



# Time Series Analysis and Forecasting

## Chapter 10: Comprehensive Review



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## Learning Objectives

By the end of this chapter, you will be able to:

- ▣ Apply the complete forecasting workflow from data to evaluation
- ▣ Select appropriate models based on data characteristics
- ▣ Evaluate forecast accuracy using proper metrics and cross-validation
- ▣ Integrate knowledge from all previous chapters in practice

## Outline

Forecasting Methodology

Case Study 1: Bitcoin Volatility (GARCH)

Case Study 2: Sunspot Cycles (Fourier)

Case Study 3: Unemployment (Prophet)

Case Study 4: Multivariate Analysis (VAR)

Synthesis and Guidelines

AI Use Case

Quiz

Summary

## The Scientific Approach to Forecasting

### Research Question

How do we **rigorously evaluate** forecast performance while avoiding overfitting?

### The Fundamental Problem

- In-sample fit  $\neq$  Out-of-sample performance
- Models can “memorize” training data without learning patterns
- **Solution:**
  - ▶ Proper train/validation/test methodology

### Key Principle

“The test set must remain **untouched** until final evaluation.”  
— Standard practice in machine learning and econometrics

## Train/Validation/Test Framework

### Time Series Train/Validation/Test Split



 TSA\_ch10\_train\_val\_test\_split

## Evaluation Metrics

### Definition 1 (Forecast Error Metrics)

Let  $y_t$  be actual,  $\hat{y}_t$  forecast:

$$\text{RMSE} = \sqrt{\frac{1}{n} \sum_t (y_t - \hat{y}_t)^2}, \quad \text{MAE} = \frac{1}{n} \sum_t |y_t - \hat{y}_t|, \quad \text{MAPE} = \frac{100\%}{n} \sum_t \left| \frac{y_t - \hat{y}_t}{y_t} \right|$$

### When to Use Each

- ▣ **RMSE**: Penalizes large errors
- ▣ **MAE**: Robust to outliers
- ▣ **MAPE**: Scale-independent (%)

### Caution

- ▣ MAPE undefined when  $y_t = 0$
- ▣ Compare on **same** test set
- ▣ Report **out-of-sample** metrics

## Forecast Evaluation Beyond RMSE

### Alternative metrics

• **MASE** (Mean Absolute Scaled Error):  $\frac{\text{MAE}_{\text{model}}}{\text{MAE}_{\text{naïve}}}$ ;  $< 1 \Rightarrow$  beats naïve

• **DA** (Directional Accuracy):  $\frac{1}{h} \sum_{t=1}^h 1(\text{sgn } \Delta \hat{y}_t = \text{sgn } \Delta y_t)$

• **QL** (Quantile Loss): asymmetric penalty  $\alpha$  vs  $1-\alpha$

$$QL_{\alpha} = \begin{cases} \alpha(y_t - \hat{q}_t), & y_t > \hat{q}_t \\ (1 - \alpha)(\hat{q}_t - y_t), & y_t \leq \hat{q}_t \end{cases}$$

• **CRPS** (Continuous Ranked Probability Score):  $\int_{-\infty}^{\infty} (F(x) - 1_{x \geq y})^2 dx$

## Forecast Evaluation: Bitcoin Results

## Bitcoin Results (GARCH volatility)

## Metric

RMSE

MAE

MASE

Dir. Accuracy 28.7% (below 50% – the model prec

- $MASE < 1$ : GARCH beats naïve
- DA 28.7%: volatility direction is hard

## Interpretation

- RMSE/MAE: absolute volatility forecast error
- $MASE < 1$ : GARCH outperforms naïve benchmark
- DA 28.7%: volatility direction is extremely hard to predict
- Evaluation must be done on the **test set**



## Formal Forecast Comparison: Diebold–Mariano

### Definition 2 (Diebold–Mariano Test)

Loss differential:  $d_t = L(e_{1t}) - L(e_{2t})$ ,    Statistic:  $DM = \frac{\bar{d}}{\sqrt{\text{Var}(\bar{d})}} \xrightarrow{d} N(0, 1)$

### Hypotheses

- ▣  $H_0$ : equal predictive accuracy
- ▣  $H_1$ : one model is significantly better
- ▣ Large  $|DM| \Rightarrow$  reject  $H_0$

### Bitcoin Result (GARCH volatility)

- ▣ Normal vs Student-t:  $DM = -0.51$
- ▣  $p = 0.612$  — **do not reject**  $H_0$
- ▣ Similar accuracy, but Student-t preferred by AIC ( $\Delta = 509$ )

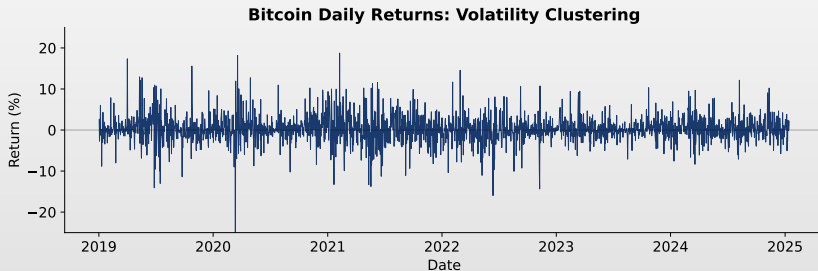
### Key message

- ▣ Lower RMSE  $\neq$  significant difference — formal testing is **mandatory**

## Bitcoin: Volatility Clustering

### Observation

- Large returns follow large returns, small follow small—**volatility clustering**



 TSA\_ch10\_btc\_returns

## Bitcoin: Problem Statement

### Research Question

Can we forecast Bitcoin's **volatility** using GARCH models?

### Data Characteristics

- ▣ Source: Yahoo Finance (BTC-USD)
- ▣ Period: Jan 2019 – Jan 2025
- ▣ Frequency: Daily
- ▣ Observations:  $\approx 2,200$  days

### Stylized Facts

- ▣ Returns: near-zero mean
- ▣ Fat tails (kurtosis  $> 3$ )
- ▣ Volatility clustering

### Key Insight

Financial returns are typically:

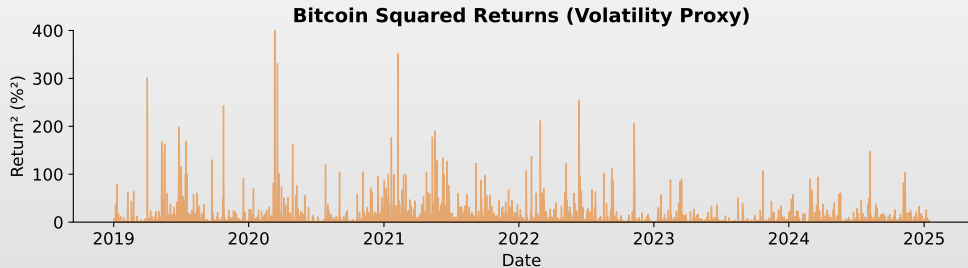
- ▣ **Unpredictable** in mean
- ▣ **Predictable** in variance

⇒ Focus on **volatility forecasting**

## Bitcoin: Evidence for GARCH

### Observation

- Squared returns  $r_t^2$  exhibit significant autocorrelation  $\Rightarrow$  GARCH effects
- Slow ACF decay  $\Rightarrow$  high volatility persistence



 TSA\_ch10\_btc\_acf\_squared

## GARCH Model Specification

### Definition 3 (GARCH(p,q) Model)

Let  $r_t$  denote returns. The GARCH(p,q) model:

$$r_t = \mu + \varepsilon_t, \quad \varepsilon_t = \sigma_t z_t, \quad z_t \stackrel{iid}{\sim} N(0, 1)$$
$$\sigma_t^2 = \omega + \sum_{i=1}^q \alpha_i \varepsilon_{t-i}^2 + \sum_{j=1}^p \beta_j \sigma_{t-j}^2$$

where  $\omega > 0$ ,  $\alpha_i \geq 0$ ,  $\beta_j \geq 0$ , and  $\sum_{i=1}^q \alpha_i + \sum_{j=1}^p \beta_j < 1$ .

