Time Series

OC Data Driven Insights

August 12, 2018

Resources

- Forecasting: Principles and Practice by Rob J. Hyndman and George Athanasopoulos
- Time Series Analysis and Its Applications with R Examples by Robert H. Shumway and David S. Stoffer

Introduction to Time Series

Outline

- What is a time series? Time series model?
  - Time Series Examples
- Fundamental building blocks of time series
  - White noise
  - Moving average
  - Random walk
- Second order properties and stationarity
- When/why linear regression fails

What is a Time Series?

- Simply: data points indexed by time order
- Natural temporal order of data
- Typically: Equally spaced points in time
- Often different than what we see in a regression setting

Why Care about Time Series

- They are everywhere!
- Economics (stock market, unemployment, etc)
- Social sciences (population series like birth rates or school enrollments)
- Epidemiology (influenza outbreaks)
- Medicine (blood pressure measurements)

Working with Time Series

- Time series analysis
  - Analyzing observed data
  - Focus on characteristics of the data
  - Explanatory focus
- Time series forecasting
  - Generating a model
  - Predictive focus

Some Additional Terminology

- Stochastic process
  - A sequence of random variables
  - Example: flipping a coin
- Sample path
  - Sample path of a stochastic process
  - One sample from a stochastic process
  - For example: HTHHTT (six coin flips)
- A stochastic process can generate MANY sample paths (infinitely many)

Fundamental Stochastic Processes

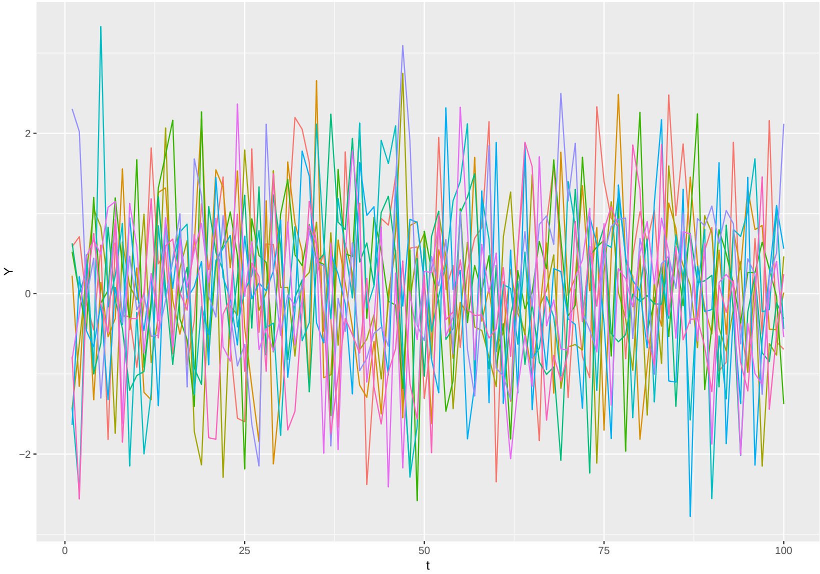
- White noise
- Moving average
- Random walks

White Noise

- Fundamental building block of other stochastic processes
- Key: no correlation between observations
- Assume $e_t \sim N(0, 1)$ is a collection of IID random variables all following a normal distribution
- Normal distribution? Anyone? Anyone at all?
- Define $Y_t = e_t$ for all t
- Y_t is called white noise (process looks like white light of spectrometers)

