



Time Series Analysis and Forecasting

Chapter 10: Comprehensive Review

Applied Case Studies with Rigorous Methodology



Outline

- 1 Forecasting Methodology
- 2 Case Study 1: Bitcoin Volatility (GARCH)
- 3 Case Study 2: Sunspot Cycles (Fourier)
- 4 Case Study 3: Unemployment (Prophet)
- 5 Case Study 4: Multivariate Analysis (VAR)
- 6 Synthesis and Guidelines

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

Time Series Train/Validation/Test Split



Training Set	Validation Set	Test Set
<ul style="list-style-type: none">• Fit parameters• Largest portion	<ul style="list-style-type: none">• Compare models• Tune hyperparams	<ul style="list-style-type: none">• Held out• Final metrics

Definition 1 (Forecast Error Metrics)

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

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

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

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

Key Insight

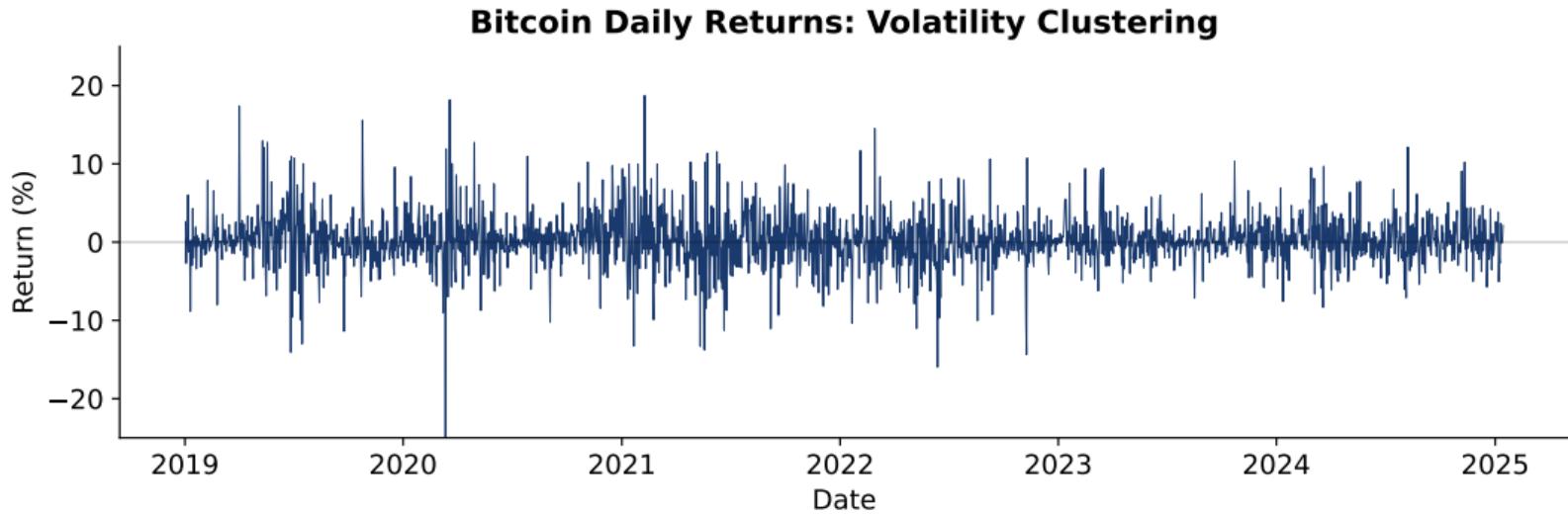
Financial returns are typically:

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

⇒ Focus on **volatility forecasting**

Stylized Facts

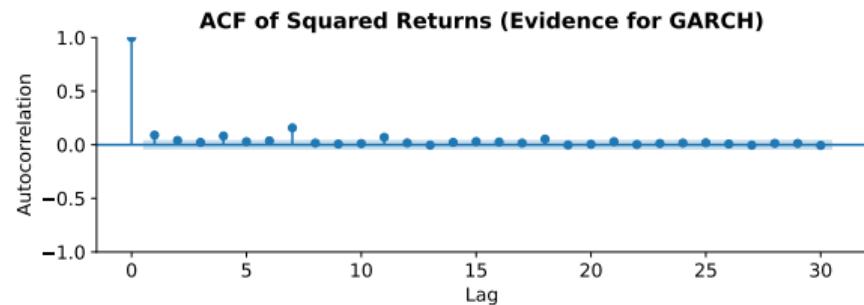
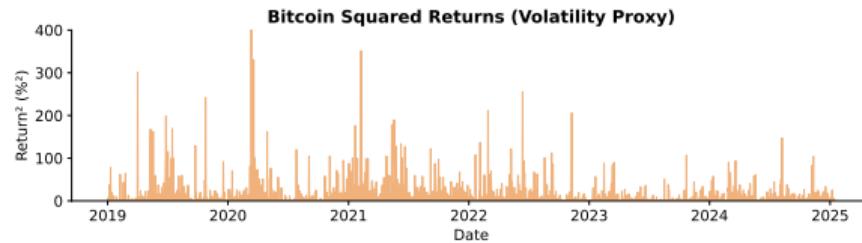
- Returns: near-zero mean
- Fat tails (kurtosis > 3)
- Volatility clustering



Observation

Large returns tend to follow large returns, small follow small. This is **volatility clustering**—the phenomenon GARCH captures.

