



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 α 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 | Value |
|--------|-------|
|--------|-------|

| | |
|------|------|
| RMSE | 2.21 |
|------|------|

| | |
|-----|------|
| MAE | 1.89 |
|-----|------|

| | |
|------|------|
| MASE | 0.98 |
|------|------|

| | |
|---------------|-------|
| Dir. Accuracy | 28.7% |
|---------------|-------|

- $MASE < 1$: 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 ($\Delta = 509$)

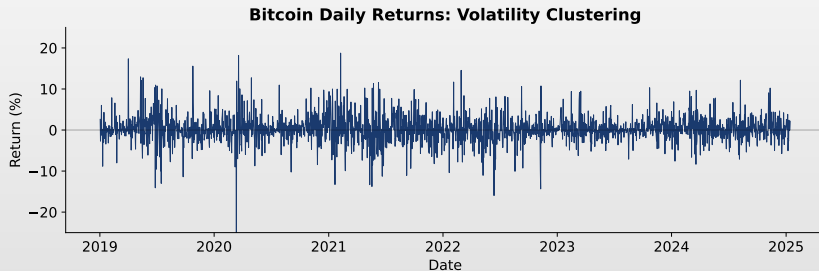
Key message

- ▣ 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:

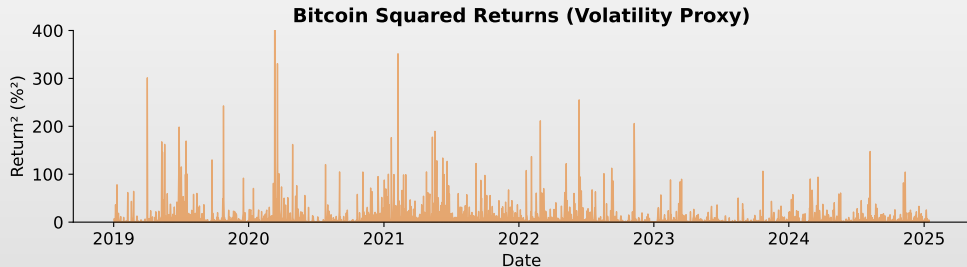
- ▣ **Unpredictable** in mean
- ▣ **Predictable** in variance

⇒ Focus on **volatility forecasting**

Bitcoin: Evidence for GARCH

Observation

- Squared returns r_t^2 exhibit significant autocorrelation \succ GARCH effects
- Slow ACF decay \succ 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

- ▣ α : Shock impact (ARCH effect)
- ▣ β : 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 (20%) | 2023-03 to 2024-06 | 441 |
| Test (10%) | 2024-06 to 2025-01 | 221 |
| Total | | 2,205 |

Stationarity Tests

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

⇒ Model **returns**, not prices

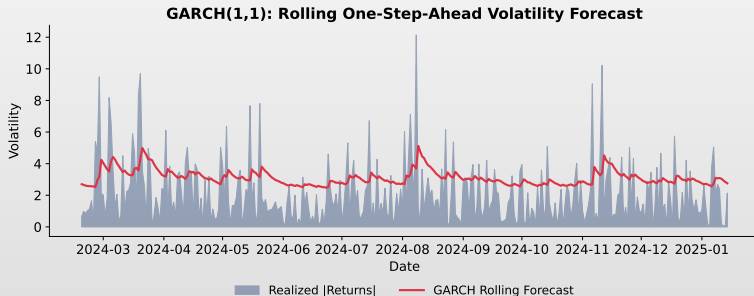
Why Stationarity Matters

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

Bitcoin: Volatility Forecast

Interpretation

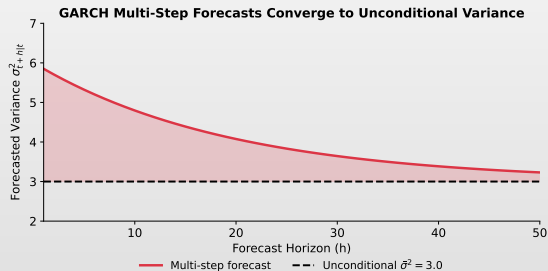
- Shaded area: 95% confidence interval of the volatility forecast
- GARCH(1,1) captures Bitcoin's volatility dynamics well



