

Unit 9: Introduction to unsupervised learning

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9 Introduction to unsupervised learning

9.1 Overview of machine learning (ML) algorithms

Broadly speaking, we can categorize machine learning algorithms into three groups:

1. *Supervised learning*

Models in this group use both input data (often called independent variables, features, covariates, predictors, or X variables) and the corresponding output data (dependent variable, outcome, target, or y variable) to establish some relationship $y = f(X)$ within a training data set. We can then use this relationship to make predictions about outputs in new data.

Subcategories within this group include:

- Regression, where output data is allowed to take on continuous values; and
- Classification, where output data is restricted to a few values, often called categories or labels.

2. *Unsupervised learning*

In this scenario, machine learning algorithms operate on unlabelled data, i.e., there is no explicit outcome variable. We can, however, use machine learning to structure or reduce this data, for example by

- Clustering, where we organise data into meaningful subgroups (clusters); or
- Dimensionality reduction, where possibly high-dimensional data is compressed into fewer dimensions while preserving relevant information.

One of the most widely used examples of dimensionality reduction is principal component analysis (PCA) which we study in more detail below.

3. *Reinforcement learning*

We won't be concerned with ML algorithms that fall into this category in this part of the course.

9.2 Principal component analysis

Principal component analysis (PCA) is one of the most widely used dimensionality reduction techniques. Assume we have a dataset consisting of $i = 1, \dots, N$ observations of $k = 1, \dots, K$ variables (or features) \mathbf{x}_k . For simplicity, assume that all \mathbf{x}_k are *centred*, i.e., they have been transformed so that they have zero means. We could imagine two ways to reduce the dimensionality of this dataset:

1. Discard some of the variables and keep only a number $J \ll K$.
2. Create a collection of alternative variables \mathbf{p}_j which are linear combinations of \mathbf{x}_k . The dimensionality reduction arises if we form only $J \ll K$ such variables.

The variables \mathbf{p}_j are called principle components if we construct them in a particular way. Let \mathbf{p}_1 be the first such component which is a linear combination of all $\{\mathbf{x}_k\}$,

$$\mathbf{p}_1 = v_{11}\mathbf{x}_1 + v_{21}\mathbf{x}_2 + \dots + v_{K1}\mathbf{x}_K = \sum_{k=1}^K v_{k1}\mathbf{x}_k$$

where the v_{1k} are called *coefficients* or *loadings* (note that the term “loadings” is not used consistently in the literature and sometimes refers to a rescaled version of v). We want to pick these coefficients in some optimal fashion, which in this case is by requiring that they maximise the sample variance of the first principle component subject to the constraint that $\sum_{k=1}^K v_{k1}^2 = 1$. Therefore, these coefficients are the solution to the following maximisation problem:

$$\max_{v_{11}, v_{21}, \dots, v_{K1}} \left\{ \frac{1}{n} \sum_{i=1}^N p_{i1}^2 \right\} = \left\{ \frac{1}{n} \sum_{i=1}^N \left(\sum_{k=1}^K v_{k1} x_{ik} \right)^2 \right\} \quad \text{subject to} \quad \sum_{k=1}^K v_{k1}^2 = 1$$

We never solve the above maximisation problem by hand to find the coefficients but instead use an algorithm from linear algebra called the *singular value decomposition*.

9.2.1 Singular value decomposition and principal components

To compute the principal components, we often use a matrix factorisation technique known as **singular value decomposition** (SVD). Alternatively (and equivalently), principal components can be computed from the eigenvalues and eigenvectors of the data's covariance matrix. We ignore this second approach in this unit.

SVD is a matrix factorisation that is commonly used in econometrics and statistics. For example, we can use it to implement PCA, principal component regression, OLS or Ridge regression (which we cover in the next unit).

Let $\mathbf{X} \in \mathbb{R}^{N \times K}$ be a matrix of data with N observations (in rows) of K variables (in columns) with $N \geq K$. The (compact) SVD of \mathbf{X} is given by

$$\mathbf{X} = \mathbf{U}\mathbf{\Sigma}\mathbf{V}^\top$$

where $\mathbf{U} \in \mathbb{R}^{N \times K}$ and $\mathbf{V} \in \mathbb{R}^{K \times K}$ are orthogonal matrices, and $\mathbf{\Sigma} \in \mathbb{R}^{K \times K}$ is a diagonal matrix

$$\mathbf{\Sigma} = \begin{bmatrix} \sigma_1 & & & \\ & \sigma_2 & & \\ & & \ddots & \\ & & & \sigma_K \end{bmatrix}$$

The elements σ_k are called singular values of \mathbf{X} , and $\mathbf{\Sigma}$ is arranged such that $\sigma_1 \geq \sigma_2 \geq \dots \geq \sigma_K$. Since \mathbf{U} is not necessarily square, it's not truly orthogonal, but its columns are still orthogonal to each other.