Bitcoin: Evidence for GARCH



Why GARCH?

Squared returns (volatility proxy) show **significant autocorrelation**. This means past volatility predicts future volatility—exactly what GARCH models!

GARCH Model Specification

Definition 2 (GARCH(p,q) Model)

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

$$r_t = \mu + \varepsilon_t, \quad \varepsilon_t = \sigma_t z_t, \quad z_t \sim N(0, 1) \quad (2)$$

$$\sigma_t^2 = \omega + \sum_{i=1}^q \alpha_i \varepsilon_{t-i}^2 + \sum_{j=1}^p \beta_j \sigma_{t-j}^2 \quad (3)$$

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**: Asymmetric shocks

Interpretation

- α : Impact of past shocks
- β : Persistence of volatility
- $\alpha + \beta \approx 1$: High persistence

Bitcoin: Data Split and Stationarity

Data Split

Set	Period	N
Training	2019-01 to 2022-09	1,365
Validation	2022-09 to 2023-10	400
Test	2023-10 to 2025-01	435
Total		2,200

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: 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.

Procedure

Refit GARCH(1,1) on Training + Validation, evaluate on **held-out test set** using **rolling one-step-ahead forecasts**.

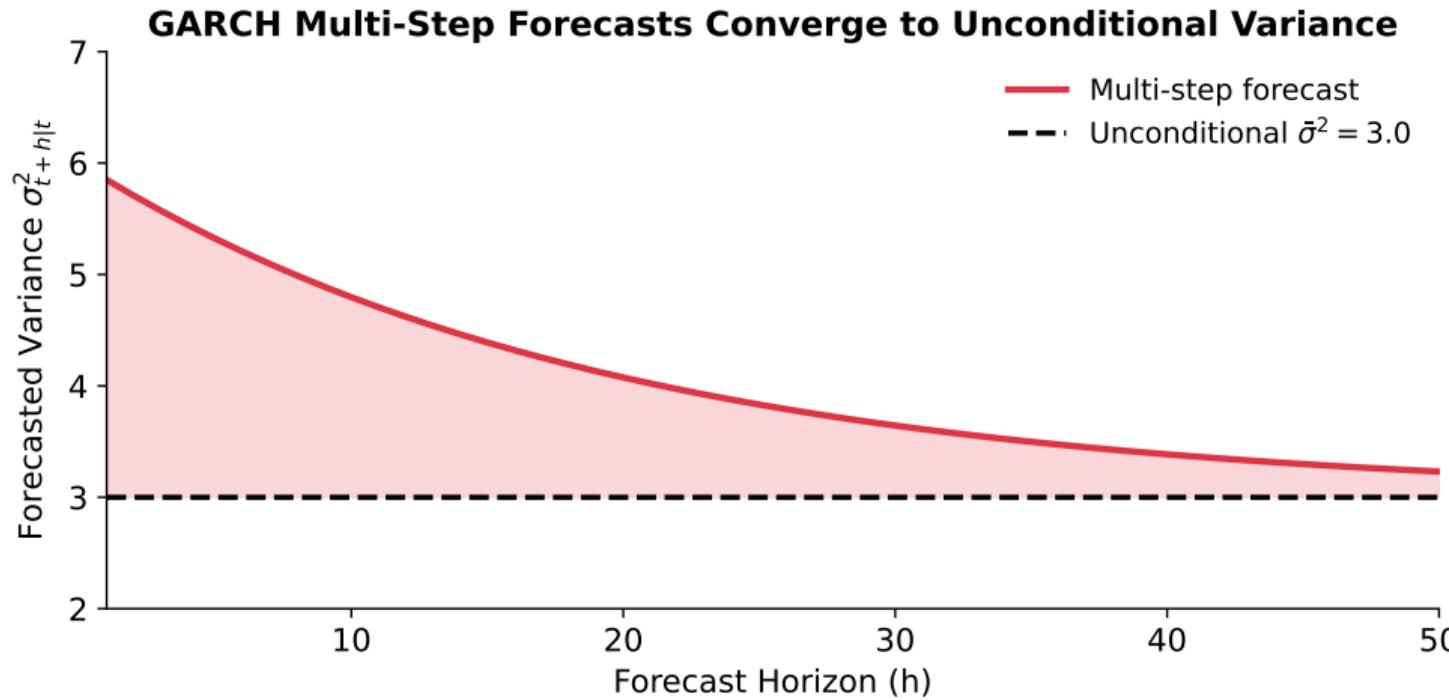
Estimated Parameters		
Param	Estimate	Std Err
ω	0.239	0.088
α_1	0.120	0.021
β_1	0.879	0.020
$\alpha_1 + \beta_1$	0.999	