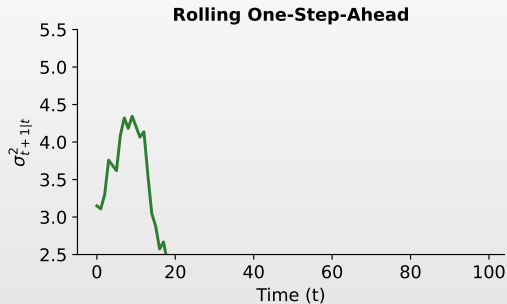
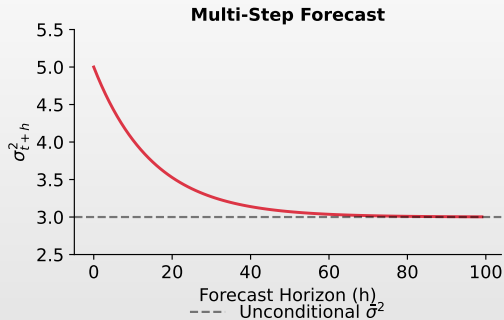
GARCH: Multi-Step Forecasts Converge

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_ν (fat tails)

Bitcoin: empirical evidence

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

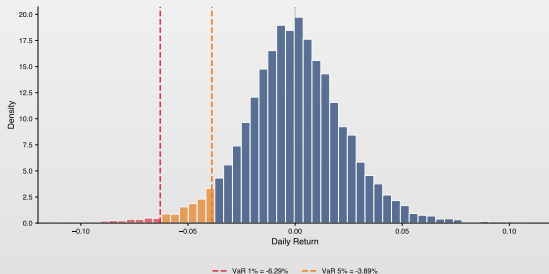
Student-t: the right choice

- $\hat{\nu} = 2.96$ 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

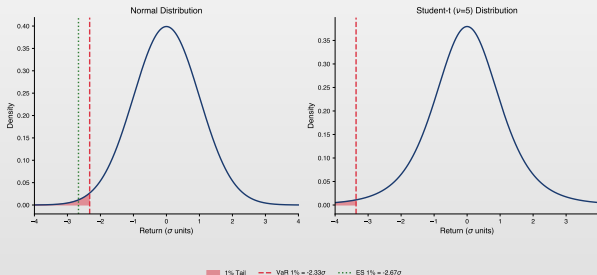
- VaR 1% = loss exceeded only in 1% of cases
- Red area = extreme losses (beyond VaR)



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 distribution



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_{α} | 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

Value at Risk — Student-t Distribution

Why Student-t?

Normal distribution **underestimates** tail risk. Student-t with ν 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: $\text{VaR}_\alpha = t_\alpha(\nu) \cdot \hat{\sigma}_{T+1} \cdot \sqrt{\frac{\nu-2}{\nu}}$

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): $\text{VaR} = 3.05 \times 0.012 \times 10,000,000 = 366,000 \text{ EUR}$

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 α :
 - ▶ Frequency: $\hat{p} = \frac{1}{T} \sum I_t \approx \alpha$; violations **independent**
- VaR 1% over 250 days \Rightarrow expect ~ 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

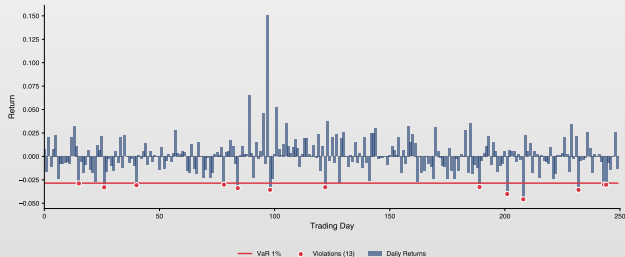
Recommendation

- 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 | ≥ 10 | Model inadequate | Maximum penalty |

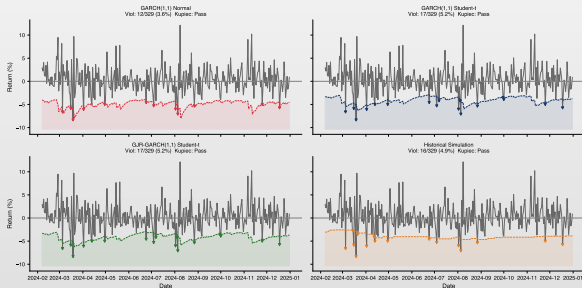
Practical Example

- 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: 16.5 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 | 17 | 5.2% | 0.890 | 0.272 | \approx 5% target |
| GJR-GARCH(1,1)-t | 17 | 5.2% | 0.890 | 0.272 | $\gamma \approx 0$ (symmetric) |
| Hist. Simulation | 16 | 4.9% | 0.909 | 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