### Model Variants

- ▣ **GARCH(1,1)**: Most common
- ▣ **GJR-GARCH**: Leverage effect
- ▣ **EGARCH**: Log-variance, asymmetric

### Interpretation

- ▣  $\alpha$ : Shock impact (ARCH effect)
- ▣  $\beta$ : Volatility persistence
- ▣  $\alpha + \beta \approx 1$ : High persistence

## GARCH: Stationarity and Unconditional Variance

### Theorem 1 (Covariance Stationarity of GARCH(1,1))

If  $\alpha_1 + \beta_1 < 1$ , then  $\{\varepsilon_t\}$  is covariance stationary with:

$$\bar{\sigma}^2 = \mathbb{E}[\sigma_t^2] = \frac{\omega}{1 - \alpha_1 - \beta_1}$$

### Derivation

Take expectations of both sides of the variance equation:

$$\begin{aligned}\mathbb{E}[\sigma_t^2] &= \omega + \alpha_1 \mathbb{E}[\varepsilon_{t-1}^2] + \beta_1 \mathbb{E}[\sigma_{t-1}^2] \\ \bar{\sigma}^2 &= \omega + (\alpha_1 + \beta_1) \bar{\sigma}^2 \quad (\text{stationarity}) \\ \bar{\sigma}^2 &= \frac{\omega}{1 - \alpha_1 - \beta_1}\end{aligned}$$

### Multi-Step Forecasts Converge to $\bar{\sigma}^2$

As  $h \rightarrow \infty$ :  $\mathbb{E}_t[\sigma_{t+h}^2] \rightarrow \bar{\sigma}^2$  at rate  $(\alpha_1 + \beta_1)^h$ .

## Bitcoin: Model Selection on Validation Set

### Methodology

Fit each model on training data, evaluate on validation set.

Model	AIC	BIC	Val MAE	Selection
GARCH(1,1)	6,994.8	7,020.6	2.638	Best
GARCH(2,1)	6,993.7	7,024.6	2.640	
GJR-GARCH(1,1)	6,983.7	7,014.6	2.669	
EGARCH(1,1)	—	—	—	Failed*

\* Analytic forecasts not available for  $h > 1$

### Result

GARCH(1,1) selected based on lowest validation MAE for volatility forecasts.

## Bitcoin: Data Split and Stationarity

### Data Split

Set	Period	N
Training (70%)	2019-01 to 2023-03	1,543
Validation (15%)	2023-04 to 2024-02	333
Test (15%)	2024-03 to 2025-01	329
<b>Total</b>		<b>2,205</b>

### Stationarity Tests

Series	ADF	Result
Prices	$p = 0.50$	Non-stationary
Returns	$p < 0.01$	Stationary

⇒ Model **returns**, not prices

### Why Stationarity Matters

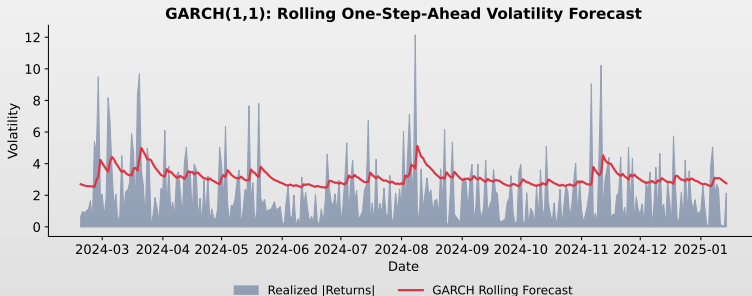
- GARCH requires weakly stationary input
- Prices follow random walk; returns are stationary



## Bitcoin: Volatility Forecast

### Interpretation

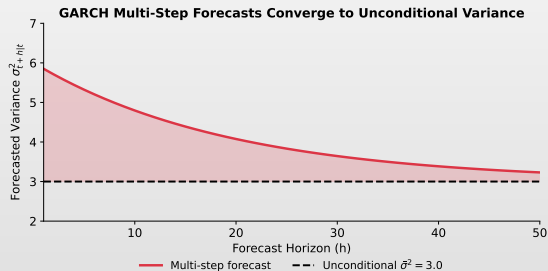
- Shaded area: 95% prediction interval of the volatility forecast
- GARCH(1,1) captures Bitcoin's volatility dynamics well



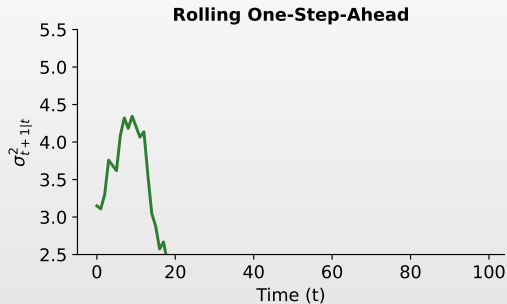
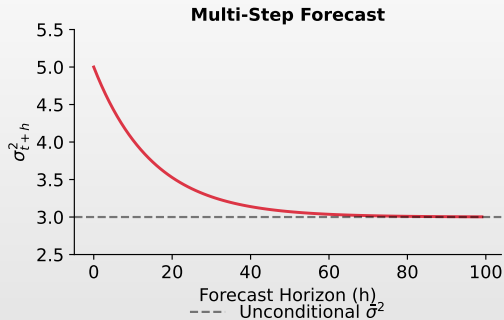
## GARCH: Multi-Step Forecasts Converge

### Key Insight

- Multi-step forecasts converge to  $\bar{\sigma}^2 = \frac{\omega}{1-\alpha-\beta}$
- Use rolling forecasts



## GARCH: Rolling One-Step-Ahead Solution



 TSA\_ch10\_rolling\_vs\_multistep

## GARCH: Innovation Distributions

### Model

$$r_t = \mu + \sigma_t Z_t$$

- Options for  $z_t$ :  $\mathcal{N}(0, 1)$  (normal) or  $t_\nu$  (fat tails)

### Bitcoin: empirical evidence

- Residual kurtosis: **13.81** (Normal = 3)
- Skewness:  $-0.29$
- Jarque-Bera: 9085,  $p < 0.001$
- Normality **underestimates** tail risk

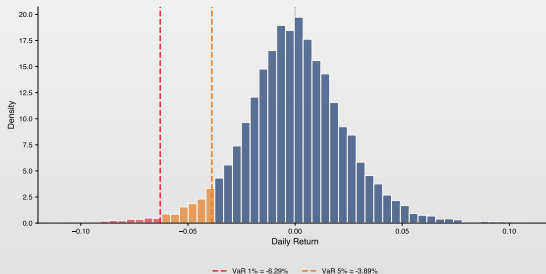
### Student-t: the right choice

- $\hat{\nu} = 2.96$  degrees of freedom
- AIC Normal: 9769 vs Student-t: **9260**
- $\Delta\text{AIC} = 509$  — **overwhelming** evidence
- Fat tails = **more realistic** VaR estimates

## VaR and ES: Graphical Illustration

### Interpretation

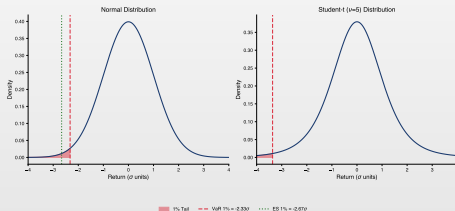
- VaR 1% = loss exceeded only in 1% of cases
- Red area = extreme losses (beyond VaR)



## VaR vs Expected Shortfall: Normal vs Student-t

### Interpretation

- ES measures average loss when VaR is exceeded; Student-t: VaR and ES are larger than under normal



 TSA\_ch5\_var\_es

### Formal Definitions

- VaR**:  $\text{VaR}_\alpha = \inf\{l : P(r_t \leq -l) \leq \alpha\}$
- ES** (preferred under Basel III/IV):  $\text{ES}_\alpha = \mathbb{E}[-r_t \mid r_t \leq -\text{VaR}_\alpha] = \frac{1}{\alpha} \int_0^\alpha \text{VaR}_u du$
- ES is **coherent** (subadditive); VaR is **not** subadditive

## Value at Risk — Numerical Example

### VaR Calculation

Portfolio: **1,000,000 EUR**, forecasted volatility  $\hat{\sigma}_{T+1} = 1.5\%$

### VaR with Normal Distribution

Level	$z_{\alpha}$	VaR (%)	VaR (EUR)
5% (1 day)	1.645	2.47%	24,675
1% (1 day)	2.326	3.49%	34,890

### Scaling for Longer Periods

$\text{VaR}_{h \text{ days}} = \text{VaR}_{1 \text{ day}} \cdot \sqrt{h}$  — assumes i.i.d. returns, which is inconsistent with the serial dependence in conditional variance modeled by GARCH

## Value at Risk — Student-t Distribution

### Why Student-t?

Normal distribution **underestimates** tail risk. Student-t with  $\nu$  degrees of freedom better captures fat tails (kurtosis  $> 3$ ).

### VaR 1% (1 day) Comparison: $\sigma = 1.5\%$ , Portfolio = 1M EUR

Distribution	Quantile	VaR (EUR)
Normal	2.326	34,890
Student-t ( $\nu = 6$ )	3.143	47,145
Student-t ( $\nu = 4$ )	3.747	56,205

### Observation

With  $\nu = 6$  (typical for stocks), VaR is **35% higher** than normal!