White Noise: 1 Sample Path

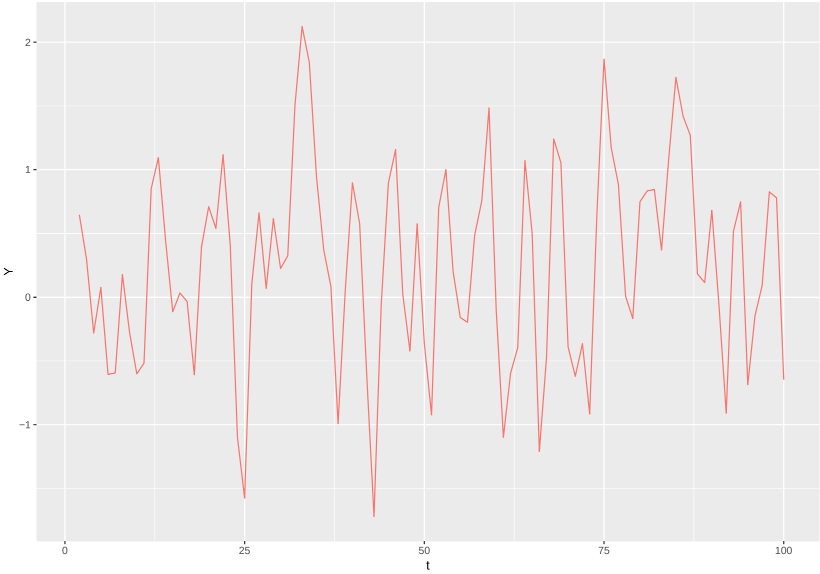
White Noise: Many Sample Paths



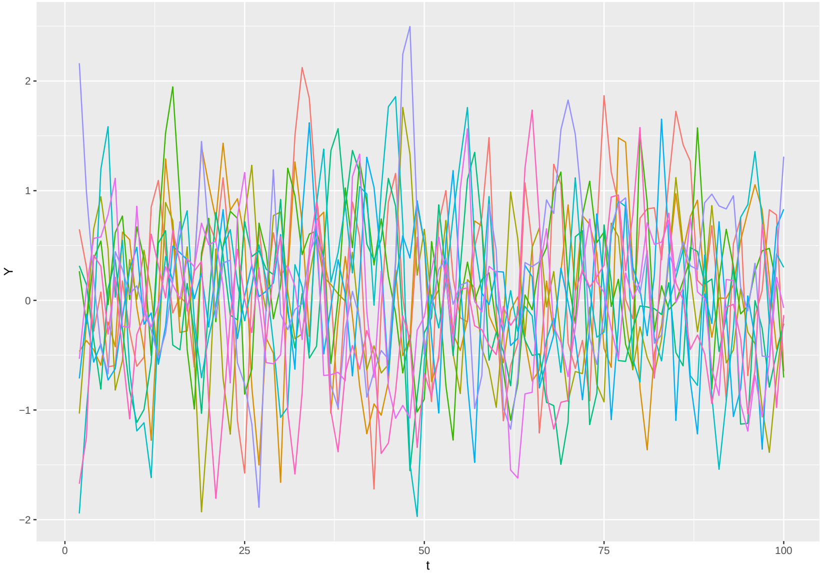
Moving Average

- Big difference: there IS correlation between observations
- Assume $e_t \sim N(0,1)$ is a collection of IID random variables all following a normal distribution
- Define $Y_t = \frac{e_t + e_{t+1}}{2}$ for all t
- Y_t is a type of moving average stochastic process