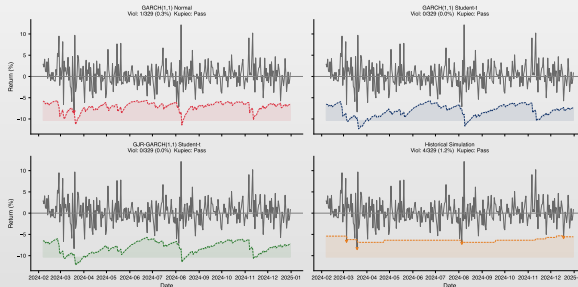
Practical Lessons

- 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% | 1.000 | 1.000 | Acceptable |
| GJR-GARCH(1,1)-t | 0 | 0.0% | 1.000 | 1.000 | Acceptable |
| Hist. Simulation | 4 | 1.2% | 0.704 | 1.000 | Acceptable |

VaR 1% Conclusions

- All models pass Kupiec ($p > 0.05$)
- With only 3.3 expected violations, test has **low statistical power**
- Cannot meaningfully distinguish between 0 and 4 violations

Lesson: 5% vs 1%

- At 5% (≈ 16 violations): powerful test, Student-t best
- At 1% (≈ 3 violations): weak test, models **indistinguishable**
- **Conclusion:** test power increases with α and T

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

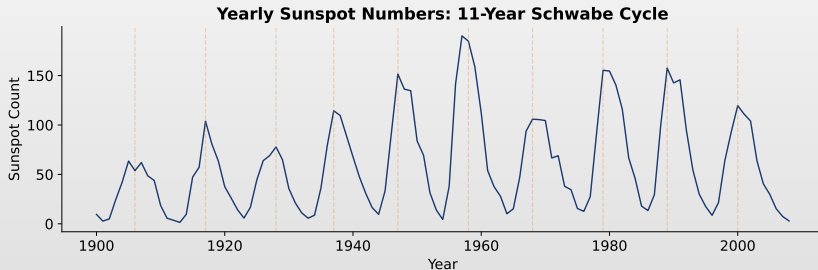
Extensions

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

Sunspots: The 11-Year Solar Cycle

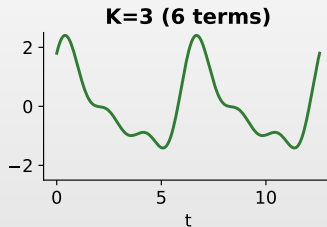
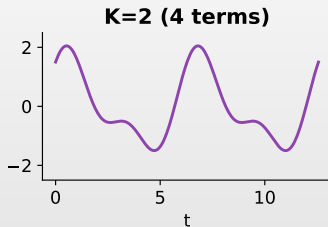
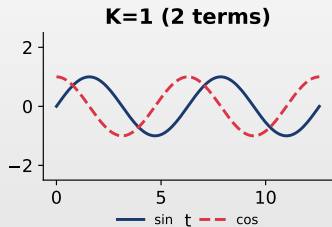
Observation

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



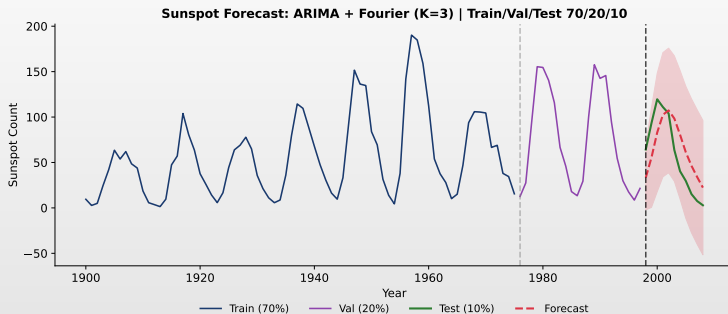
Fourier Terms for Seasonality

Fourier Terms: More K = More Flexibility



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Sunspots: Forecast Results



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 |
| | Total | | 109 |

| Model Comparison | | | |
|------------------|-------|--------------|------|
| K | AIC | Val RMSE | |
| 1 | 665.9 | 87.15 | |
| 2 | 668.0 | 86.92 | |
| 3 | 671.8 | 86.81 | 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