## VaR — Complete Example with GARCH

### VaR Calculation Procedure

1. Estimate GARCH(1,1) model with Student-t distribution
2. Obtain volatility forecast:  $\hat{\sigma}_{T+1}$
3. Calculate VaR:  $\text{VaR}_\alpha = t_\alpha(\nu) \cdot \hat{\sigma}_{T+1}$

### Example: S&P 500

- ▣ Estimated parameters:  $\alpha = 0.088$ ,  $\beta = 0.900$ ,  $\nu = 6.4$
- ▣ Forecasted volatility:  $\hat{\sigma}_{T+1} = 1.2\%$
- ▣ Portfolio: 10,000,000 EUR

**VaR 1% (1 day):**  $\text{VaR} = 3.05 \times 0.012 \times 10,000,000 = \mathbf{366,000 \text{ EUR}}$

## What is VaR Backtesting?

### Definition

- **Backtesting** = ex-post verification of VaR model quality
- Compares realized losses with the forecasted VaR threshold
  - ▶ A **violation** occurs when  $r_t < -\text{VaR}_t$

### Backtesting Principle

- Violation indicator:  $I_t = 1(r_t < -\text{VaR}_{\alpha,t})$
- For a correctly specified model at level  $\alpha$ :
  - ▶ Frequency:  $\hat{p} = \frac{1}{T} \sum I_t \approx \alpha$ ; violations **independent**
- VaR 1% over 250 days  $\Rightarrow$  expect  $\sim 2.5$  violations/year

### Importance

- Regulatory requirement under **Basel III/IV** for banks: backtesting is mandatory

## Kupiec Test (1995) — Unconditional Coverage

### Hypotheses

- ▣  $H_0$ : Violation rate equals the VaR level ( $p = \alpha$ )
- ▣  $H_1$ : Violation rate differs from the VaR level ( $p \neq \alpha$ )

### Test Statistic (Likelihood Ratio)

- ▣ **Formula:**  $LR_{uc} = -2 \ln \left[ \frac{\alpha^x (1-\alpha)^{T-x}}{\hat{p}^x (1-\hat{p})^{T-x}} \right] \sim \chi^2(1)$
- ▣ **Notation:**  $x$  = no. violations,  $T$  = no. observations,  $\hat{p} = x/T$

### Example

- ▣ VaR 1%,  $T = 250$  days,  $x = 5$  violations:  $\hat{p} = 2\%$ 
  - ▶ Too many violations  $\Rightarrow$  model **underestimates** risk
- ▣ VaR 1%,  $T = 250$  days,  $x = 1$  violation:  $\hat{p} = 0.4\% \Rightarrow$  acceptable

## Christoffersen Test (1998) — Conditional Coverage

### Motivation

- ▣ Kupiec only tests the **frequency** of violations
- ▣ Does not detect **clustering** of violations (consecutive violations)
  - ▶ If violations cluster  $\Rightarrow$  model fails to capture volatility dynamics

### Independence + Conditional Coverage Test

- ▣ **Formula:**  $LR_{cc} = LR_{uc} + LR_{ind} \sim \chi^2(2)$
- ▣  $LR_{ind}$  tests whether  $P(I_t = 1 | I_{t-1} = 1) = P(I_t = 1 | I_{t-1} = 0)$
- ▣ A good model: violations are rare **and** uniformly distributed over time

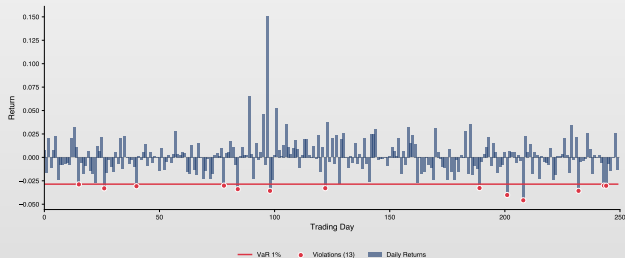
### Recommendation

- ▣ Use **both** tests: Kupiec (frequency) + Christoffersen (independence)

## VaR Backtesting: Visualization

### Interpretation

- ▣ Red line: VaR 1% threshold estimated with GARCH(1,1)
- ▣ Red dots: 13 violations out of 250 days ( $\hat{p} = 5.2\%$ )
  - ▶ **Basel red zone**  $\Rightarrow$  model significantly underestimates risk
  - ▶ Solutions: Student-t distribution, EGARCH model, or more conservative VaR level



## VaR Backtesting: Basel Traffic Light

### Basel III/IV Traffic Light Zones

Zone	Violations/250 days	Interpretation	Penalty
Green	0–4	Model acceptable	No penalty
Yellow	5–9	Needs investigation	Factor $k$ increases
Red	$\geq 10$	Model inadequate	Maximum penalty

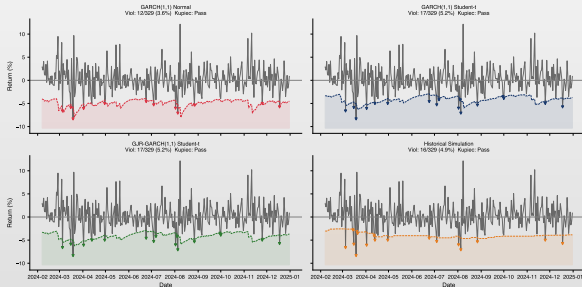
### Practical Example

- Portfolio with VaR 1%: 250 days of backtesting
- 3 violations  $\Rightarrow$  **Green zone**  $\Rightarrow$  model acceptable
- 7 violations  $\Rightarrow$  **Yellow zone**  $\Rightarrow$  revision needed
- 13 violations  $\Rightarrow$  **Red zone**  $\Rightarrow$  model rejected

## Application: Rolling VaR with Multiple Models

### Methodology

- Rolling one-step-ahead VaR:  $\text{VaR}_{t+1}^{\alpha} = \mu + \hat{\sigma}_{t+1} \cdot z_{\alpha}$
- 4 models compared on Bitcoin test set (329 days, 2024)



## VaR Backtesting: Model Comparison

Bitcoin Results — VaR 5% (T = 329 days, expected: 16.4 violations)

Model	Violations	Rate	Kupiec $p$	Chr. $p$	Conclusion
GARCH(1,1)-N	12	3.6%	0.238	1.000	Too conservative
GARCH(1,1)-t	<b>17</b>	<b>5.2%</b>	<b>0.890</b>	0.272	$\approx$ 5% target
GJR-GARCH(1,1)-t	17	5.2%	0.890	0.272	$\gamma \approx 0$ (symmetric)
Hist. Simulation	<b>16</b>	<b>4.9%</b>	<b>0.909</b>	0.216	$\approx$ 5% target

### Conclusions

- **Student-t**: perfect coverage (5.2%  $\approx$  5%)
- Normal: too conservative (3.6% < 5%)
- GJR  $\approx$  GARCH: no leverage for Bitcoin
- All pass both Kupiec **and** Christoffersen

### Practical Lessons

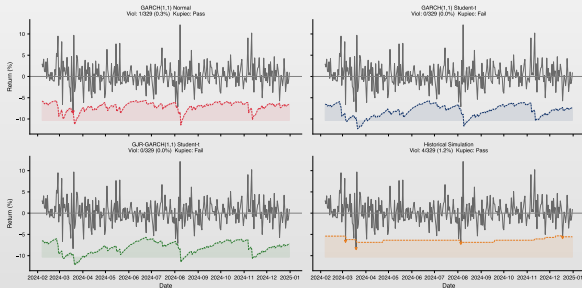
- GARCH-t and HistSim: both  $\approx$  5% target
- Historical simulation: simple and effective alternative
- Formal statistical testing (Kupiec, Christoffersen) is **mandatory**



## Application: Rolling VaR 1% on Multiple Models

### Methodology

- Rolling one-step-ahead VaR at  $\alpha = 1\%$  (extreme risk)
- Same 4 models; expected:  $T \times 0.01 = 3.3$  violations



## VaR 1% Backtesting: Model Comparison

Bitcoin Results — VaR 1% ( $T = 329$  days, expected: 3.3 violations)

Model	Violations	Rate	Kupiec $p$	Chr. $p$	Conclusion
GARCH(1,1)-N	1	0.3%	0.137	1.000	Acceptable
GARCH(1,1)-t	0	0.0%	<b>0.010</b>	1.000	<b>Rejected</b>
GJR-GARCH(1,1)-t	0	0.0%	<b>0.010</b>	1.000	<b>Rejected</b>
Hist. Simulation	4	1.2%	<b>0.704</b>	1.000	$\approx$ 1% target