Test Set Performance	Metric	Value
	Volatility MAE	1.88
	Volatility RMSE	2.21

Interpretation

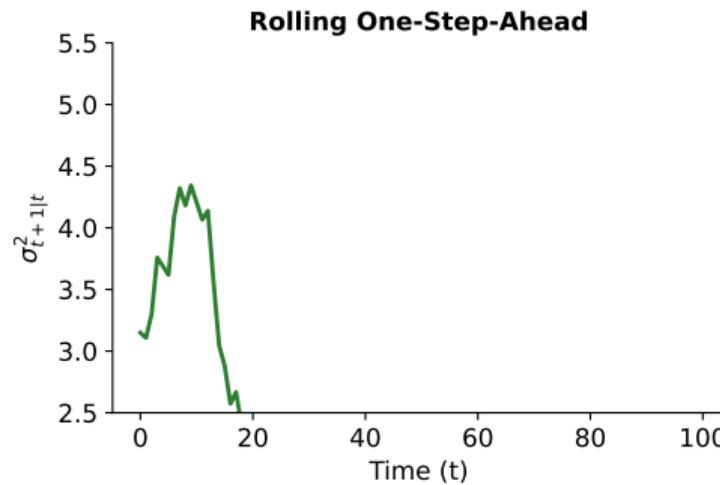
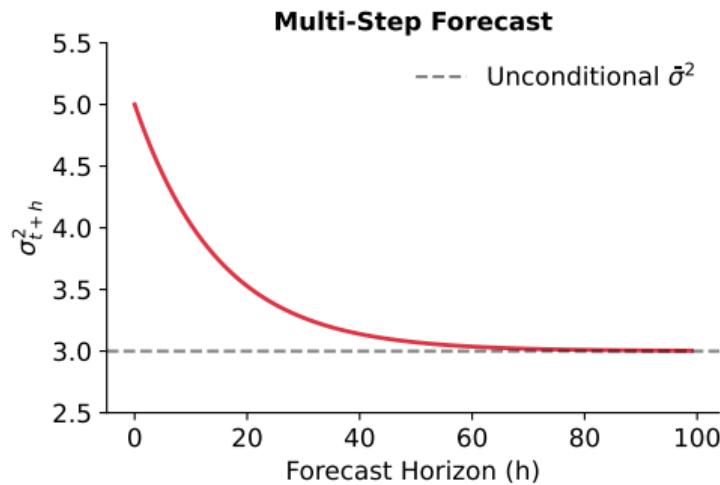
High persistence ($\alpha + \beta \approx 1$) confirms volatility clustering.

GARCH: Multi-Step Forecasts Converge



Problem

GARCH: Rolling One-Step-Ahead Solution



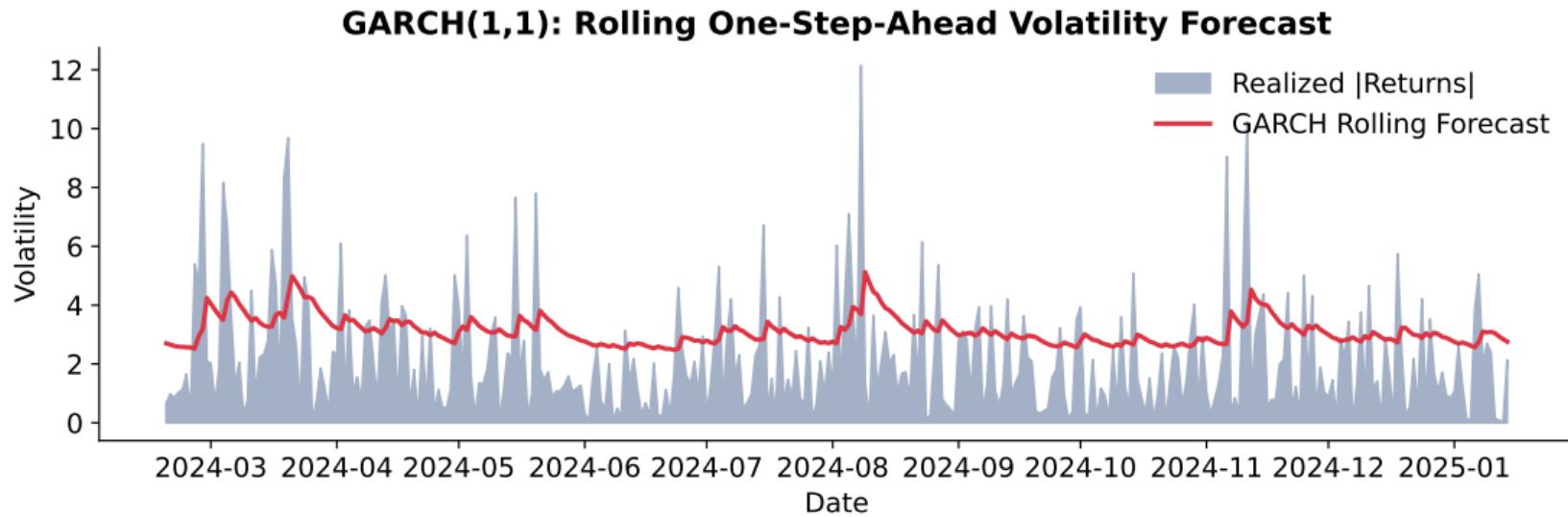
Multi-Step (Left)

Converges to $\bar{\sigma}^2$ (flat)

Rolling 1-Step (Right)

Re-estimate at each t (dynamic)

Bitcoin: GARCH Volatility Forecast (Test Set)



Result

Rolling one-step-ahead GARCH(1,1) forecasts capture the **dynamic volatility patterns**. The forecast (red line) tracks the realized volatility (blue area), demonstrating the predictability of variance.