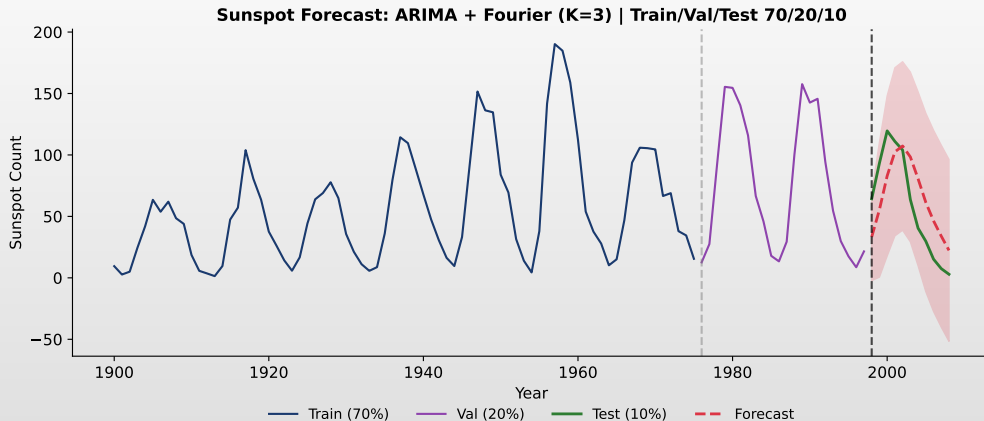
Solution: validation

- ▣ 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 |

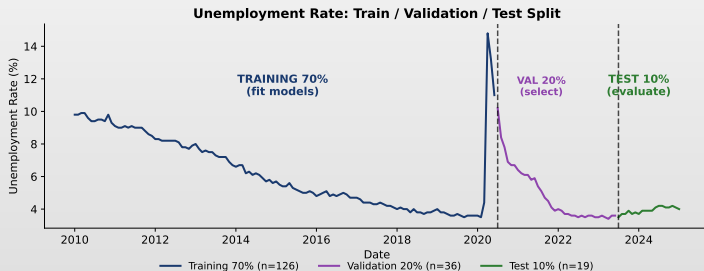
Applications

Climate cycles, business cycles, astronomical phenomena

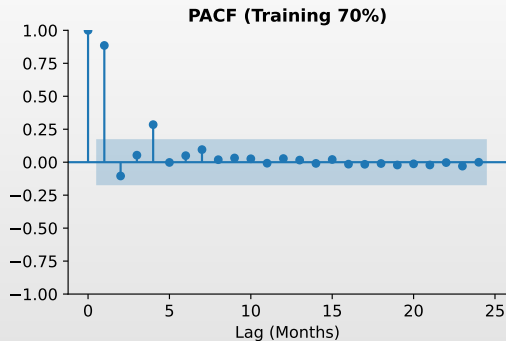
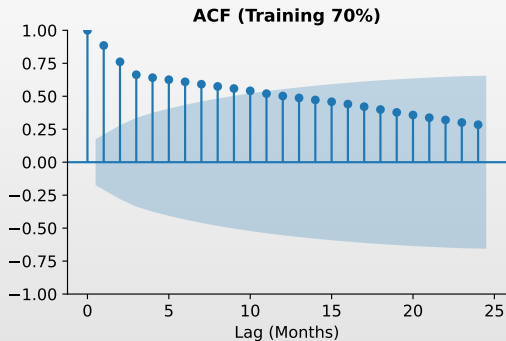
Unemployment: Train / Validation / Test Split

Methodology

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

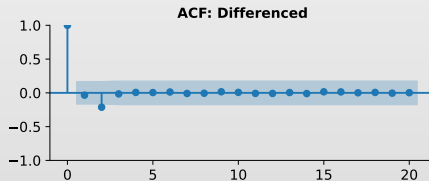
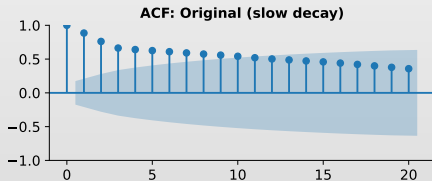
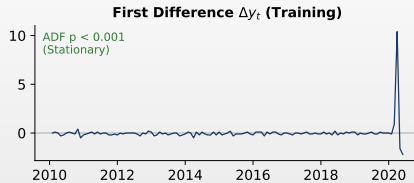
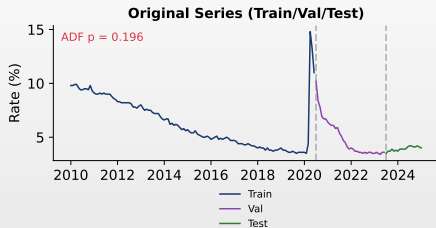


