

Time Series Analysis

Lecture 3: Introduction to ARIMA

Tohid Ardeshiri

Linköping University
Division of Statistics and Machine Learning

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Recap

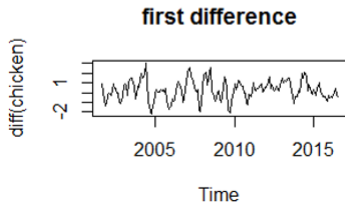
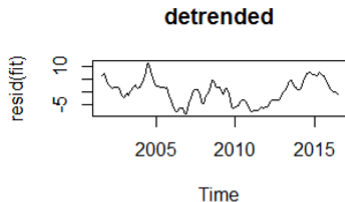
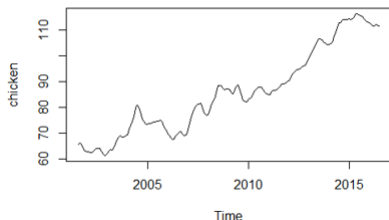
How to make data stationary?

- Transformations (log, other)
- Detrending
 - ▶ Differencing
 - ▶ Linear regression
 - ▶ Kernel smoother
 - ▶ ...

How shall we model the data after detrending and transformations (residuals)? → ? **ARIMA models!**

ARIMA models

- Why ARIMA models?
 - ▶ Removing trend is not sufficient



Moving average models

- **Moving average model of order q , $MA(q)$**

$$\begin{aligned}x_t &= w_t + \theta_1 w_{t-1} + \dots + \theta_q w_{t-q} \\ &= \sum_{j=0}^q \theta_j w_{t-j}\end{aligned}$$

- ▶ $w_t \sim wn(0, \sigma_w^2)$
- ▶ $\theta_1, \dots, \theta_q$ constants, $\theta_q \neq 0$ and $\theta_0 = 1$

- **Moving average operator**

$$\theta(B) = \sum_{j=0}^q \theta_j B^j$$

- $MA(q)$: $x_t = \theta(B)w_t$

Linear process

x_t is a **linear process** if

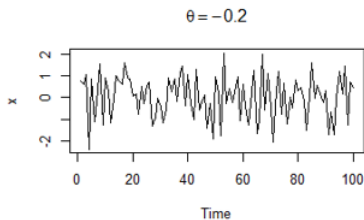
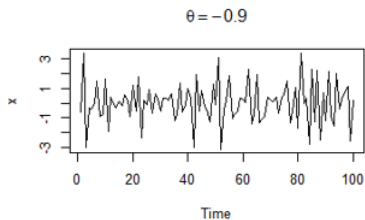
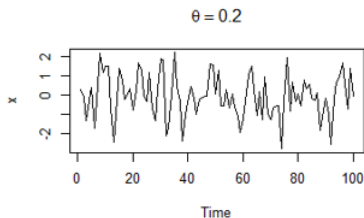
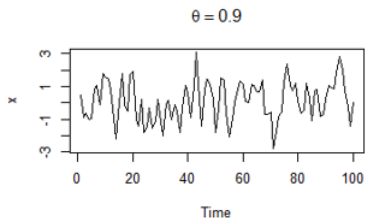
$$x_t = \mu + \sum_{j=-\infty}^{\infty} \psi_j w_{t-j}$$

Property: It can be shown that

$$\gamma_x(h) = \sigma_w^2 \sum_{j=-\infty}^{\infty} \psi_{j+h} \psi_j$$

Example: MA(1)

$$x_t = w_t + \theta w_{t-1}$$



Example: MA(1)

$$x_t = w_t + \theta w_{t-1}$$

- Autocovariance and ACF

$$\gamma(h) = \begin{cases} (1 + \theta^2)\sigma_w^2 & h = 0 \\ \theta\sigma_w^2 & h = 1 \\ 0 & h > 1 \end{cases}$$

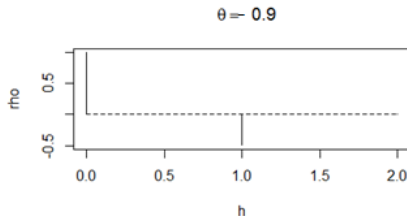
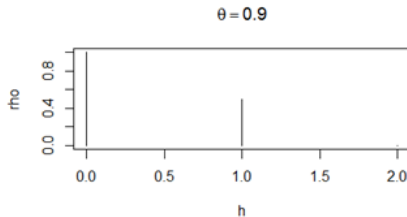
$$\rho(h) = \begin{cases} \frac{\theta}{1+\theta^2} & h = 1 \\ 0 & h > 1 \end{cases}$$

Note: $\rho(0) = 1$ is often not written as it is trivial.