### VaR 1% Conclusions

- GARCH-t/GJR-t: 0 violations  $\Rightarrow$  Kupiec **rejects** ( $p = 0.010$ )
- Student-t tails too heavy ( $\nu \approx 3$ )  $\Rightarrow$  VaR 1% **too conservative**
- **Hist. Simulation**: 1.2%  $\approx$  1% — only accurate model

### Lesson: 5% vs 1%

- At 5%: GARCH-t and HistSim both excellent
- At 1%: GARCH-t **rejected** (too conservative)
- **Optimal model depends on the  $\alpha$  level!**

## GARCH Limitations and Modern Extensions

### Limitations

- Does not capture **jumps**
- Constant parameters over time
- Sensitive to chosen distribution
- Does not model different **regimes**

### Extensions

- **GJR-GARCH**: leverage effect
- **EGARCH**: asymmetric shocks
- **Markov-Switching GARCH**: regimes
- Realized volatility (HAR)
- Hybrid GARCH + ML

### Key message

- GARCH is a **starting point**, not the end of risk modeling

## Bitcoin: Key Findings

### Summary

1. **Returns are stationary**; prices are not
2. **GARCH(1,1)** outperforms more complex variants
3. **High persistence** ( $\alpha + \beta = 0.93$ )
4. Volatility is **predictable** even when returns are not

### Practical Implications

- ▣ Risk management: VaR, Expected Shortfall
- ▣ Option pricing requires volatility forecasts
- ▣ Portfolio optimization with time-varying risk

### Limitations

- ▣ GARCH assumes **symmetric** shocks
- ▣ Does not capture **jumps**
- ▣ Normal distribution may be restrictive

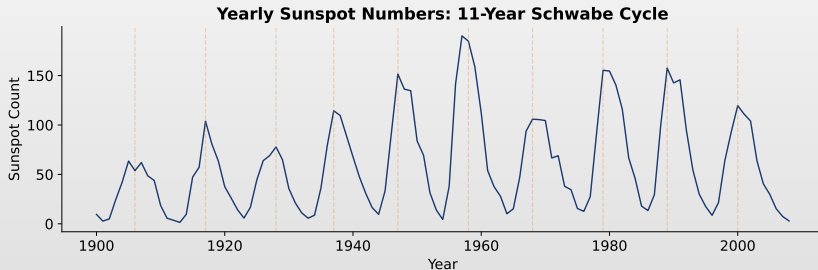
### Extensions

- ▣ Student-t innovations
- ▣ Realized volatility
- ▣ HAR models

## Sunspots: The 11-Year Solar Cycle

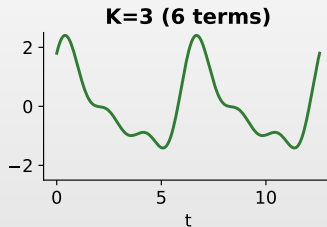
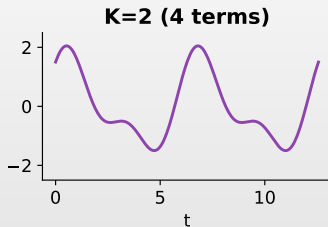
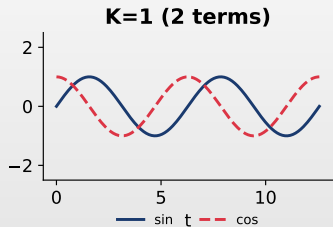
### Observation

- Clear  $\approx 11$ -year solar cycle; variable amplitude across cycles
- Periodic ACF  $\Rightarrow$  long seasonality, ideal for Fourier terms



## Fourier Terms for Seasonality

**Fourier Terms: More K = More Flexibility**



 TSA\_ch10\_fourier\_terms

## Sunspots: Model Selection

### Methodology

Compare  $K = 1, 2, 3, 4$  Fourier harmonics on validation set.

Data Split	Set	Period	N
	Training (70%)	1900–1975	76
	Validation (20%)	1976–1997	22
	Test (10%)	1998–2008	11
	<b>Total</b>		<b>109</b>

Model Comparison			
K	AIC	Val RMSE	
1	665.9	87.15	
2	668.0	86.92	
3	671.8	<b>86.81</b>	Best
4	674.5	87.93	

### Result

$K = 3$  Fourier harmonics selected (6 parameters for 11-year cycle).

## Overfitting in Choosing $K$

### Overfitting risk

- ▣  $K$  too large = memorizing historical cycle
- ▣ Model fits noise, not signal
- ▣ Test performance **degrades**

### Fourier $\approx$ periodic regression

- ▣ Each harmonic adds 2 parameters (sin, cos)
- ▣  $K = 3$ : 6 extra parameters
- ▣  $K = 6$ : 12 parameters — overfitting risk

### Solution: validation

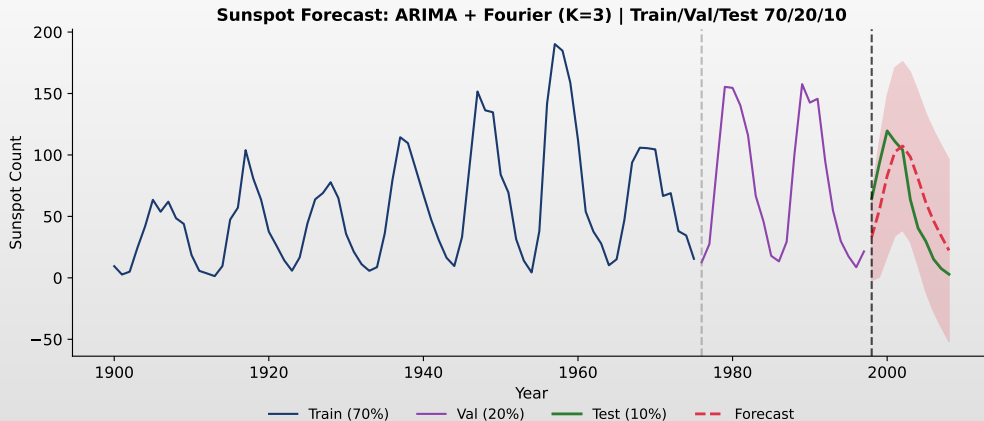
- ▣ Select  $K$  on **validation** set
- ▣ Evaluate on **test** — untouched
- ▣ Trade-off: complexity vs generalization

### Our results

- ▣  $K = 3$  minimizes Val RMSE
- ▣  $K = 4$  increases error  $\Rightarrow$  overfitting



## Sunspots: Forecast Results



## Sunspots: Key Takeaways

### When to Use Fourier Terms

- Seasonal period  $s$  is **long** (e.g., 11 years, 52 weeks)
- SARIMA would require too many seasonal lags
- Pattern is **smooth and periodic**
- Multiple cycles need to be captured

### Choosing $K$

- Start with  $K = 1$ , increase until validation error stops improving
- Too high  $K$  = overfitting

### Fourier vs SARIMA

	Fourier	SARIMA
Long seasons	✓	×
Short seasons	OK	✓
Parameters	$2K$	Many
Flexibility	Fixed	Adaptive

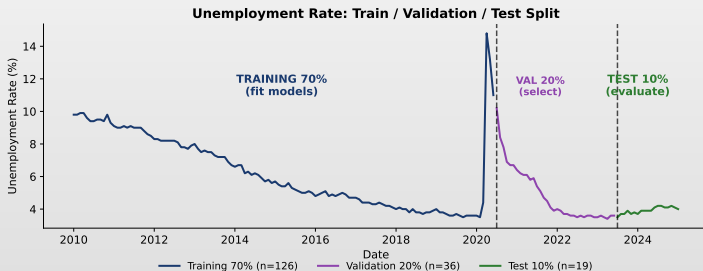
### Applications

Climate cycles, business cycles, astronomical phenomena

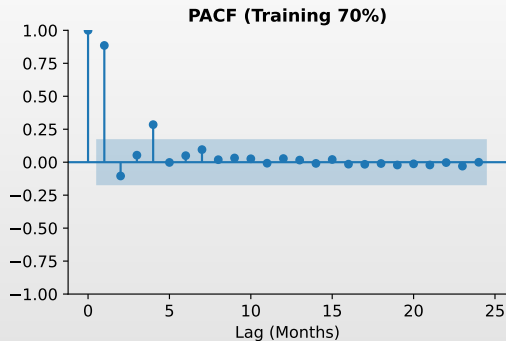
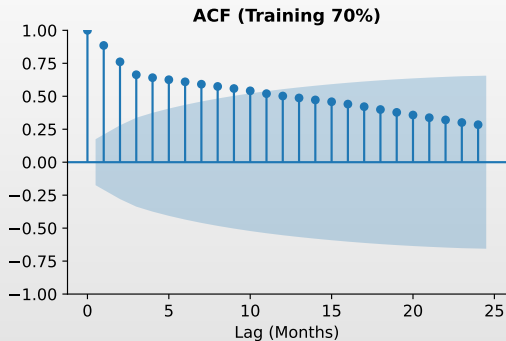
## Unemployment: Train / Validation / Test Split