Unemployment: Preliminary Analysis



 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

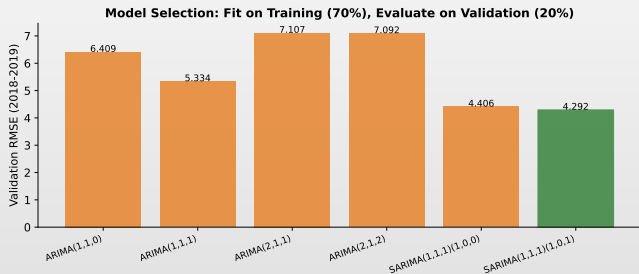
Key message

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

Unemployment: Model Selection (Validation Set)

Best: SARIMA(1,1,1)(1,0,0)₁₂

Selected by lowest validation RMSE



Unemployment: SARIMA Parameters

SARIMA(1,1,1)(1,0,0)₁₂ fitted on Train+Val (2010-2019)

- 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:

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

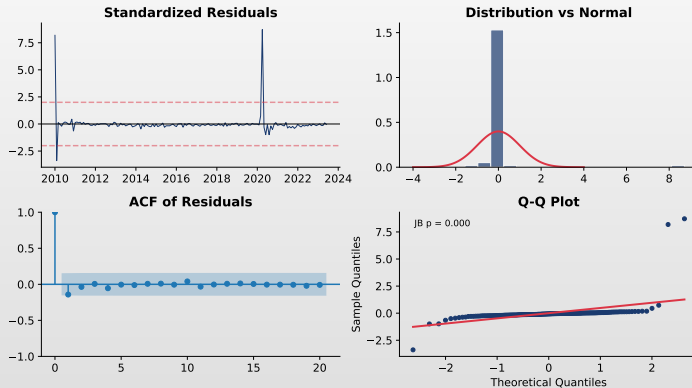
where p, q are ARMA orders. H_0 : Residuals are white noise.

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

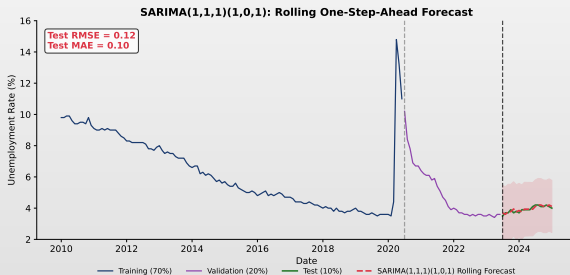
SARIMA(1,1,1)(1,0,1) Diagnostics on Train+Val (85%) | Ljung-Box $p = 1.00$



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, σ^2 = noise variance (estimated).

Changepoint Detection

- Automatic location selection
- `changepoint_prior_scale` controls flexibility

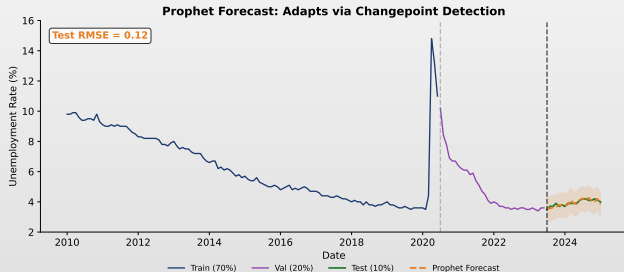
Advantages

- Handles missing data
- Interpretable components
- Robust to outliers

Unemployment: Prophet Forecast Results

Key Finding

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



 TSA_ch10_unemployment_forecast

Unemployment: Model Tuning

Hyperparameter Tuning

Tune `changepoint_prior_scale` on validation set.

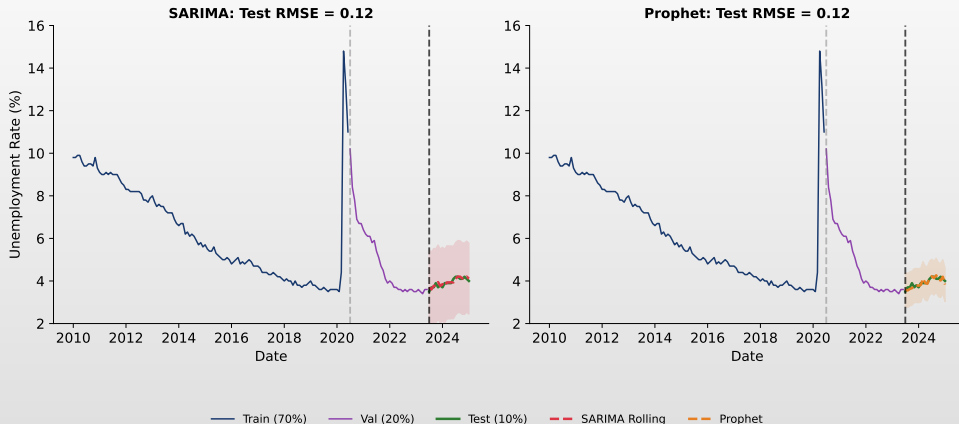
| Data Split | Set | Period | N |
|------------|------------------|--------------------|------------|
| | Training (70%) | 2010-01 to 2020-06 | 126 |
| | Validation (20%) | 2020-07 to 2023-06 | 36 |
| | Test (10%) | 2023-07 to 2025-01 | 19 |
| | Total | | 181 |