Summary

- ❶ Returns are stationary; prices are not
- ❷ GARCH(1,1) outperforms more complex variants
- ❸ High persistence ($\alpha + \beta = 0.999$)
- ❹ Volatility is predictable even when returns are not

Limitations

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

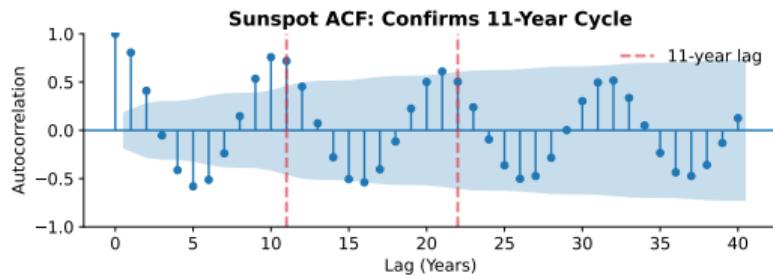
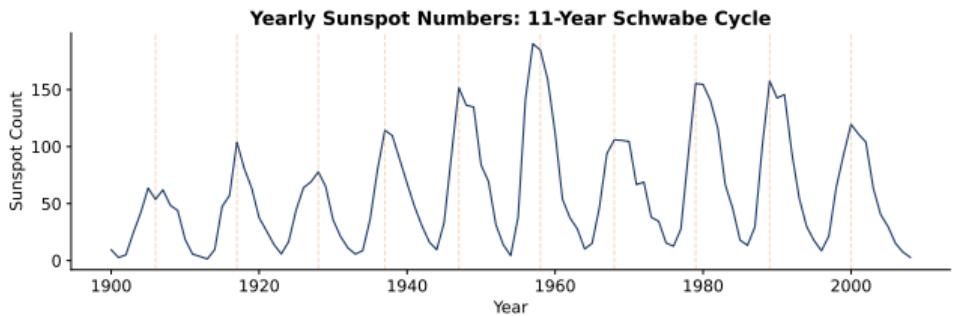
Practical Implications

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

Extensions

- Student-t innovations
- Realized volatility
- HAR models

Sunspots: The 11-Year Solar Cycle



Data

Period: 1900–2008, 109 years. ACF confirms 11-year periodicity.

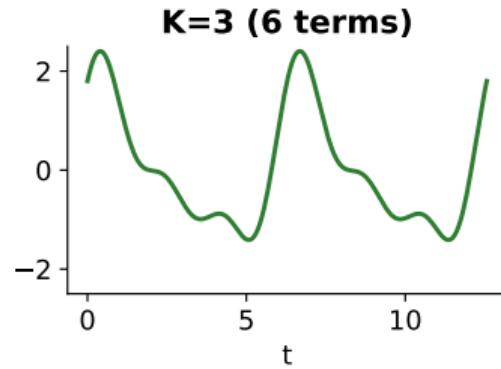
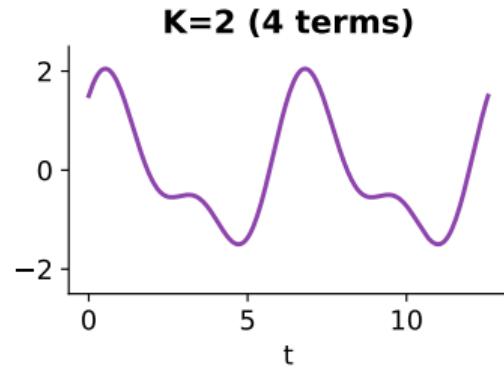
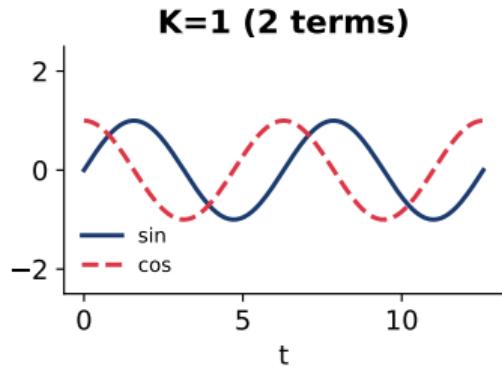
Challenge

SARIMA with $s = 11$ needs too many parameters.

Solution: Fourier terms.

Fourier Terms for Seasonality

Fourier Terms: More K = More Flexibility



Formula

$$S_t = \sum_{k=1}^K \left[\alpha_k \sin\left(\frac{2\pi k t}{s}\right) + \beta_k \cos\left(\frac{2\pi k t}{s}\right) \right]$$

Advantages

Only $2K$ parameters (not s). K controls flexibility.