Moving Average: 1 Sample Path



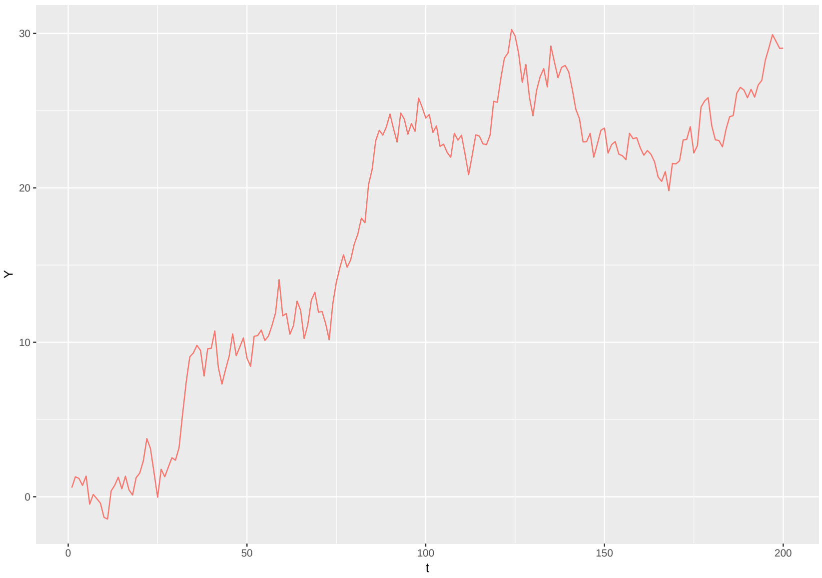
Moving Average: Many Sample Paths



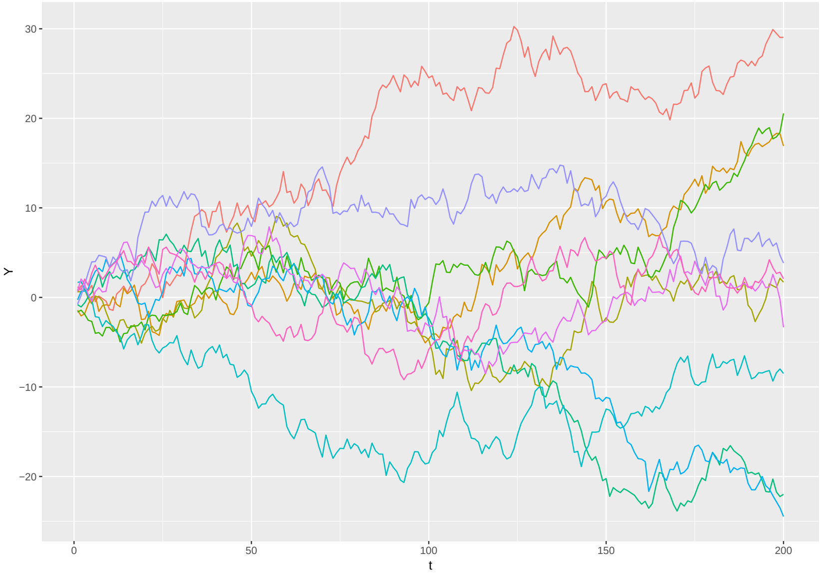
Random Walk

- Assume $e_t \sim N(0, 1)$ is a collection of IID random variables all following a normal distribution
- Define $Y_t = e_1 + e_2 + ... + e_t$ for all t
- Y_t is a random walk

Random Walk: 1 Sample Path



Random Walk: Many Sample Paths



Why Care about Stochastic Processes?

- We have ONE sample path of observations
- From this sample path we intend to infer the stochastic process that generated it
- We are NOT fitting lines to the data
- We are understanding the sample paths the process could take

Typical Process

- We observe a process to a specific point
- We determine what sample paths are likely as we look later in time