### Methodology

- ▣ **Training:** Fit models
- ▣ **Validation:** Select best
- ▣ **Test:** Final evaluation

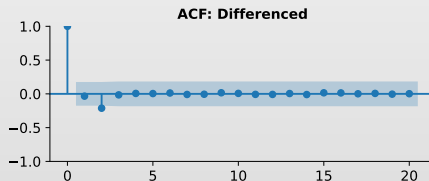
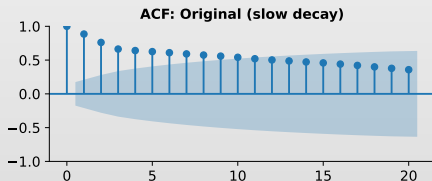
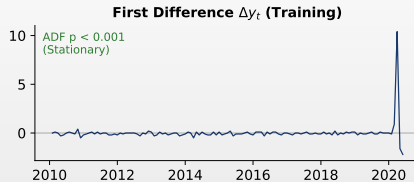
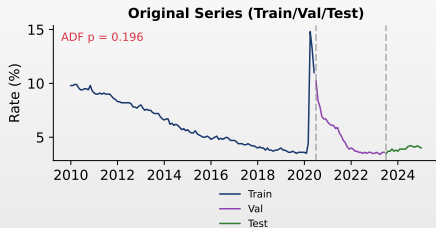


## Unemployment: Preliminary Analysis



 TSA\_ch10\_unemployment\_acf\_pacf

## Unemployment: Stationarity Tests



## Structural Breaks: Formal Approach

### Classical methods

- ▣ **Chow Test**: break at known point
- ▣ **Bai–Perron**: multiple unknown breaks
- ▣ **CUSUM**: sequential detection

### Problem

- ▣ ADF can confuse **break** with **unit root**
- ▣ Zivot–Andrews test: ADF with endogenous break

### Result: Unemployment at COVID (March 2020)

- ▣ Chow Test:  $F = 21.73$ ,  $p < 0.001$
- ▣ Structural break **confirmed**
- ▣ SARIMA: constant parameters — risk
- ▣ Prophet: detects changepoints automatically

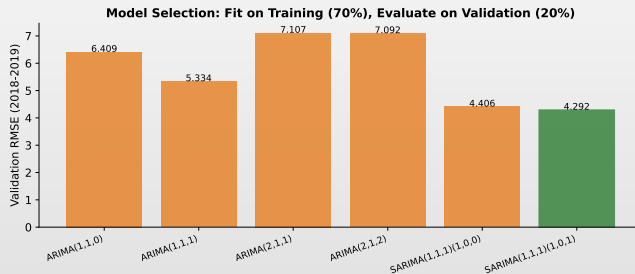
### Key message

- ▣ Model must be adapted to **parameter stability**

## Unemployment: Model Selection (Validation Set)

Best: SARIMA(1,1,1)(1,0,0)<sub>12</sub>

Selected by lowest validation RMSE



## Unemployment: SARIMA Parameters

SARIMA(1,1,1)(1,0,0)<sub>12</sub> fitted on Train+Val (2010–2023)

- AR(1):  $\phi_1 = -0.86$
- MA(1):  $\theta_1 = 0.78$
- SAR(12):  $\Phi_1 = -0.08$  (n.s.)

**SARIMA(1,1,1)(1,0,1) - Fitted on Train+Val (85%)**

Parameter	Coef	Std Err	P-value	Sig
ar.L1	0.8423	0.2084	0.0001	***
ma.L1	-0.9540	0.1973	0.0000	***
ar.S.L12	0.0326	4.5951	0.9943	
ma.S.L12	-0.0113	4.6087	0.9980	
sigma2	0.8122	0.0608	0.0000	***



## Ljung-Box Test for Residual Autocorrelation

### Definition 4 (Ljung-Box Test)

For residuals  $\hat{\varepsilon}_t$  with sample autocorrelations  $\hat{\rho}_k$ , the test statistic:

$$Q(h) = n(n+2) \sum_{k=1}^h \frac{\hat{\rho}_k^2}{n-k} \stackrel{H_0}{\sim} \chi^2(h-p-q)$$

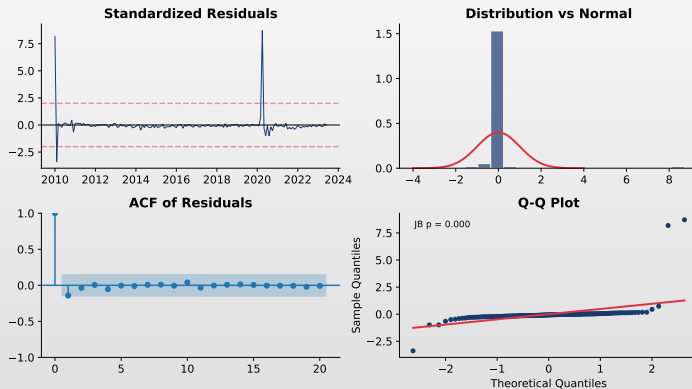
where  $p, q$  are ARMA orders.  $H_0$ : Residuals are white noise.

### Interpretation

- ▣ Large  $Q$  (small p-value): Reject  $H_0$ , residuals have structure
- ▣ Small  $Q$  (large p-value): Fail to reject  $H_0$ , model is adequate
- ▣ Rule of thumb: Use  $h = \min(10, n/5)$  for lag order

## Unemployment: SARIMA Diagnostics

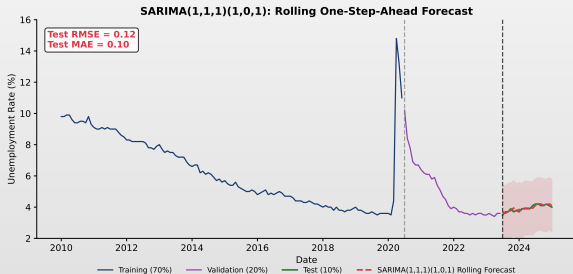
**SARIMA(1,1,1)(1,0,1) Diagnostics on Train+Val (85%) | Ljung-Box  $p = 1.00$**



## Unemployment: SARIMA Rolling Forecast

### Problem: Structural Break

- Rolling one-step-ahead forecast (re-estimate at each  $t$ )
- Test RMSE = 0.12**



## Prophet Model

### Definition 5 (Prophet Decomposition)

$$y_t = g(t) + s(t) + h(t) + \varepsilon_t, \quad \varepsilon_t \sim N(0, \sigma^2)$$

where  $g(t)$  = trend,  $s(t)$  = seasonality,  $h(t)$  = holidays,  $\sigma^2$  = noise variance (estimated).

### Changepoint Detection

- Automatic location selection
- `changepoint_prior_scale` controls flexibility

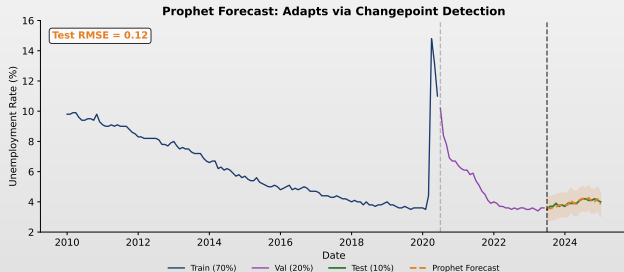
### Advantages

- Handles missing data
- Interpretable components
- Robust to outliers

## Unemployment: Prophet Forecast Results

### Key Finding

- Prophet adapts via changepoint detection
- Test RMSE = 0.58**



## Unemployment: Model Tuning

### Hyperparameter Tuning

Tune `changepoint_prior_scale` on validation set.