Sunspots: Model Selection

Methodology

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

	Set	Period	N
Data Split	Training	1900–1975	76
	Validation	1976–1991	16
	Test	1992–2008	17
Total			109

	K	AIC	Val RMSE
Model Comparison	1	665.9	87.15
	2	668.0	86.92
	3	671.8	86.81
	4	674.5	87.93

Result

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

Sunspots: Test Set Results

Final Model

ARIMA(2,0,1) + 3 Fourier harmonics

Significant Coefficients:

Term	Coef	p-value
\sin_1	34.71	< 0.001
\cos_1	-29.21	0.018
AR(1)	1.34	< 0.001

Test Performance

Metric	Value
RMSE	48.51
MAE	39.31

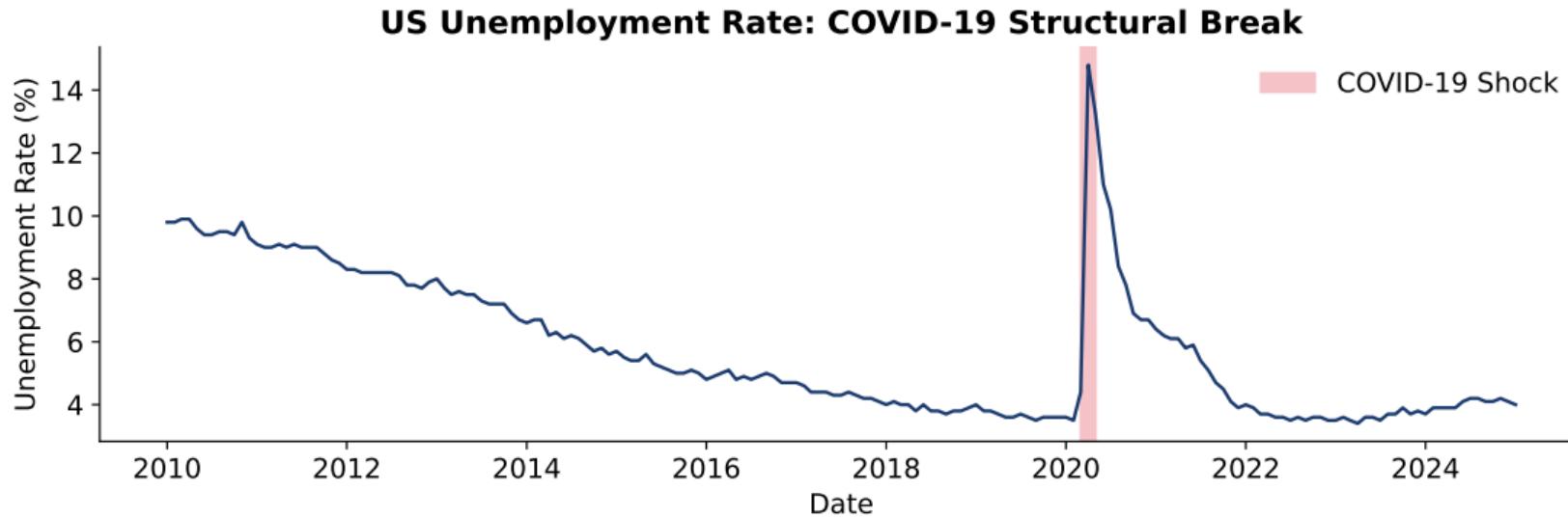
Note

High MAPE due to near-zero values at solar minimum.

Key Insight

Fourier terms efficiently capture the 11-year cycle with only 6 parameters.

Unemployment: COVID-19 Structural Break



Key Statistics

- Pre-COVID min: 3.5%
- COVID peak: 14.8%

Solution

Prophet with automatic changepoint detection adapts to structural breaks.

Definition 3 (Prophet Decomposition)

Prophet models time series as:

$$y_t = g(t) + s(t) + h(t) + \varepsilon_t \quad (4)$$

- $g(t)$: Piecewise linear/logistic **trend** with changepoints
- $s(t)$: Fourier-based **seasonality**
- $h(t)$: **Holiday** effects
- ε_t : Error term

Changepoint Detection

- Automatic selection of changepoint locations
- `changepoint_prior_scale` controls flexibility
- Higher = more changepoints

Advantages

- Handles missing data
- Interpretable components
- Robust to outliers
- Uncertainty quantification

Hyperparameter Tuning

Tune `changepoint_prior_scale` on validation set.

	Set	Period	N
Data Split	Training	2010-01 to 2019-09	117
	Validation	2019-10 to 2021-10	25
	Test	2021-11 to 2025-01	38
Total			180

	Scale	Val RMSE	
	0.01	4.21	
	0.05	3.89	
Scale Comparison	0.10	3.52	Best
	0.30	3.67	
	0.50	3.81	