| Scale Comparison | Scale | Val RMSE | |
|------------------|-------|-------------|------|
| | 0.01 | 4.21 | |
| | 0.05 | 3.89 | |
| | 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: 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!

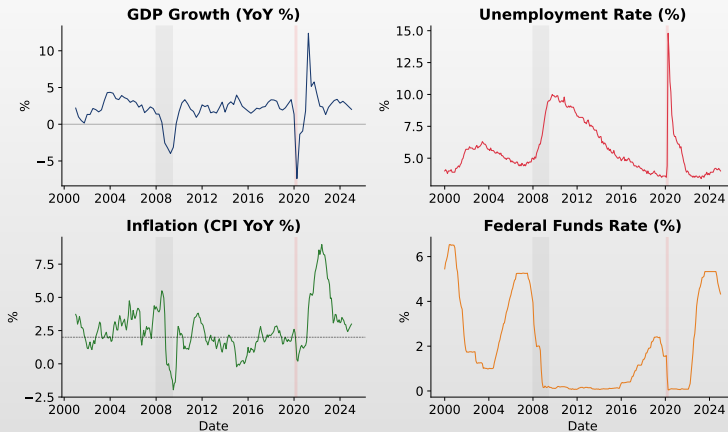
Prophet vs ARIMA

| | 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, $u_t \sim N(0, \Sigma)$, Σ = 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 $n > 7$
- More parsimonious

VAR: Lag Selection and Estimation

BIC by Lag Order

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

Validation Check

VAR(2) also achieves lowest validation RMSE.

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-Q1 | 10 |
| Total | | 97 |

VAR Model Stability

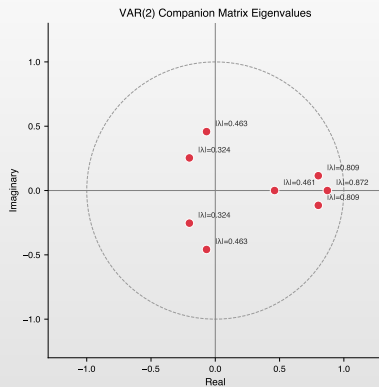
Stability condition

- 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 $ | 0.872 |
| $ \lambda_7 , \lambda_8 $ | 0.810 |

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



VAR vs VECM: Cointegration

Problem

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

Definition 8 (VECM)

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

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 | 64.09 | 47.85 | Yes |
| 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

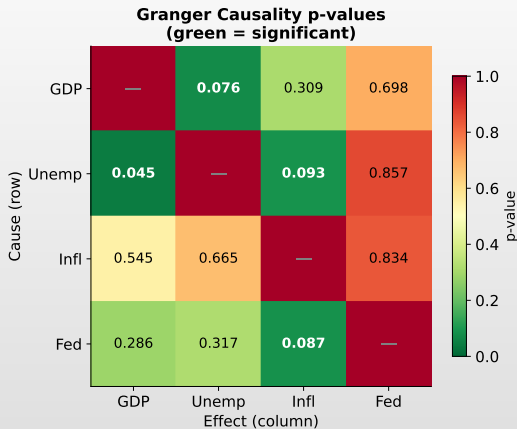
Interpretation

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

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: Empirical Results



Granger Causality: Formal Definition

Definition 9 (Granger Causality)

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

$$\text{MSE} \left[\mathbb{E}[Y_{t+h} | \mathcal{F}_t^{X,Y}] \right] < \text{MSE} \left[\mathbb{E}[Y_{t+h} | \mathcal{F}_t^Y] \right]$$

where $\mathcal{F}_t^{X,Y}$ includes past values 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