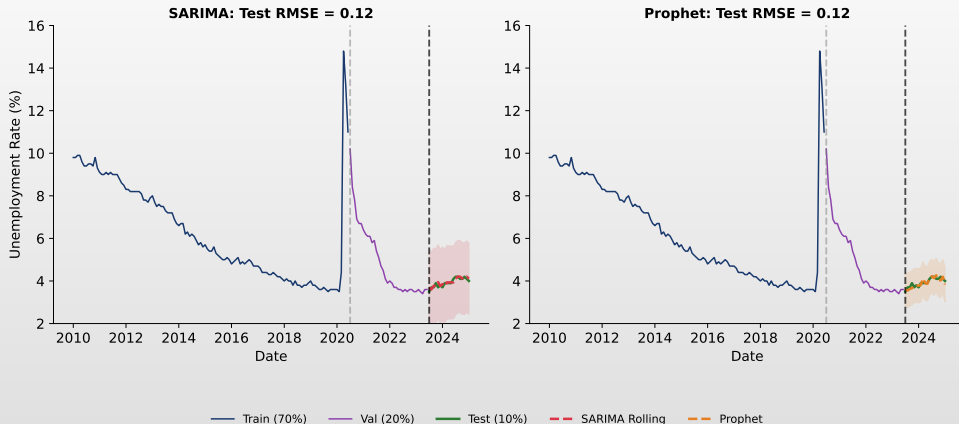
Data Split	Set	Period	N
	Training (70%)	2010-01 to 2020-06	126
	Validation (20%)	2020-07 to 2023-06	36
	Test (10%)	2023-07 to 2025-01	19
	<b>Total</b>		<b>181</b>

Scale Comparison	Scale	Val RMSE	
	0.01	4.21	
	0.05	3.89	
	0.10	<b>3.52</b>	Best
	0.30	3.67	
	0.50	3.81	

### Interpretation

Scale = 0.10 balances flexibility (capturing COVID shock) with stability.

## Unemployment: SARIMA vs Prophet Comparison



## Prophet: When to Use It

### Ideal Use Cases

- Business data with **holidays**
- **Missing values** present
- Need **interpretable** components
- Forecasts with **uncertainty bands**

### Caveat: Structural Breaks

Prophet handles breaks via changepoints, but **SARIMA outperformed** it on unemployment (0.12 vs 0.58). Always validate!

### Prophet vs ARIMA

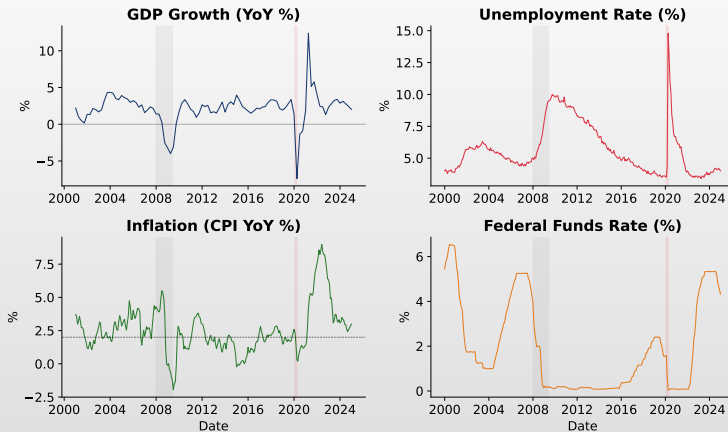
	Prophet	ARIMA
Changepoints	✓	×
Missing data	✓	×
Holidays	✓	×
Speed	Fast	Moderate
Interpretable	✓	×

### Key Parameters

`changepoint_prior_scale`: flexibility  
`seasonality_prior_scale`: smoothness



## VAR: Multivariate Economic Data



## VAR Model Specification

### Definition 6 (Vector Autoregression VAR(p))

For  $K$  variables  $y_t = (y_{1t}, \dots, y_{Kt})'$ :

$$y_t = c + A_1 y_{t-1} + A_2 y_{t-2} + \dots + A_p y_{t-p} + u_t$$

where  $A_i$  are  $K \times K$  coefficient matrices,  $u_t \sim N(0, \Sigma)$ ,  $\Sigma$  = covariance matrix.

### For Our 4-Variable System

VAR(2) has:

- ▣ 4 intercepts
- ▣  $2 \times 4 \times 4 = 32$  AR coefficients
- ▣ **36 parameters total**

### Lag Selection

Use information criteria:

- ▣ AIC: Tends to overfit
- ▣ **BIC**: More parsimonious
- ▣ Cross-validation on held-out data

## Information Criteria for Model Selection

### Definition 7 (Akaike and Bayesian Information Criteria)

For a model with log-likelihood  $\mathcal{L}$ ,  $k$  parameters, and  $n$  observations:

$$\text{AIC} = -2\mathcal{L} + 2k$$

$$\text{BIC} = -2\mathcal{L} + k \ln(n)$$

#### AIC

- Asymptotically efficient
- May overfit with small  $n$
- Minimizes prediction error

#### BIC

- Consistent (finds true model)
- Heavier penalty:  $\ln(n) > 2$  if  $n \geq 8$
- More parsimonious

## VAR: Lag Selection and Estimation

### BIC by Lag Order

Lag	BIC
1	-4.810
2	<b>-5.178</b> Best
3	-4.633
4	-4.614

### Data Split

Set	Period	N
Training (70%)	2001-Q1 to 2017-Q4	67
Validation (20%)	2018-Q1 to 2022-Q4	20
Test (10%)	2023-Q1 to 2025-Q2	10
<b>Total</b>		<b>97</b>

### Validation Check

VAR(2) also achieves lowest validation RMSE.

## VAR Model Stability

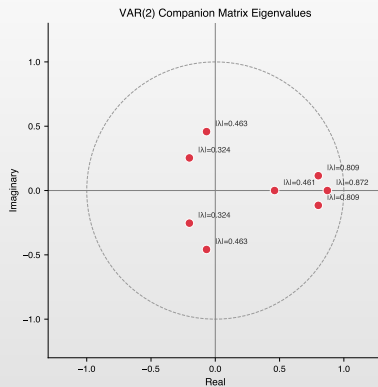
### Stability condition

- All eigenvalues of the companion matrix:  
 $|\lambda_i| < 1, \forall i$

### VAR(2) Results — economic data

$ \lambda_1 ,  \lambda_2 $	0.324
$ \lambda_3 ,  \lambda_4 $	0.463
$ \lambda_5 $	0.461
$ \lambda_6 $	<b>0.872</b>
$ \lambda_7 ,  \lambda_8 $	0.810

- $\text{Max } |\lambda| = 0.872 < 1$  — **stable**



## VAR vs VECM: Cointegration

## Problem

- ▣ If variables are  $I(1) \Rightarrow$  VAR on levels produces spurious regressions

## Definition 8 (VECM)

$$\Delta y_t = \mu + \Pi y_{t-1} + \sum_{i=1}^{p-1} \Gamma_i \Delta y_{t-i} + u_t, \quad \Pi = \alpha \beta'$$

## Key message

- ▣ VAR on differences: loses long-run relationship; VECM: preserves it through  $\Pi = \alpha \beta'$

## Johansen Test — economic data

$r$	Trace	CV 5%	Reject?
0	<b>64.09</b>	47.85	<b>Yes</b>
1	24.03	29.80	No
2	11.89	15.49	No
3	1.28	3.84	No

- ▣ **1 cointegrating relation** found
- ▣ VECM more appropriate than VAR on levels

## Granger Causality: Empirical Results

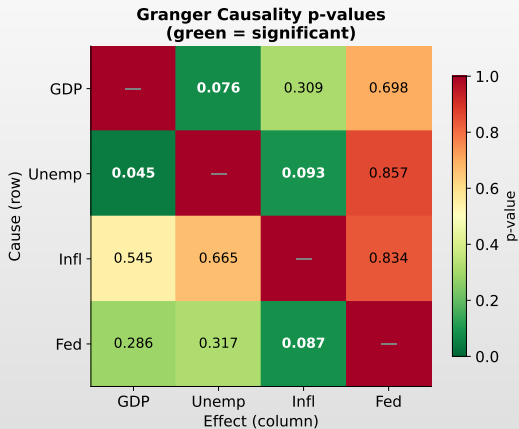
### Interpretation

Each cell shows p-value for testing whether the row variable Granger-causes the column variable. Green:  $p < 0.10$ . Interpretation: row variable Granger-causes column variable.

### Economic Findings

- Unemp  $\rightarrow$  GDP ( $p = 0.045$ ): Okun's Law
- Fed  $\rightarrow$  Inflation ( $p = 0.087$ ): Monetary policy transmission
- GDP  $\rightarrow$  Unemp: Weak evidence

## Granger Causality: $p$ -value Heatmap





## Granger Causality: Formal Definition

### Definition 9 (Granger Causality)

$X$  **Granger-causes**  $Y$  if, for some  $h > 0$ :

$$\mathbb{E} \left[ (Y_{t+h} - \mathbb{E}[Y_{t+h} | \mathcal{F}_t^{X,Y}])^2 \right] < \mathbb{E} \left[ (Y_{t+h} - \mathbb{E}[Y_{t+h} | \mathcal{F}_t^Y])^2 \right]$$

where  $\mathcal{F}_t^{X,Y}$  includes past of both  $X$  and  $Y$ , while  $\mathcal{F}_t^Y$  includes only past  $Y$ .