Interpretation

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

Unemployment: Results

Test Set Performance

Metric	Value
RMSE	0.42
MAE	0.35
MAPE	9.2%

Detected Changepoints

- 2020-03: COVID onset
- 2020-05: Recovery begins
- 2022-01: Stabilization

Key Finding

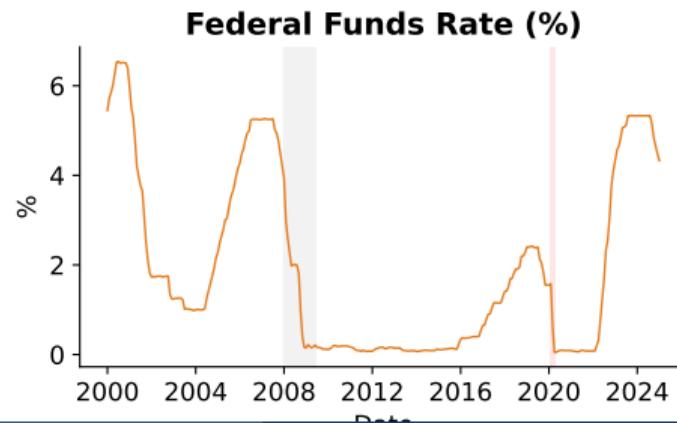
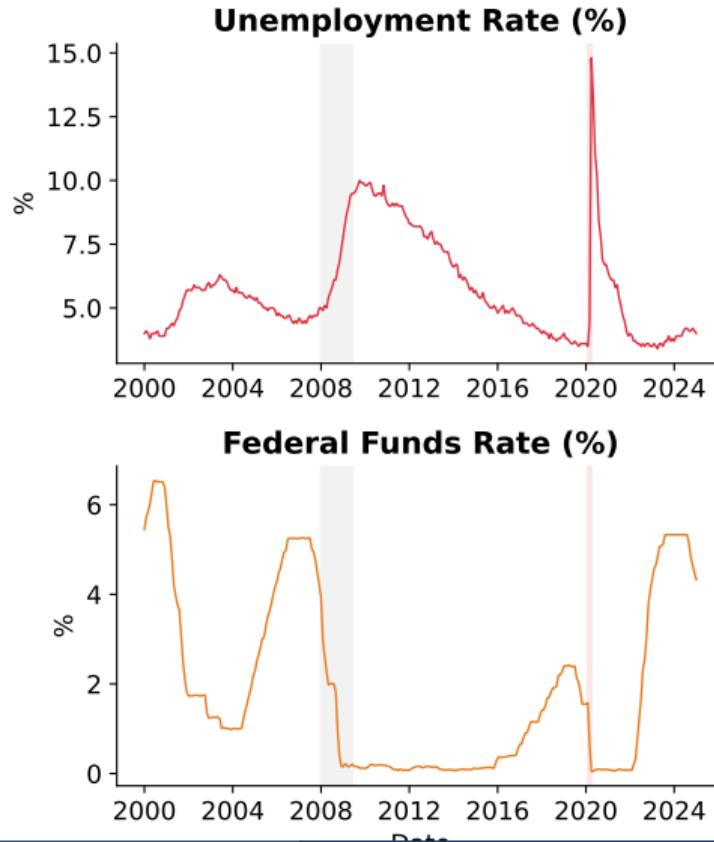
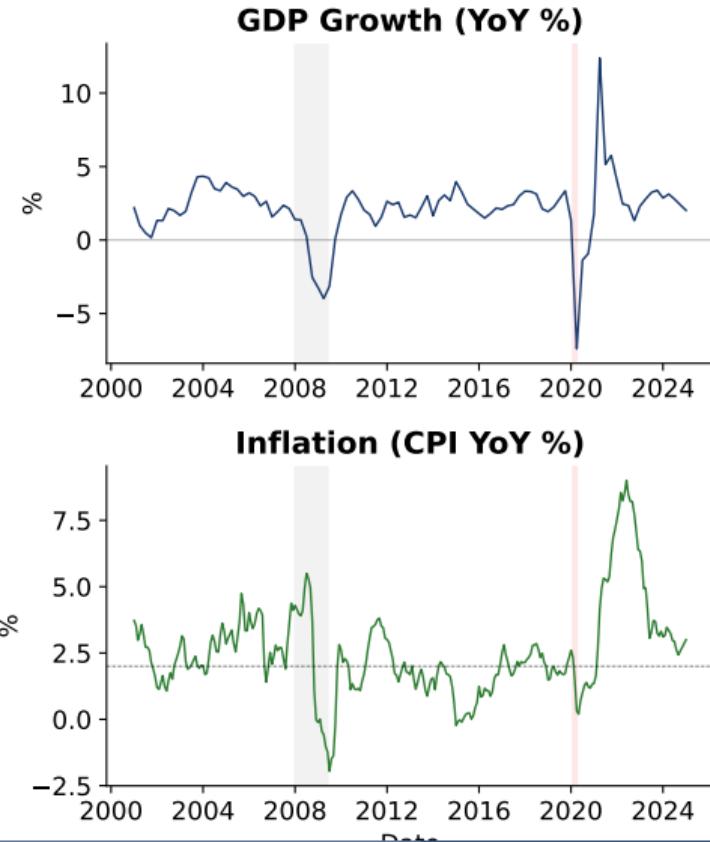
Prophet successfully:

- Detected COVID changepoint
- Adapted trend post-shock
- Provided uncertainty bands

Practical Value

- Economic policy analysis
- Labor market monitoring
- Early warning system

VAR: Multivariate Economic Data



Definition 4 (Vector Autoregression VAR(p))

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

$$y_t = c + A_1 y_{t-1} + A_2 y_{t-2} + \dots + A_p y_{t-p} + u_t \quad (5)$$

where A_i are $K \times K$ coefficient matrices and $u_t \sim N(0, \sigma^2)$.