These matrices satisfy the following useful properties:

$$\begin{aligned} \mathbf{U}^\top \mathbf{U} &= \mathbf{I}_n \\ \mathbf{V}^\top \mathbf{V} &= \mathbf{V} \mathbf{V}^\top = \mathbf{I}_n \\ \mathbf{V}^\top &= \mathbf{V}^{-1} \end{aligned}$$

where \mathbf{I}_n is the $n \times n$ identity matrix.

Once we have obtained the singular value decomposition, we can project the data \mathbf{X} onto the coordinate system underlying the principal components to obtain the transformed data \mathbf{P} :

$$\mathbf{P} = \mathbf{X}\mathbf{V}$$

Intuitively, the j -th column of \mathbf{V} defines how the j -th column in \mathbf{P} is obtained as a linear combination of the columns of \mathbf{X} . If you recall our definition of the first principle component from above,

$$\mathbf{p}_1 = v_{11}\mathbf{x}_1 + v_{21}\mathbf{x}_2 + \cdots + v_{K1}\mathbf{x}_K$$

you can immediately see that the coefficients v_{k1} are stored in the first column of \mathbf{V} , and the first column of \mathbf{P} corresponds to the first principal component \mathbf{p}_1 .

The power of PCA comes from the fact that we don't need to use all columns in \mathbf{V} so that the dimension of \mathbf{P} is lower than the dimension of the original data \mathbf{X} .

In Python, we compute the SVD using the `svd()` function from `numpy.linalg`.

9.2.2 Example: Bivariate normal sample

Imagine we construct \mathbf{X} as 200 random draws from a bivariate normal:

```
[1]: import numpy as np
      from numpy.random import default_rng

      # Draw a bivariate normal sample using the function we defined above
      mu = np.array([0.0, 1.0])          # Vector of means
      sigma = np.array([0.5, 1.0])       # Vector of standard deviations
      rho = 0.75                         # Correlation coefficient
      Nobs = 200                         # Sample size

      # Correlation matrix
      corr = np.array([
          [1.0, rho],
          [rho, 1.0]
      ])
      # Create variance-covariance matrix
      vcv = sigma[:, None] * corr * sigma

      # Draw multivariate normal random numbers:
      # each row represents one sample draw.
      rng = default_rng(123)
      X = rng.multivariate_normal(mean=mu, cov=vcv, size=Nobs)

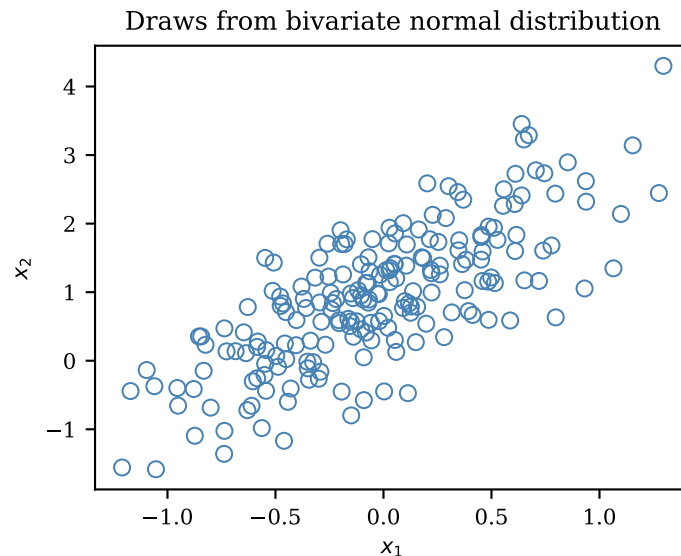
      # Split into variables X1, X2
      x1, x2 = X.T
```

We use a scatter plot to visualise the random draws:

```
[2]: import matplotlib.pyplot as plt

      # Scatter plot of sample
      plt.scatter(x1, x2, linewidths=0.75, c='none', edgecolors='steelblue')
      plt.xlabel(r'$x_1$')
      plt.ylabel(r'$x_2$')
      plt.title('Draws from bivariate normal distribution')
```

```
[2]: Text(0.5, 1.0, 'Draws from bivariate normal distribution')
```



Performing PCA manually using SVD

In a first step, we compute the principal components manually using SVD. Later on, we will examine how we do the same task using `scikit-learn`, one of the most widely used Python libraries for ML.