### Important Caveat

- Granger causality = **predictive causality**, not true causality
- “ $X$  Granger-causes  $Y$ ”  $\Rightarrow$   $X$  contains useful info for forecasting  $Y$
- Does **not** imply  $X$  causes  $Y$  in a structural sense

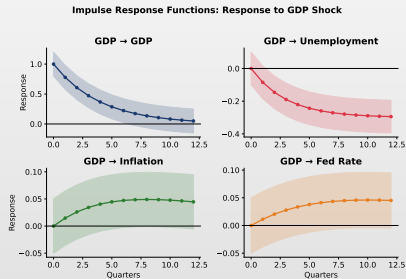
### Test Procedure

- F-test (or Wald):  $H_0$ : coefficients on lagged  $X$  are jointly zero in  $Y$  equation
- Reject  $H_0 \Rightarrow X$  Granger-causes  $Y$

## Impulse Response Functions (IRF)

### Effects

□  $\uparrow$  GDP  $\Rightarrow$   $\downarrow$  Unemployment (Okun),  $\uparrow$  Inflation (demand), Fed raises rate

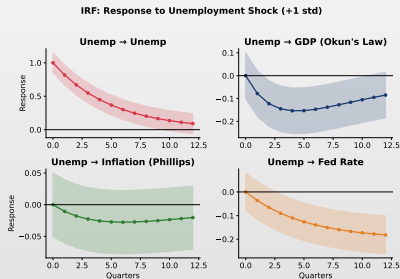


TSA\_ch10\_irf\_gdp\_shock

## IRF: Unemployment Shock

### Effects

□  $\uparrow$  Unemp  $\Rightarrow$   $\downarrow$  GDP,  $\downarrow$  Infl, Fed cuts rates

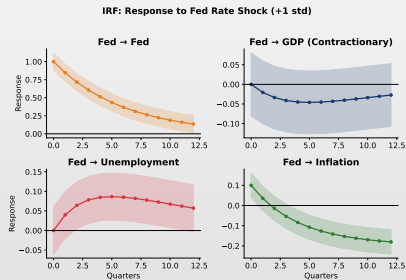


 TSA\_ch10\_irf\_unemp\_shock

## IRF: Fed Rate Shock

## Monetary Policy

☐ Rate hike  $\Rightarrow$  GDP  $\downarrow$ , Unemp  $\uparrow$ , Infl  $\downarrow$

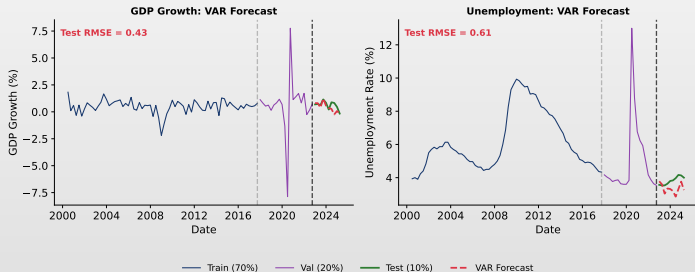


 TSA\_ch10\_irf\_fed\_shock

## VAR: Forecast (Train/Val/Test)

### Rolling One-Step-Ahead Forecast

- VAR captures GDP-Unemployment dynamics
- COVID shock visible in test period



## VAR: Test Set Results

### Test Set Performance by Variable

Variable	RMSE	MAE	Dir. Acc.
GDP Growth	1.33	0.99	50%
Unemployment	0.64	0.52	50%
Inflation	1.56	1.12	60%
Fed Rate	2.59	2.45	80%
<b>Average</b>	<b>1.53</b>	<b>1.27</b>	<b>60%</b>

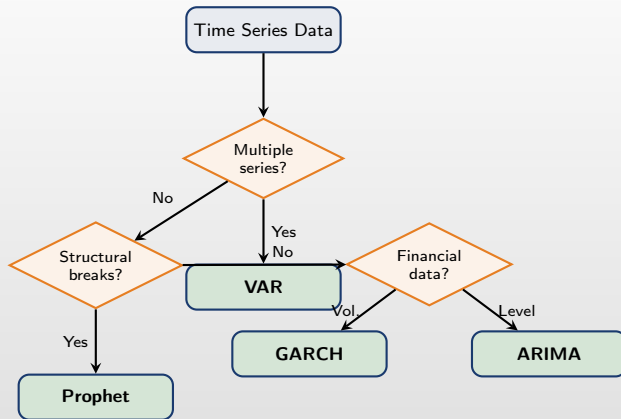
#### Strengths

- Cross-variable dynamics
- Good directional accuracy

#### Limitations

- Many parameters
- Sensitive to lag selection

## Model Selection Framework



## Comprehensive Model Comparison

Feature	GARCH	Fourier	Prophet	VAR
Target	Volatility	Level	Level	Multiple
Seasonality	No	Yes (long)	Yes (multi)	No
Structural breaks	No	No	Yes	No
Multiple series	No	No	No	Yes
Interpretable	Medium	High	High	High
Parameters	Few	2K	Auto	Many
Missing data	No	No	Yes	No
Best for	Finance	Cycles	Business	Macro

### Empirical Conclusions

- ▣ **GARCH**: Student-t  $>$  Normal ( $\Delta\text{AIC} = 509$ )
- ▣ **Fourier**:  $K = 3$  harmonics, validated on validation set
- ▣ **Prophet**: adapts to breaks via changepoints
- ▣ **VAR**: significant macro interactions (Granger)

### Key Insight

- ▣ RMSE cannot be compared across different datasets!
- ▣ Each model excels in its domain
- ▣ The art: matching model  $\leftrightarrow$  data



## Best Practices for Applied Forecasting

### Methodology

1. **Explore** data
2. **Test** stationarity
3. **Split** train/val/test
4. **Compare** on validation
5. **Report** test metrics

### Common Mistakes

- Test set contamination
- Over-fitting
- Ignoring assumptions

### Practical Tips

- Start simple (naive)
- Add complexity if needed
- Check residuals
- Report CIs

### Remember

"All models are wrong, but some are useful." — Box

## Forecasting vs Causality vs Decision

Objective	Model	Focus
Pure prediction	ARIMA / ML	Out-of-sample accuracy
Financial risk	GARCH	Volatility, VaR
Macro dynamics	VAR	Multivariate interactions
Structural relations	SVAR / VECM	Causal identification
Regimes	Markov Switching	Regime changes

### Key Message

- ▣ There is no universal model
- ▣ There is **fit between model and problem**

## Key Takeaways

### 1. Rigorous Methodology

- ▶ Train/validation/test split prevents overfitting
- ▶ Test set must remain untouched until final evaluation

### 2. Match Model to Data

- ▶ Financial volatility  $\Rightarrow$  GARCH
- ▶ Long seasonality  $\Rightarrow$  Fourier terms
- ▶ Structural breaks  $\Rightarrow$  Prophet
- ▶ Multiple series  $\Rightarrow$  VAR

### 3. Interpret Results Carefully

- ▶ Granger causality  $\neq$  true causality
- ▶ Out-of-sample performance matters most
- ▶ Simpler models often work better

## The Role of AI in Time Series Modeling

### AI can

- ▣ Generate code for estimation and forecasting
- ▣ Select models (AutoML, grid search)
- ▣ Combine forecasts (ensemble)
- ▣ Detect anomalies and patterns

### But cannot

- ▣ Replace statistical validation
- ▣ Automatically detect **data leakage**
- ▣ Guarantee correct economic interpretation
- ▣ Verify model assumptions

### Principle

- ▣ AI is a **tool**, not an authority
- ▣ Statistical validation remains the researcher's responsibility

## AI Exercise: Critical Thinking

Prompt to test in ChatGPT / Claude / Copilot

"Download monthly US Retail Sales from FRED (series RSXFS) for 2010-01 to 2024-12 (180 observations). Perform a complete time series analysis: decomposition, stationarity tests, model selection (compare ETS, SARIMA, and Prophet), 12-month forecast, and evaluation using RMSE/MAE/MASE on a 70/15/15 temporal split. Give me publication-quality Python code."

**Exercise:**

1. Run the prompt in an LLM of your choice and critically analyze the response.
2. Does it follow the correct workflow? (plot → decompose → test → model → diagnose → forecast)
3. Does it compare multiple models (ETS, ARIMA, SARIMA) with proper benchmarks?
4. Is the train/test split done properly? Is there any data leakage?
5. Does it discuss limitations and assumptions of the chosen model?

