



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

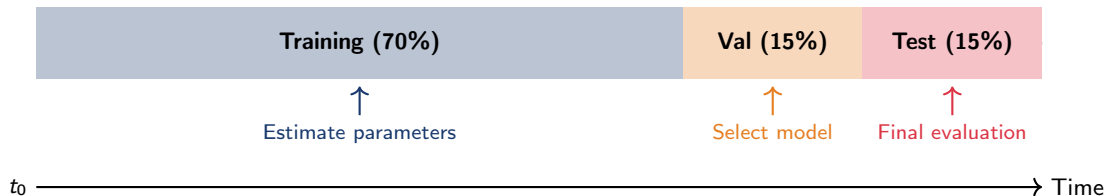
- In-sample fit \neq Out-of-sample performance
- Models can “memorize” training data without learning patterns
- **Solution:** Proper train/validation/test methodology

Key Principle

“The test set must remain **untouched** until final evaluation.”

— Standard practice in machine learning and econometrics

Train/Validation/Test Framework



Training Set	Validation Set	Test Set
<ul style="list-style-type: none">• Fit model parameters• $\hat{\theta} = \arg \min_{\theta} L(\theta)$• Largest portion	<ul style="list-style-type: none">• Compare models• Tune hyperparameters• Select best approach	<ul style="list-style-type: none">• Held out until end• Unbiased evaluation• Report final metrics

Definition 1 (Forecast Error Metrics)

Let y_t be actual values and \hat{y}_t forecasts for $t = 1, \dots, n$:

$$\text{RMSE} = \sqrt{\frac{1}{n} \sum_{t=1}^n (y_t - \hat{y}_t)^2} \quad (1)$$

$$\text{MAE} = \frac{1}{n} \sum_{t=1}^n |y_t - \hat{y}_t| \quad (2)$$

$$\text{MAPE} = \frac{100\%}{n} \sum_{t=1}^n \left| \frac{y_t - \hat{y}_t}{y_t} \right| \quad (3)$$

When to Use Each

- **RMSE**: Penalizes large errors
- **MAE**: Robust to outliers

Caution

- MAPE undefined when $y_t = 0$
- Compare models on same test set

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**

GARCH Model Specification

Definition 2 (GARCH(p,q) Model)

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

$$r_t = \mu + \varepsilon_t, \quad \varepsilon_t = \sigma_t z_t, \quad z_t \sim N(0, 1) \quad (4)$$

$$\sigma_t^2 = \omega + \sum_{i=1}^q \alpha_i \varepsilon_{t-i}^2 + \sum_{j=1}^p \beta_j \sigma_{t-j}^2 \quad (5)$$

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.

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	Failed*
EGARCH(1,1)	—	—	—	

*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**.

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	2.64
Volatility RMSE	2.82

Interpretation

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

Bitcoin: Key Findings

Summary

- ➊ Returns are **stationary**; prices are not
- ➋ **GARCH(1,1)** outperforms more complex variants
- ➌ **High persistence** ($\alpha + \beta = 0.999$)
- ➍ 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

Research Question

How do we model **long seasonal cycles** that exceed SARIMA's capacity?

Data Characteristics

- Source: Statsmodels (Wolfer)
- Period: 1900 – 2008
- Frequency: Annual
- Observations: 109 years

Known Feature

- **Schwabe cycle**: ≈ 11 years
- Irregular amplitude
- Non-negative values

The Challenge

Standard $\text{SARIMA}(p, d, q)(P, D, Q)_s$ requires:

- $s = 11$ for annual data
- $(P + D + Q) \times 11$ seasonal lags
- **Too many parameters!**

Solution

Use **Fourier terms** as exogenous regressors in ARIMA.

Fourier Terms for Seasonality

Definition 3 (Fourier Representation)

A seasonal pattern with period s can be approximated by:

$$S_t = \sum_{k=1}^K \left[\alpha_k \sin\left(\frac{2\pi kt}{s}\right) + \beta_k \cos\left(\frac{2\pi kt}{s}\right) \right] \quad (6)$$

where $K \leq \lfloor s/2 \rfloor$ is the number of harmonic pairs.

Advantages

- Only $2K$ parameters (not s)
- Handles **any** seasonal period
- Smooth seasonal pattern
- K controls flexibility

Model Structure

ARIMA(p, d, q) with Fourier regressors:

$$y_t = \underbrace{S_t}_{\text{Fourier}} + \underbrace{\eta_t}_{\text{ARIMA}} \quad (7)$$

where η_t follows ARIMA dynamics.

Methodology

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

Data Split	Set	Period	N	Model Comparison	K	AIC	Val RMSE	Best
	Training	1900–1975	76		1	665.9	87.15	
	Validation	1976–1991	16		2	668.0	86.92	
	Test	1992–2008	17		3	671.8	86.81	
	Total		109		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.

Research Question

How do we model time series with **sudden structural changes**?

Data Characteristics

- Source: FRED (UNRATE)
- Period: 2010 – 2025
- Frequency: Monthly
- Observations: \approx 180 months

Key Statistics

- Pre-COVID minimum: 3.5%
- COVID peak (Apr 2020): **14.8%**
- Change: +10.3 pp in one month

The Challenge

- April 2020: Largest monthly increase in US history
- Traditional ARIMA treats this as outlier
- Need model that **adapts** to structural breaks

Solution

Prophet with automatic changepoint detection.