Before performing PCA, it is recommended to standardise the variables, i.e., transform them so that they have zero mean and unit variance. For this example, we will only demean the data but ignore the variance.

```
[3]: # Demean variables

# Mean of each column
Xmean = np.mean(X, axis=0)

# Matrix Xcen stores the centred (demeaned) columns of X
Xcen = (X - Xmean)
```

We can now use the SVD factorisation to compute the principal components. Once we have computed the matrix V , the data is transformed using the matrix multiplication

$$P = XV$$

where X now denotes the standardised values.

```
[4]: from numpy.linalg import svd

# Apply SVD to standardised values. IMPORTANT: use full_matrices=False,
# otherwise SVD can take a long time and consume lots of memory!
U, S, Vt = svd(Xcen, full_matrices=False)

# Project onto principal components coordinates
PC = Xcen @ Vt.T

# Variance is highest for first component
var_PC = np.var(PC, axis=0, ddof=1)
print(f'Principal component variances: {var_PC}')
```

Principal component variances: [1.17607859 0.09444617]

We next plot the principal components in the original data space (left panel). Moreover, the right panel shows the data rotated and rescaled so that each axes corresponds to a principal component. Most of the variation clearly occurs along the first axis!

```
[5]: # Plot principal components

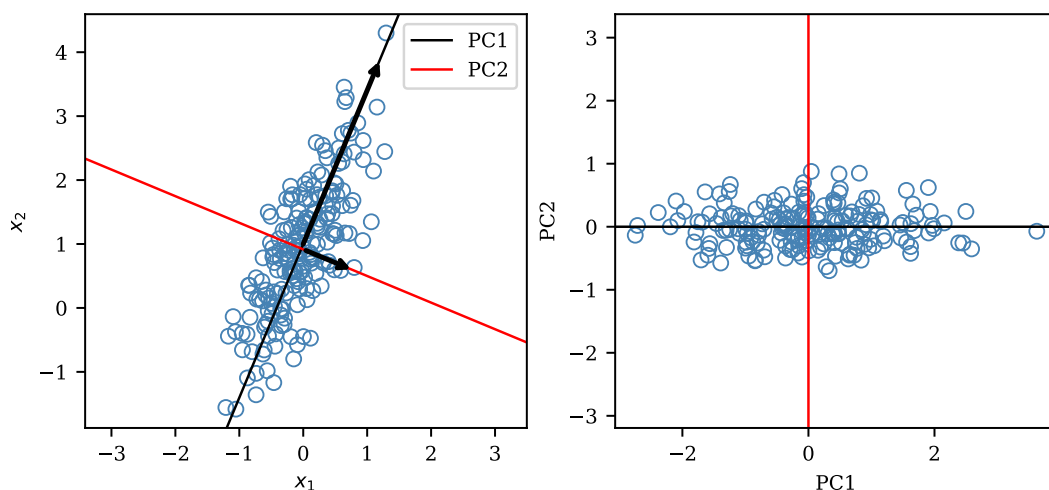
# Scatter plot of sample
fig, (ax0, ax1) = plt.subplots(1, 2, figsize=(7,3))
ax0.scatter(X[:, 0], X[:, 1], linewidths=0.75, c='none', edgecolors='steelblue')
ax0.axis('equal')
ax0.set_xlabel(r'$x_1$')
ax0.set_ylabel(r'$x_2$')
ax0.axline(Xmean, Xmean + Vt[0], label='PC1', lw=1.0, c='black', zorder=1)
ax0.axline(Xmean, Xmean + Vt[1], label='PC2', lw=1.0, c='red', zorder=1)

# Plot arrows pointing along axes of individual components
PC_arrows = Vt * np.sqrt(var_PC[:, None])
for v in PC_arrows:
    # Scale up arrows by 3 so that they are visible!
    ax0.annotate(' ', Xmean + v*3, Xmean, arrowprops=dict(arrowstyle='->', linewidth=2))

ax0.legend()

# Plot in principal component coordinate system
ax1.scatter(PC[:, 0], PC[:, 1], linewidths=0.75, c='none', edgecolors='steelblue')
ax1.set_xlabel('PC1')
ax1.set_ylabel('PC2')
ax1.axis('equal')
ax1.axvline(0.0, lw=1.0, c='red')
ax1.axhline(0.0, lw=1.0, c='black')
```

```
[5]: <matplotlib.lines.Line2D at 0x7f1a4b710c10>
```



Performing PCA using scikit-learn

Of course, in real applications we don't need to manually compute the principal components but can use a library such as `scikit-learn` to do it for us (see the documentation for [PCA](#) and the section on PCA in the [official user guide](#) for details).

Most models implemented in `scikit-learn` follow the same paradigm:

1. We create an instance of a class that presents the model we want to fit to the data. In our present case, the class is called `PCA`.