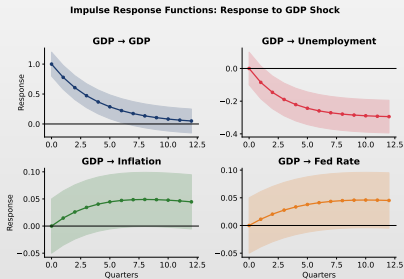
Test Procedure

- 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 \succ \downarrow Unemployment (Okun), \uparrow Inflation (demand), Fed raises rate

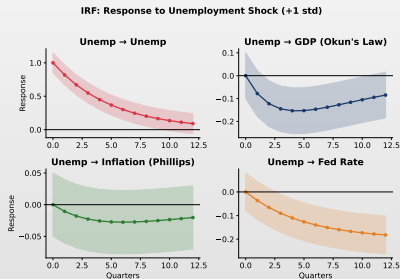


 TSA_ch10_irf_gdp_shock

IRF: Unemployment Shock

Effects

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

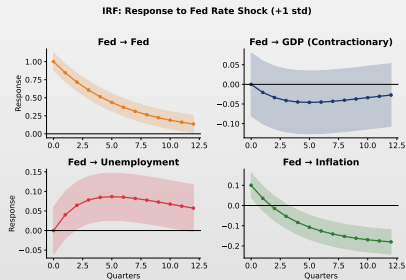


 TSA_ch10_irf_unemp_shock

IRF: Fed Rate Shock

Monetary Policy

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

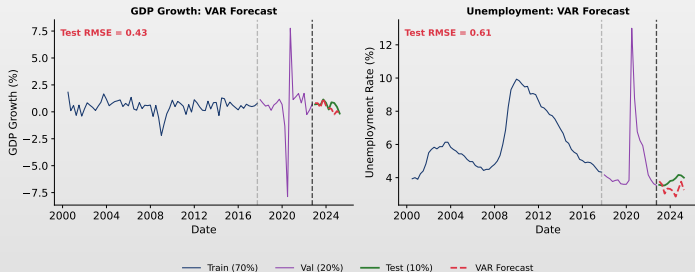


 TSA_ch10_irf_fed_shock

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% |
| Average | 1.53 | 1.27 | 60% |

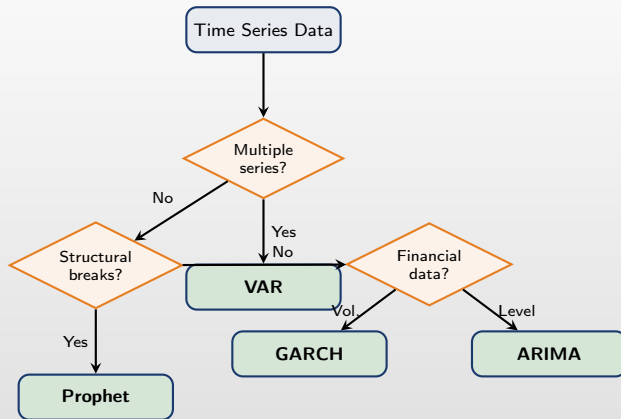
Strengths

- Cross-variable dynamics
- Good directional accuracy

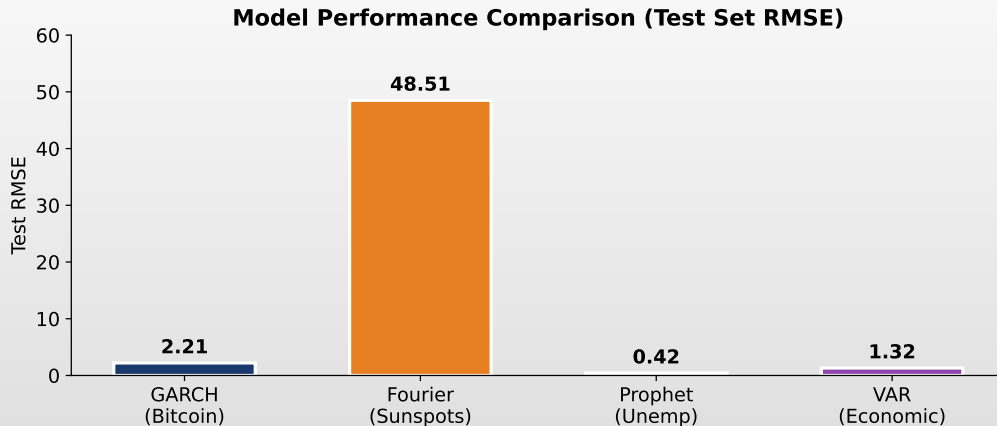
Limitations

- Many parameters
- Sensitive to lag selection

Model Selection Framework



Summary: Model Comparison



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 \succ Normal ($\Delta\text{AIC} = 509$)
- ▣ **Fourier**: $K = 3$ harmonics, validated on test 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