- Process is stationary

Example: MA(1)

- Note: $\rho(0) = 1$ is often not shown \rightarrow only 1 bar



AR models

- Autoregressive model of order p , $AR(p)$

$$x_t = \phi_1 x_{t-1} + \dots + \phi_p x_{t-p} + w_t$$

- ▶ x_t is **stationary** if x_0 is sampled from the stationary distribution
- ▶ $w_t \sim wn(0, \sigma_w^2)$
- ▶ ϕ_1, \dots, ϕ_p constants, $\phi_p \neq 0$
- ▶ $Ex_t = 0$

- **Note:** if $Ex_t = \mu \neq 0$, model $x'_t = x_t - \mu$

AR models

Another form

- **Autoregressive operator**

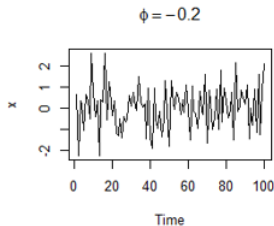
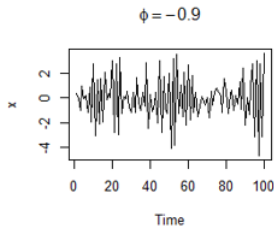
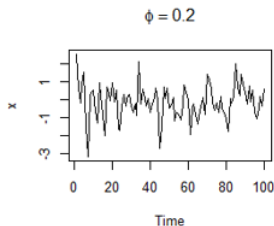
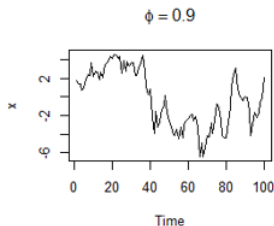
$$\phi(B) = 1 - \phi_1 B - \dots - \phi_p B^p$$

- AR(p) model

$$\boxed{\phi(B)x_t = w_t}$$

Example: AR(1)

- How do these plots differ? $x_t = \phi x_{t-1} + w_t$



Ar(1) (read at home)

$$x_t = \phi x_{t-1} + w_t$$

Mean function:

$$Ex_t = \phi Ex_{t-1} + Ew_t = \phi Ex_{t-1} = \phi(\phi Ex_{t-2}) = \cdots = \phi^t Ex_0$$

for $Ex_0 = 0$, $Ex_t = 0$ for all t .

Variance $\text{var}(x_t)$ when $Ex_0 = 0$ and w_t is uncorrelated with x_0 for all t :

$$\begin{aligned}\text{var}(x_t) &= E\{(x_t - 0)^2\} = E\{\phi^2 x_{t-1}^2 + 2\phi x_{t-1} w_t + w_t^2\} = \\ &\phi^2 \text{var}(x_{t-1}) + 2\phi \text{cov}(x_{t-1}, w_t) + \text{var}(w_t) = \phi^2 \text{var}(x_{t-1}) + \text{var}(w_t) = \\ &\phi^2 \text{var}(x_{t-1}) + \sigma_w^2 = \phi^2(\phi^2 \text{var}(x_{t-2}) + \sigma_w^2) + \sigma_w^2 = \\ &\phi^{2t} \text{var}(x_0) + \sigma_w^2 \sum_{k=0}^{t-1} (\phi^{2k}) = \phi^{2t} \text{var}(x_0) + \frac{\sigma_w^2(1-\phi^{2t})}{1-\phi^2}\end{aligned}$$

When $\text{var}(x_0) = \frac{\sigma_w^2}{1-\phi^2}$ then $\text{var}(x_t) = \frac{\sigma_w^2}{1-\phi^2}$ and time independent.