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

VAR: Lag Selection and Estimation

Information Criteria

Lag	BIC
1	-4.810
2	-5.178
3	-4.633
4	-4.614

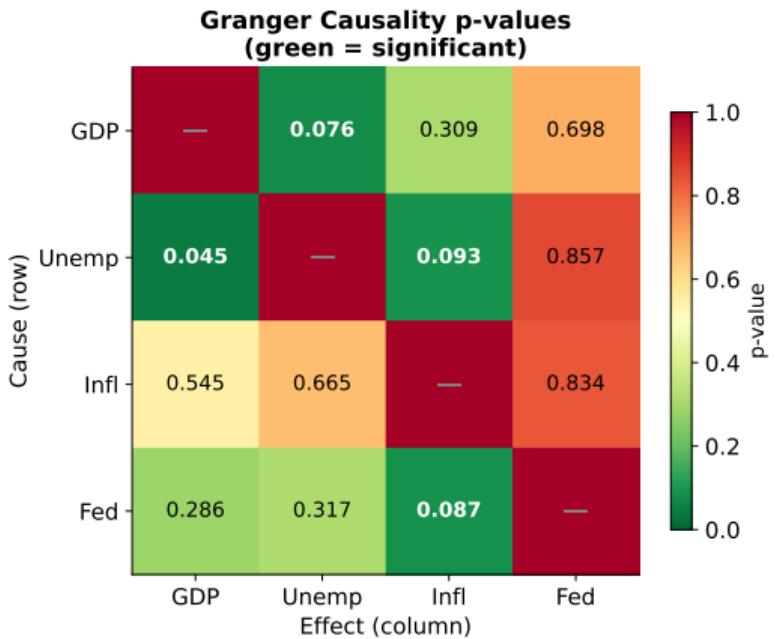
Data Split

Set	Period	N
Training	2001-Q1 to 2017-Q4	68
Validation	2018-Q1 to 2021-Q2	14
Test	2021-Q3 to 2024-Q3	14
Total		96

Validation Check

VAR(2) also achieves lowest validation RMSE.

Granger Causality Analysis



Definition

X Granger-causes Y if past values of X help predict Y .
Note: Granger \neq true causality.

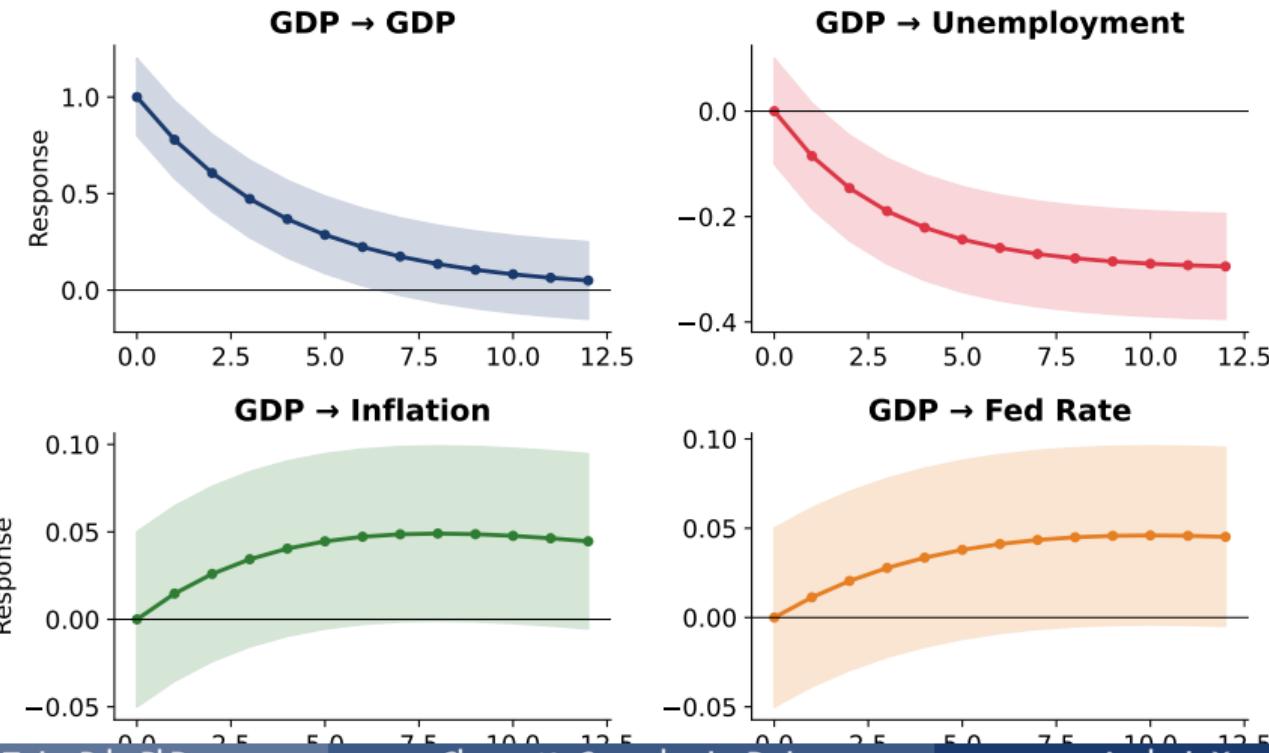
Key Findings

- Unemployment \rightarrow GDP ($p = 0.045$)
- Fed Rate \rightarrow Inflation ($p = 0.087$)

Consistent with Okun's Law and Taylor Rule.