- ☐ Peeking at test data
- ☐ 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 → 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

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.*

Question 1

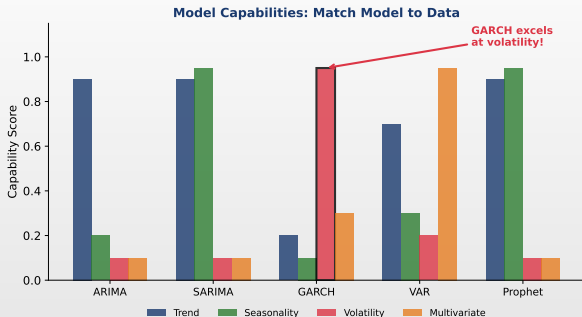
Question

☐ 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

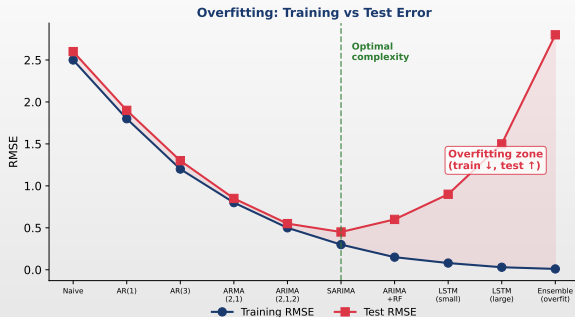
Question

- ☐ 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

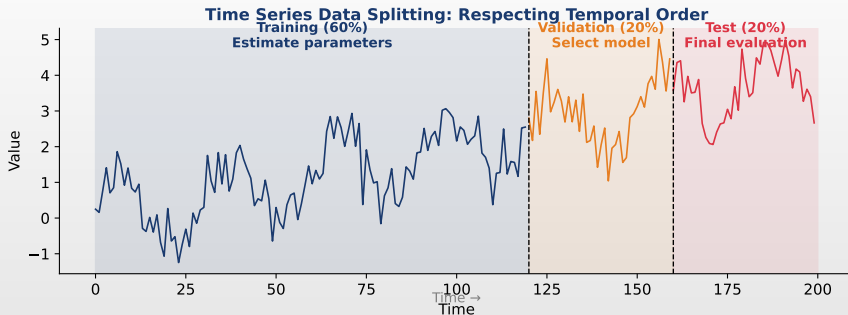
Question

☐ 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

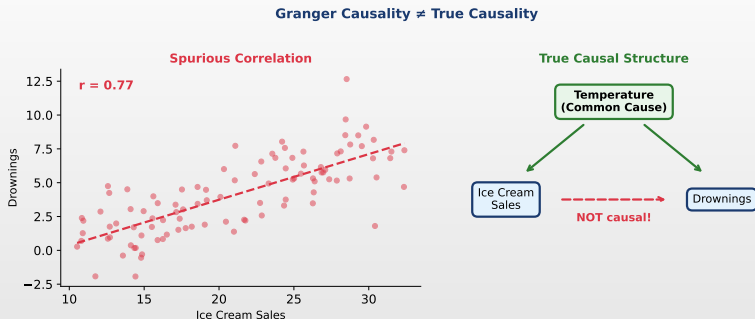
Question

☐ 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



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

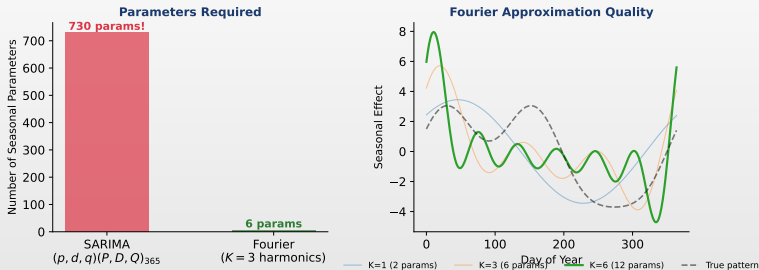
Question

□ 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)

- SARIMA₃₆₅ needs ~ 730 seasonal parameters — infeasible. Fourier terms with $K = 3$ use only 6 parameters. Prophet and TBATS handle multiple seasonalities automatically.

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- ▣ Makridakis, S., Spiliotis, E., & Assimakopoulos, V. (2020). The M4 Competition, *International Journal of Forecasting*, 36(1), 54–74.
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Key Takeaways

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