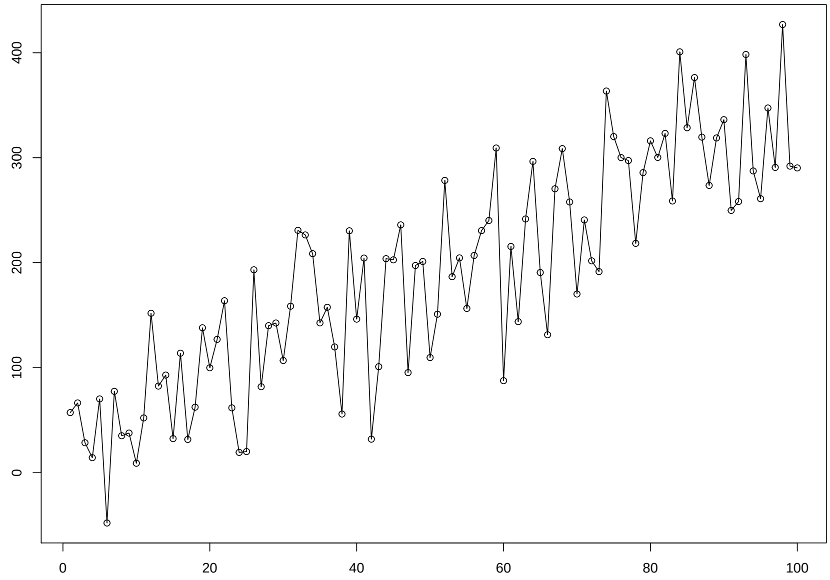
Stationarity

- Heavily mathematical definition
- Essence of it:
  - The mean (or expected value of the stochastic process) is constant
  - Covariance (or corelation between points only depends on distance between points and not on the value of t)
- Stationarity is an extremely common assumption in time series modeling!

Time Series: Linear Trend

- Assume stochastic process is $Y_t = \beta_0 + \beta_1 t + X_t$
- Assume $E[X_t] = 0$ and X_t is stationary
- This is just like linear regression so let's use OLS

Time Series: Linear Trend



Time Series

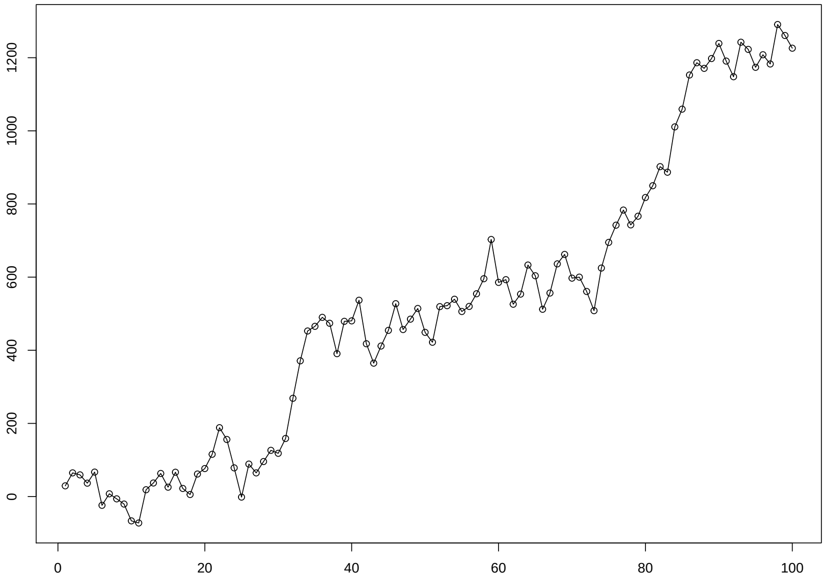
- Linear regression recovers the true parameters (close)

```
## # A tibble: 2 x 5
##   term        estimate std.error statistic  p.value
##   <chr>          <dbl>     <dbl>     <dbl>    <dbl>
## 1 (Intercept)    30.7     11.3        2.73 7.57e- 3
## 2 t               3.13     0.194     16.2  2.13e-29
```

Time Series: Linear Model for Random Walk

- What if we fit a random walk Y_t with a linear model?
- Put another way: what if we regress a random walk on time with a linear model?
- Good choice, bad choice?

Linear Model for a Random Walk



Linear Model for a Random Walk

- Linear regression fails. Hard
- Significant trend when there is NOT one
- Reminder: there is not a trend because the expected value of Y_t is 0

```
## # A tibble: 2 x 5
##   term        estimate std.error statistic  p.value
##   <chr>          <dbl>     <dbl>     <dbl>    <dbl>
## 1 (Intercept)   -150.     22.9       -6.53 2.97e- 9
## 2 t               13.1     0.394     33.2  4.34e-55
```

What Happened?

- Spurious regression
- DO NOT regress non-stationary time series
- Our mistake
  - Coefficient is okay
  - Standard error is underestimated
- A random walk does not follow required linear regression assumptions!
  - Which key assumption does it not follow?