Impulse Response Functions

Impulse Response Functions: Response to GDP Shock



Test Set Performance by Variable

Variable	RMSE	MAE	Direction Acc.
GDP Growth	2.18	1.72	71%
Unemployment	0.89	0.71	79%
Inflation	1.24	0.98	64%
Fed Rate	0.95	0.78	71%
Average	1.32	1.05	71%

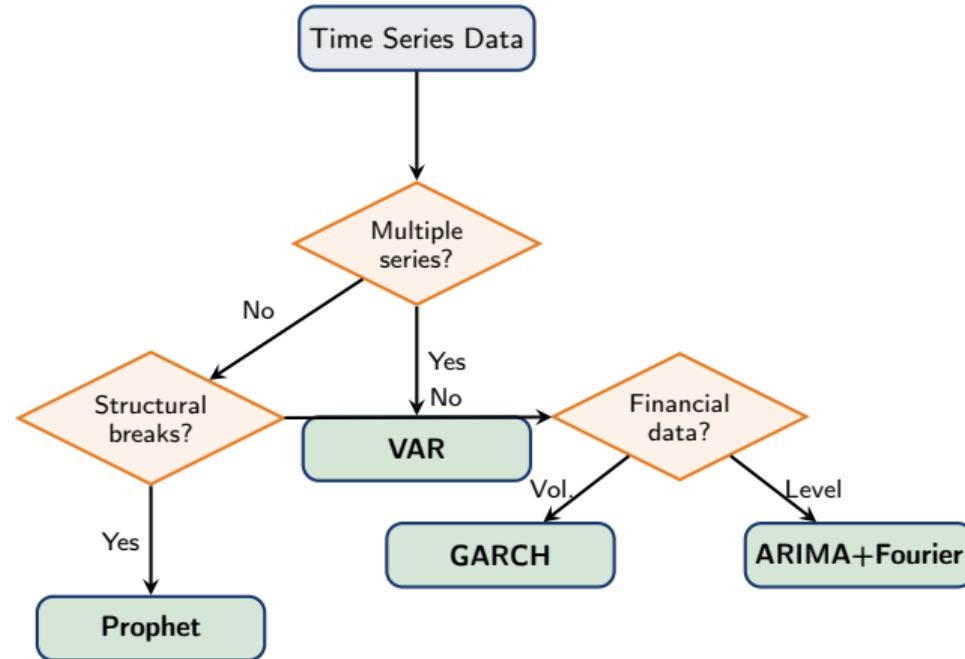
Strengths

- Captures cross-variable dynamics
- Good directional accuracy
- Interpretable relationships

Limitations

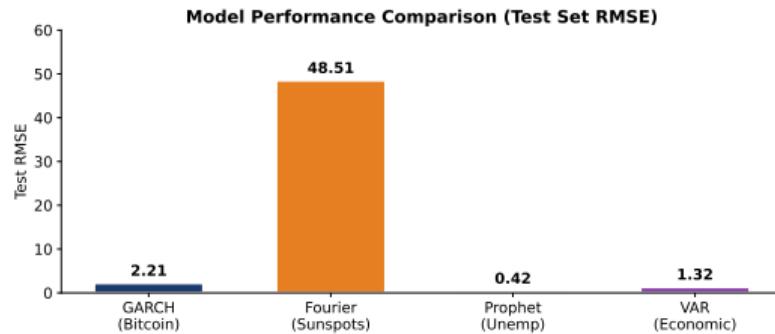
- Many parameters (curse of dimensionality)
- Sensitive to lag selection
- COVID period challenging

Model Selection Framework



Summary: Model Comparison

Case	Challenge	Model	RMSE
Bitcoin	Volatility	GARCH	2.21
Sunspots	Seasonality	Fourier	48.51
Unemp	Break	Prophet	0.42
Economic	Multi-var	VAR	1.32



Key Principle

Match the model to the data characteristics. No single model dominates—choose based on:

- Nature of the forecasting problem (level vs. volatility)
- Data properties (seasonality, breaks, multiple series)
- Interpretability requirements

Best Practices for Applied Forecasting

Methodology

- ① Explore data thoroughly
- ② Test for stationarity
- ③ Split train/validation/test
- ④ Compare models on validation
- ⑤ Report test set metrics

Practical Tips

- Start simple (random walk, naive)
- Add complexity only if needed
- Visualize forecasts vs actuals
- Check residuals for patterns
- Report confidence intervals

Common Mistakes

- Peeking at test data
- Over-fitting to training set
- Ignoring model assumptions
- Not reporting uncertainty

Remember

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

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 → GARCH
- Long seasonality → Fourier terms
- Structural breaks → Prophet
- Multiple series → VAR

③ Interpret Results Carefully

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

References

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-  Sims, C.A. (1980). Macroeconomics and Reality. *Econometrica*, 48(1), 1-48.

Real Data Used in This Chapter

- **Bitcoin:** Yahoo Finance (BTC-USD), 2019–2025
- **Sunspots:** Statsmodels Wolfer dataset, 1900–2008
- **US Unemployment:** Federal Reserve FRED (UNRATE), 2010–2025
- **Economic Variables:** FRED (GDPC1, UNRATE, CPIAUCSL, FEDFUNDS), 2000–2025

Reproducibility

All analyses can be reproduced using the accompanying Jupyter notebook:
`chapter10_lecture_notebook.ipynb`

Thank You

Questions?

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