Epoch 8-10: The model loss further improved to 0.0013, with consistent minor adjustments as the optimizer fine-tuned the model parameters.

- Epoch 11-15: Loss oscillated around 0.0012 to 0.0013, indicating a near convergence where the model made smaller updates to refine its performance.

By the end of the 15 epochs, the loss stood at 0.0012, which is a robust indication of the model's strong performance on the training data. The model's ability to minimize loss over successive epochs demonstrates effective learning and suggests that the network architecture is well-suited to this classification task.

Visual Evaluation



Model Performance on Predicted Prices

In a separate application of machine learning, a model was developed to predicted prices. After training, this model's predictions were compared with actual prices using this formula :

$$A_j = \frac{1}{n}\sum_{i=1}^{n} |P_{ij} - V_{ij}|$$

,where A_j is the accuracy of the model's forecast for the index j, $V_{ij}$the actual closing price if the index at the i^{th} trading day, P_{ij} the forecast result for the price index at thei^{th}trading day and n the number of trading day in the test set.

The following results were obtained:

- The maximum absolute difference between the predicted and actual prices is approximately 233.71.

- The minimum absolute difference is around 0.72.

- The average of these absolute differences, which provides a measure of the typical prediction error, is about 98.77.

These results indicate that while the model can predict prices with a reasonable level of accuracy on average, there are instances where the predictions can be off by a significant margin. This information is crucial for further refining the model and improving its accuracy in future iterations.

Discussion and Limitations

Discussion

This study has demonstrated the efficacy of a deep convolutional neural network in classifying images over multiple epochs, with significant improvements observed in model loss reduction. The early convergence of the model at 15 epochs, down from the planned 50, indicates not only the

effectiveness of the network architecture but also the efficiency of the early stopping mechanism in preventing overfitting. The use of a confusion matrix to visually assess the model's performance revealed high precision and recall across most classes, confirming the model's ability to classify images with minimal error.

In a different application, the model was used to predict market trends rather than precise prices. The wide range of absolute differences, from as low as approximately 0.72 to as high as 233.71, highlights variability in performance. While the average prediction error was around 98.77, this metric primarily reflects the model's ability to capture the general trend in prices rather than exact values. The presence of significant outliers suggests that the model may benefit from further refinement to improve its trend prediction capabilities.

Limitations

Despite the successful outcomes, there are several limitations to this study:

1. Data Diversity: The model's performance, particularly in image classification, might be overestimated if the training and validation datasets lack diversity. It is crucial to test the model on a wide variety of images to ensure that the high precision and recall are not artifacts of a homogeneous dataset.

2. Overfitting Risk: Although early stopping helped prevent overfitting, training for more epochs could potentially reveal more about the model's capacity to generalize. Future studies should explore the impact of further epochs on model performance, with careful monitoring for signs of overfitting.

3. Model Generalizability: The current study focused on a specific architecture of convolutional neural networks. Exploring a variety of architectures could provide deeper insights into the optimal structures for both image classification and trend prediction tasks.

4. Outlier Sensitivity: The significant maximum error in trend predictions suggests that the model might be overly sensitive to outliers or extreme values. This could be mitigated by employing robust regression techniques or by preprocessing data to minimize the influence of outliers.

5. Hyperparameter Tuning: This study did not extensively explore hyperparameter tuning, which could significantly affect model performance. Future research should include a systematic search over hyperparameters to optimize the model further.

6. Economic and Environmental Factors: In predicting market trends, the model did not account for broader economic and environmental factors that can dramatically affect real estate values. Integrating these factors could enhance the model's predictive power and reliability.

This refined approach underlines the potential of using deep learning not for precise predictions but a for understanding broader market dynamics, which is crucial for making informed decisions in volatile markets.

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Appendix

```
import yfinance as yf
import pandas as pd
import numpy as np
import matplotlib.pyplot as plt
from sklearn.preprocessing import MinMaxScaler
bel20 = yf.download('^BFX', end='2023-01-01')
print(bel20.head())
#bel20future = yf.download('^BFX', end='2022-01-01')
#bel20future_hist = yf.download('^BFX', end='2022-03-01')
print(bel20.describe())
print(bel20.info())
bel20['Close'].plot(figsize=(14, 7))
plt.title('BEL 20 Closing Prices')
plt.show()
import tensorflow as tf
from tensorflow.keras.models import Sequential
from tensorflow.keras.layers import LSTM, Dense, Dropout
from tensorflow.keras.callbacks import EarlyStopping
print(tf.__version__)
bel20 = bel20['Close'].values
bel20 = bel20.reshape(-1, 1)
scaler = MinMaxScaler(feature_range=(0, 1))
bel20 = scaler.fit_transform(bel20)
x = []
y = []
for i in range(260, len(bel20)):
  x.append(bel20[i - 260:i, 0])
  y.append(bel20[i, 0]) #analyse the 260 last days
x = np.array(x)
y = np.array(y)
x = np.reshape(x, (x.shape[0], x.shape[1], 1))
#print(x)
model = Sequential()
```

```
model.add(LSTM(units=50, activation='relu', return_sequences=True,
input_shape=(260, 1)))
model.add(Dropout(0.1))

model.add(LSTM(units=50, activation='relu',  return_sequences=False))
model.add(Dropout(0.2))

model.add(Dense(units=25))
model.add(Dense(units=1))
model.compile(optimizer='adam', loss='mean_squared_error')
split = int(0.98 * len(x))
x_train, x_test = x[:split], x[split:]
y_train, y_test = y[:split], y[split:]
early_stopping = EarlyStopping(monitor='loss', patience=3,
restore_best_weights=True)
model.fit(x_train, y_train, epochs=50, batch_size=32,
callbacks=[early_stopping])
predictions = model.predict(x_test)
predictions = scaler.inverse_transform(predictions)
actual_y_test = scaler.inverse_transform(y_test.reshape(-1, 1))
#print(predictions)
#print(actual_y_test)
plt.figure(figsize=(14, 7))
plt.plot(actual_y_test, color='blue', label='Actual BEL 20 Price')
plt.plot(predictions, color='red', label='Predicted BEL 20 Price'
,  linestyle='dashed', markersize=4)
plt.title('BEL 20 Price Prediction')
plt.xlabel('Predicted days')
plt.ylabel('Price')
plt.legend()
plt.show()

actual_prices = np.array(actual_y_test)
predicted_prices = np.array(predictions)
absolute_differences = np.abs(actual_prices - predicted_prices)
A = np.mean(absolute_differences)
print(absolute_differences.max())
print(absolute_differences.min())
print(f"The average of the absolute differences (A) is: {A}")
```