A(1) (read at home)

$$x_t = \phi x_{t-1} + w_t$$

$$x_t = \phi(\phi x_{t-2} + w_{t-1}) + w_t = \cdots = \phi^h x_{t-h} + \sum_{j=0}^{h-1} \phi^j w_{t-j}$$

$$\begin{aligned}\gamma(x_t, x_{t-h}) &= \text{cov}(x_t, x_{t-h}) = E(x_t x_{t-h}) = \\ E\{(\phi^h x_{t-h} + \sum_{j=0}^{h-1} \phi^j w_{t-j}) x_{t-h}\} &= \phi^h \text{var}(x_{t-h}) = \frac{\phi^h \sigma_w^2}{1 - \phi^2}\end{aligned}$$

Hence,

$$\gamma(h) = \frac{\phi^h \sigma_w^2}{1 - \phi^2}$$

Also,

$$\rho(h) = \phi^h$$

- **Property:** If $|\phi| < 1$ and $\sup \text{var}(x_t) < \infty$

$$x_t = \sum_{j=0}^{\infty} \phi^j w_{t-j}$$

- Show it by
 - ▶ Substitution
 - ▶ Taylor expansion
 - ▶ Coefficient matching
- Autocovariance and ACF

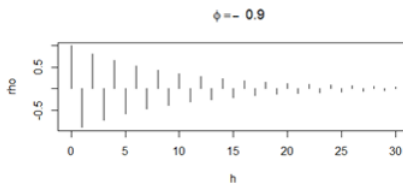
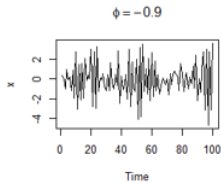
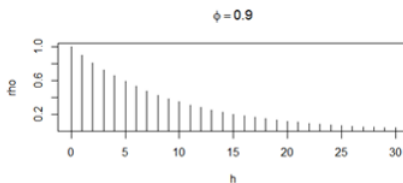
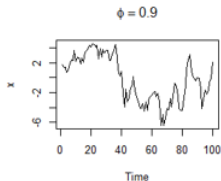
$$\gamma(h) = \frac{\sigma_w^2 \phi^h}{1 - \phi^2} \quad \rho(h) = \phi^h$$

for $h \geq 0$.

Example: AR(1)

Autocovariance and ACF (for $h \geq 0$)

$$\gamma(h) = \frac{\sigma_w^2 \phi^h}{1 - \phi^2} \quad \rho(h) = \phi^h$$



Explosive AR models

- **Explosive** = series become arbitrarily large in magnitude
- AR(1): What if $|\phi| > 1$?
 - ▶ $x_t = \phi^p x_{t-p} + \sum_{j=0}^{p-1} \phi^j w_{t-j} \rightarrow$ grows exponentially
 - ▶ **Stationary?** Check variance

- Can we make it stationary?

$$x_t = \phi^{-1} x_{t+1} - \phi^{-1} w_{t+1} = \phi' x_{t+1} + w'_t$$

- ▶ Stationary, but dependent on the future
- ▶ $w'_t \sim N(0, \phi^{-2} \sigma_w^2)$
- ▶ $x_t = - \sum_{j=1}^{\infty} \phi^{-j} w_{t+j}$

Causal process

A stationary process is **causal** if it is only dependent on the past values of the process

Def: A linear process is **nonexplosive** and **causal** if it can be written as a one-sided sum:

$$x_t = \sum_{j=0}^{\infty} \psi_j w_{t-j} = \psi(B)w_t$$

where $\psi(B) = \sum_{j=0}^{\infty} \psi_j B^j$ and $\sum_{j=0}^{\infty} |\psi_j| < \infty$.

$$\rho(h) = \begin{cases} \frac{\theta}{1+\theta^2} & h = 1 \\ 0 & h > 1 \end{cases}$$

Note: MA(1) gives equivalent models for $\theta = s$ and $\theta = \frac{1}{s}$

Probabilistic expressions equivalent: ACF identical

→ we can not distinguish between these models

Invertibility of MA

Def: An MA process is **invertible** if it has a causal AR representation,

$$w_t = \sum_{j=0}^{\infty} \pi_j x_{t-j}$$

Example: MA(1) with $\theta = 1/5$ is invertible, $\theta = 5$ not.