**Warning:** AI-generated code may run without errors and look professional. *That does not mean it is correct.*

## Synthesis: From Theory to Practice

Chapter	Concept	Formula	Application
Ch1	<b>Stationarity</b>	$\gamma(h) = \text{Cov}(X_t, X_{t+h})$	<b>ADF/KPSS Test</b>
Ch2	<b>ARMA</b>	$\phi(L)X_t = \theta(L)\varepsilon_t$	<b>Box-Jenkins</b>
Ch3	<b>ARIMA</b>	$(1 - L)^d X_t \sim \text{ARMA}$	<b>Differencing</b>
Ch4	<b>SARIMA</b>	$(1 - L^s)^D X_t$	<b>Seasonality</b>
Ch5	<b>GARCH</b>	$\sigma_t^2 = \omega + \alpha \varepsilon_{t-1}^2 + \beta \sigma_{t-1}^2$	<b>VaR</b>
Ch6	<b>VAR</b>	$\mathbf{Y}_t = \mathbf{A}_1 \mathbf{Y}_{t-1} + \varepsilon_t$	<b>Granger</b>
Ch7	<b>VECM</b>	$\Delta \mathbf{Y}_t = \Pi \mathbf{Y}_{t-1} + \dots$	<b>Cointegration</b>
Ch8	<b>Extensions</b>	<b>ARFIMA, RF, LSTM</b>	<b>Long memory</b>
Ch9	<b>Prophet</b>	$y(t) = g(t) + s(t) + h(t) + \varepsilon_t$	<b>Forecasting</b>

## Question 1

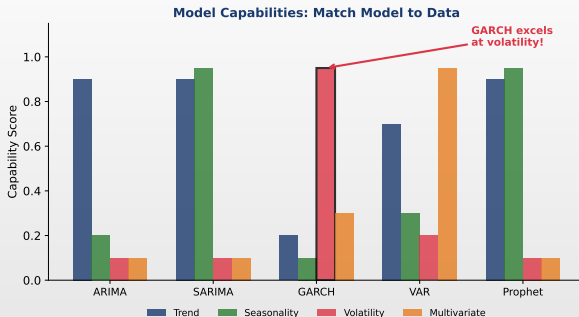
### Question

☐ Which model would you choose to forecast the volatility of financial returns?

### Answer Choices

- (A) ARIMA — captures trends and autocorrelations
- (B) GARCH — models conditional variance
- (C) Prophet — detects changepoints and seasonality
- (D) VAR — multivariate model for interdependencies

## Question 1: Answer



Answer: (B)

- GARCH captures volatility clustering and time-varying risk. ARIMA models the level, Prophet handles seasonality, VAR captures cross-series dynamics — none model variance directly.



## Question 2

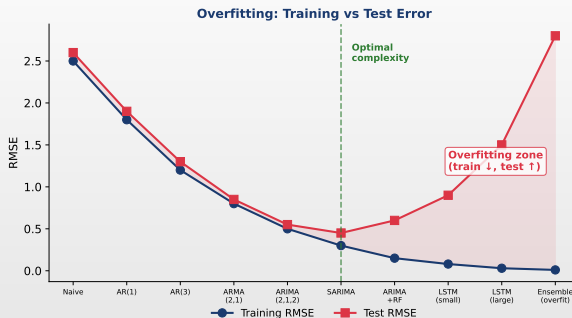
### Question

- ☐ A SARIMA model achieves  $\text{RMSE} = 0.05$  on training but  $\text{RMSE} = 2.30$  on test. What does this indicate?

### Answer Choices

- (A) The model is excellent — low training error confirms quality
- (B) The model suffers from overfitting — it memorizes noise
- (C) The test set is faulty and should be replaced
- (D) The difference is normal — all models have higher test error

## Question 2: Answer



Answer: (B)

- A  $46\times$  ratio between test and training RMSE signals severe overfitting. The model fits noise in the training data and fails to generalize. Solution: simpler model, proper validation.

### Question 3

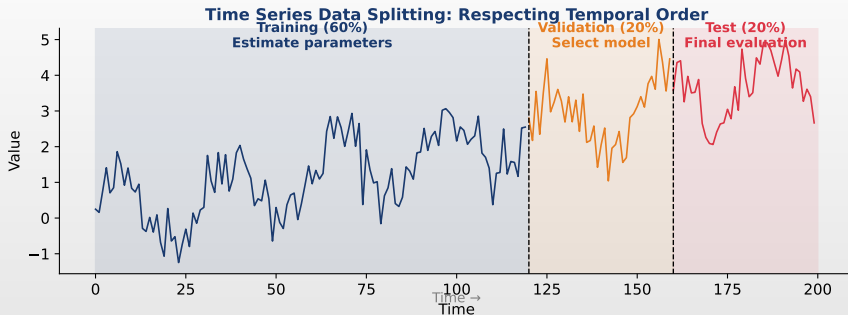
#### Question

☐ Why is it important to separate data into train/validation/test sets?

#### Answer Choices

- (A) To have more training data
- (B) To prevent overfitting and evaluate correctly
- (C) It is just a convention with no real importance
- (D) To reduce computation time

### Question 3: Answer



Answer: (B)

- Train: estimate parameters. Validation: select model/hyperparameters. Test: final unbiased evaluation. Mixing these roles leads to optimistic performance estimates.

## Question 4

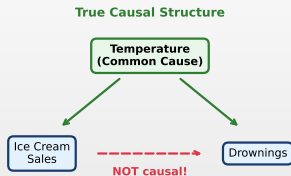
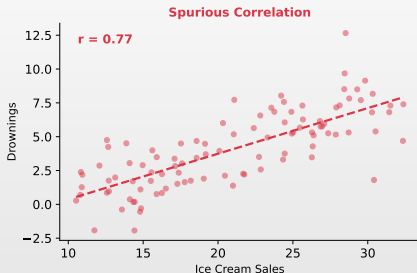
### Question

☐ Is Granger causality equivalent to true (structural) causality?

### Answer Choices

- (A) Yes — if  $X$  predicts  $Y$ , then  $X$  causes  $Y$
- (B) No — it only tests predictive content, not causation
- (C) It depends on the number of lags selected
- (D) Yes, if the p-value is below 0.05

## Question 4: Answer

Granger Causality  $\neq$  True Causality

Answer: (B)

- Granger causality tests whether past  $X$  improves forecasts of  $Y$ . Spurious correlations (e.g., ice cream sales and drownings) can pass the test due to common causes.

## Question 5

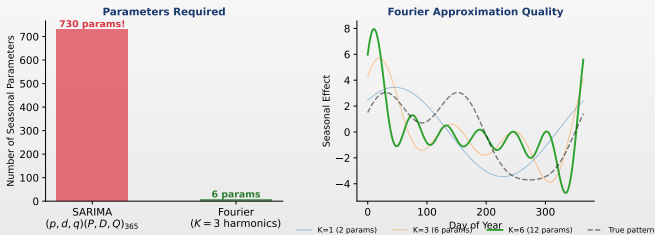
### Question

□ What model do you use for a series with long seasonality (e.g.,  $s = 365$  days)?

### Answer Choices

- (A)  $\text{SARIMA}(p, d, q)(P, D, Q)_{365}$
- (B) GARCH — models variation
- (C) ARIMA + Fourier terms or Prophet/TBATS
- (D) VAR with 365 lags

## Question 5: Answer

Long Seasonality ( $s = 365$ ): Fourier Terms vs SARIMA

Answer: (C)

- SARIMA<sub>365</sub> requires lag polynomials of order 365 — infeasible. Fourier terms ( $K=3$ ) use only 6 parameters. Prophet and TBATS handle multiple seasonalities automatically.



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### Online Resources and Code

- ▣ **Quantlet:** <https://quantlet.com> – Code platform for quantitative methods
- ▣ **Quantinar:** <https://quantinar.com> – Learning platform for quantitative methods
- ▣ **GitHub TSA:** [https://github.com/QuantLet/TSA/tree/main/TSA\\_ch10](https://github.com/QuantLet/TSA/tree/main/TSA_ch10) – Python code for this chapter

## Course Summary

### What We Learned

- Model selection depends on data characteristics: stationarity, seasonality, volatility
- The Box-Jenkins methodology provides a systematic framework for time series modeling
- Proper evaluation requires out-of-sample testing and time series cross-validation

### Important

No single model wins everywhere. Match the model to the data: ARIMA for trends, SARIMA for seasonality, GARCH for volatility, VAR/VECM for multivariate dynamics, Prophet/TBATS for complex patterns. Always validate out-of-sample!

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# Thank You!

## Questions?

Course materials available at: <https://danpele.github.io/Time-Series-Analysis/>



Quantlet



Quantinar