Prophet Model

Definition 4 (Prophet Decomposition)

Prophet models time series as:

$$y_t = g(t) + s(t) + h(t) + \varepsilon_t \quad (8)$$

- $g(t)$: 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.

Data Split	Data Split			Scale Comparison	Scale Comparison		
	Set	Period	N		Scale	Val RMSE	
	Training	2010-01 to 2019-09	117		0.01	4.21	
	Validation	2019-10 to 2021-10	25		0.05	3.89	
	Test	2021-11 to 2025-01	38		0.10	3.52	Best
Total			180				

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

Research Question

How do we model **dynamic interdependencies** between multiple economic variables?

Variables (FRED)

- GDP Growth (YoY %)
- Unemployment Rate (%)
- Inflation (CPI YoY %)
- Federal Funds Rate (%)

Data

- Period: 2000 – 2025
- Frequency: Quarterly
- Observations: ≈ 100 quarters

Economic Relationships

- **Okun's Law:** GDP \leftrightarrow Unemployment
- **Phillips Curve:** Unemployment \leftrightarrow Inflation
- **Taylor Rule:** Inflation \rightarrow Fed Rate

Why VAR?

Each variable may be **both cause and effect** of others.

VAR Model Specification

Definition 5 (Vector Autoregression VAR(p))

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

$$y_t = c + A_1 y_{t-1} + A_2 y_{t-2} + \dots + A_p y_{t-p} + u_t \quad (9)$$

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 Best
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 6 (Granger Causality)

Variable X **Granger-causes** Y if past values of X help predict Y , beyond Y 's own past.

Note: Granger causality \neq true causality. It measures predictive content.

Granger Causality p-values (row \rightarrow column)

	GDP	Unemp	Inflation	Fed Rate
GDP Growth	—	0.076	0.309	0.698
Unemployment	0.045	—	0.093	0.857
Inflation	0.545	0.665	—	0.834
Fed Rate	0.286	0.317	0.087	—

Key Finding

Unemployment Granger-causes GDP ($p = 0.045$), consistent with Okun's Law.

Impulse Response Functions

Definition 7 (Impulse Response Function)

The IRF traces the effect of a one-unit shock to variable j on variable i over h periods:

$$\text{IRF}_{ij}(h) = \frac{\partial y_{i,t+h}}{\partial u_{jt}} \quad (10)$$

Response to GDP Shock

A positive shock to GDP growth:

- **Unemployment:** Decreases (Okun's Law confirmed)
- **Inflation:** Increases with lag (demand-pull)
- **Fed Rate:** Increases after 2-3 quarters (Taylor Rule)

Economic Interpretation

The VAR captures the classic macroeconomic transmission mechanism from output to employment, prices, and monetary policy.

VAR: Test Set Results

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%

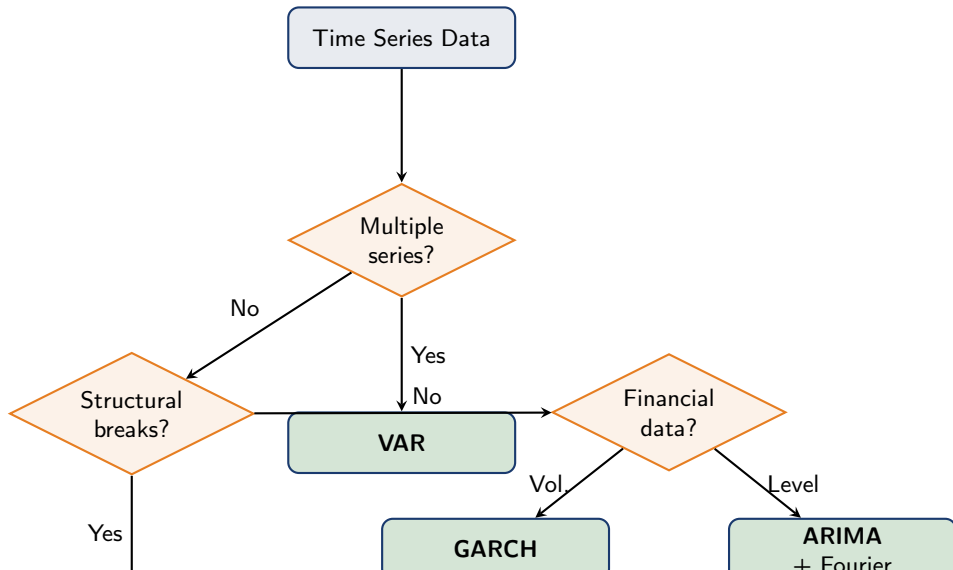
Strengths

- 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 Study	Challenge	Model	Key Feature	Test RMSE
Bitcoin	Volatility clustering	GARCH(1,1)	σ_t^2 dynamics	2.82
Sunspots	Long seasonality	ARIMA + Fourier	Sin/Cos terms	48.51
Unemployment	Structural break	Prophet	Changepoints	0.42
Economic	Multiple series	VAR(2)	Cross-dynamics	1.32 (avg)

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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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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