ARMA models

- Autoregressive moving average ARMA(p,q)

$$x_t = \phi_1 x_{t-1} + \dots + \phi_p x_{t-p} + w_t + \theta_1 w_{t-1} + \dots + \theta_q w_{t-q}$$

- ▶ $\phi_p \neq 0, \theta_q \neq 0$
- ▶ Is stationary
- ▶ $E x_t = 0$

- p -autoregressive order, q -moving average order
- Alternative form

$$\phi(B)x_t = \theta(B)w_t$$

- **Note:** $x_t = \phi^{-1}(B)\theta(B)w_t = \sum_{j=-\infty}^{\infty} \psi_j w_{t-j}$
 - ▶ But series might be non-convergent

Parameter redundancy

Note: we can multiply both sides with $\eta(B)$

$$\eta(B)\phi(B)x_t = \eta(B)\theta(B)w_t$$

- The resulting model looks different (higher orders)
- Underlying model is actually the same

Example: $x_t = w_t$, white noise. Let $\eta(B) = 1 - 0.5B$.

We get

$$x_t - 0.5x_{t-1} = w_t - 0.5w_{t-1}$$

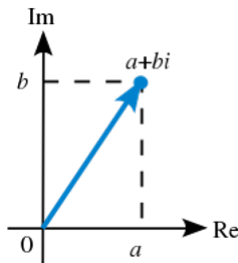
Looks like ARMA(1,1)!

Reminder: complex numbers

- Imaginary unit $i^2 = -1$
- Complex number $z = a + ib$
- Conjugate $\bar{z} = a - ib$
- Absolute value $|z|^2 = z\bar{z} = a^2 + b^2$
- Trigonometric form
 $z = r(\cos(\theta) + i\sin(\theta))$
- Eulers formula $e^{i\theta} = \cos(\theta) + i\sin(\theta)$
- Therefore

$$\cos(\theta) = \frac{e^{i\theta} + e^{-i\theta}}{2}$$

$$\sin(\theta) = \frac{e^{i\theta} - e^{-i\theta}}{2i}$$



Reminder: polynomials

- Any polynomial $P_r(x)$ of degree r can be written as

$$P_r(x) = a(x - z_1) \dots (x - z_r)$$

- where z_i are roots (real or complex)
- If z_i is a root, \bar{z}_i is also a root

Causal ARMA

Def: Linear process is **causal** and **nonexplosive** if

- $x_t = \sum_{j=0}^{\infty} \psi_j w_{t-j}$ (depends on the past only)
- $\sum_{j=0}^{\infty} |\psi_j| < \infty$
- We set $\psi_0 = 1$ by convention.

Property: ARMA(p,q) is **causal** iff roots $\phi(z') = 0$ are outside unit circle, i.e. $|z'| > 1$

$$\phi(B)x_t = \theta(B)w_t$$

Causal ARMA

Example: Is the ARMA process below causal?

$$x_t = 0.4x_{t-1} + 0.3x_{t-2} + 0.2x_{t-3} + w_t - 0.1w_{t-1}$$
$$\Rightarrow \phi(B) = 1 - 0.4B - 0.3B^2 - 0.2B^3$$

```
> z=c(1, -0.4,-0.3,-0.2)
> polyroot(z)
[1] 1.060419-0.000000i -1.280210+1.753904i -1.280210-1.753904i
>
```

Invertible ARMA

Def: ARMA(p,q) is **invertible** if

- $w_t = \sum_{j=0}^{\infty} \pi_j x_{t-j}$ (depends on the past only)
- $\sum_{j=0}^{\infty} |\pi_j| < \infty$

Property: ARMA(p,q) is **invertible** iff roots $\theta(z') = 0$ are outside unit circle, i.e. $|z'| > 1$

$$\phi(B)x_t = \theta(B)w_t$$

- $x_t = \sum_{j=0}^{\infty} \psi_j w_{t-j} \rightarrow x_t = \psi(B)w_t$
- $w_t = \sum_{j=0}^{\infty} \pi_j w_{t-j} \rightarrow w_t = \pi(B)x_t$
- How to find coefficients in ψ and $\pi \rightarrow$ **coefficient matching**

$$\phi(z)\psi(z) = \theta(z) \quad \pi(z)\theta(z) = \phi(z)$$

- **Example:** $x_t = 0.4x_{t-1} + 0.45x_{t-2} + w_t + w_{t-1} + 0.25w_{t-2}$

```
> ARMAtoMA(ar=.9,ma=0.5, 6)
[1] 1.400000 1.260000 1.134000 1.020600 0.918540 0.826686
```

Home reading

- Shumway and Stoffer, section 3.1
- R code: `arima.sim`, `arima`, `polyroot`, `ARMAtoMA`, `ARMAacf`
 - ▶ Check carefully `arima()` docs to see how `ar` and `ma` coefficients are specified in the software