In many cases, we specify arguments that govern how a model is fit to the data, e.g., the number of principal components to use.

2. We fit the model (on the training data set) by calling the `fit()` method.
3. Frequently, we can use the `transform()` method to transform any other data (e.g., the test or validation sample) using the fitted model.

Note that in the case of PCA, scikit-learn automatically demeanes the input data (but does not normalise the variance to 1), so we don't need to do it manually.

```
[6]: from sklearn.decomposition import PCA

# Use same data X as before

# Create PCA with 2 components (which is the max, since we have only two
# variables)
pca = PCA(n_components=2)

# Perform PCA on input data
pca.fit(X)
```

```
[6]: PCA(n_components=2)
```

To obtain the transformed data, we call the `transform()` method. Note that we could have called `fit_transform()` instead to perform the two previous steps in a single call.

```
[7]: # Obtain data projected onto principal components
PC_skl = pca.transform(X)

# Check that these are identical to PC we obtained manually
assert np.all(np.abs(PC_skl - PC) < 1.0e-10)
```

The principal component coefficients (used to create the transformed data) are stored in the attribute `components_` and are identical to the matrix V^T we computed above.

```
[8]: # The attribute components_ can be used to retrieve the V' matrix
print("components_ (matrix V'):")
print(pca.components_)

# Check that these are identical to the matrix V' we computed via SVD
assert np.all(np.abs(pca.components_ - Vt) < 1.0e-10)
```

```
components_ (matrix V'):
[[ 0.38420018  0.92324981]
 [ 0.92324981 -0.38420018]]
```

The fitted `pca` object contains other useful attributes (see the [documentation](#) for a full list). For example,

- `explained_variance_` stores the variances of all principal components; and
- `explained_variance_ratio_` stores the fraction of the variance “explained” by each component.

```
[9]: # The attribute explained_variance_ stores the variances of all PCs
print(f'Variance of each PC: {pca.explained_variance_}')

# Fraction of variance explained by each component:
print(f'Fraction of variance of each PC: {pca.explained_variance_ratio_}')
```

```
Variance of each PC: [1.17607859 0.09444617]
Fraction of variance of each PC: [0.92566365 0.07433635]
```

From the above output, we see that the first principal component captures about 92% of the variance in the data.

Finally, it is often interesting to examine how much any of the original variables in \mathbf{X} contribute to each principal component. These contributions are called *loadings* (again, note that the term “loadings” is not used consistently) and can be computed as follows:

```
[10]: loadings = pca.components_.T * np.sqrt(pca.explained_variance_)

# Use pandas DataFrame to tabulate loadings
import pandas as pd
pd.DataFrame(loadings, columns=['PC1', 'PC2'], index=['X1', 'X2'])
```

```
[10]:      PC1      PC2
X1  0.416654  0.283734
X2  1.001238 -0.118073
```

The output tells us that the first principal component (which corresponds to the first column in the above matrix) loads more heavily on the second column of \mathbf{X} , which can also be seen from the previous graph.

9.2.3 Example: Higher-dimensional data

Creating highly correlated inputs

The previous example was meant as an introduction but did not really illustrate the dimension reduction of PCA. After all, with only two dimensions there was not much to be reduced! Consider now a higher-dimensional (but still artificial) example with 10 dimensions. For this purpose, we create highly correlated data as follows:

1. We draw N independent samples from a bivariate normal distribution,

$$\mathbf{z}_i \stackrel{\text{iid}}{\sim} N\left(\mathbf{0}, \begin{bmatrix} \sigma_1^2 & 0 \\ 0 & \sigma_2^2 \end{bmatrix}\right)$$

and stack them in the matrix $\mathbf{Z} \in \mathbb{R}^{N \times 2}$.

2. For some $2 \times K$ matrix \mathbf{A} with $K \gg 2$, we compute

$$\mathbf{X} = \mathbf{Z}\mathbf{A}$$

which gives us the higher-dimensional matrix $\mathbf{X} \in \mathbb{R}^{N \times K}$.

For illustrative purposes, we draw the elements of \mathbf{A} from a normal distribution but we could have picked almost any other coefficients. The point of the example is that we take two independent variables in \mathbf{Z} and create $K \gg 2$ variables in \mathbf{X} which are linear combinations of \mathbf{Z} . Intuitively, many of the columns of \mathbf{X} will be highly correlated since they were created from the same variation in \mathbf{Z} .

```
[11]: from numpy.random import default_rng
import pandas as pd

rng = default_rng(123)

K = 10          # Number of columns in matrix X
N = 100         # Number of observations

# Std. dev. of columns in Z
sigma = np.array([1.0, 3.0])

# Draw 2 independent, normally distributed random variables and rescale
# their variances
```

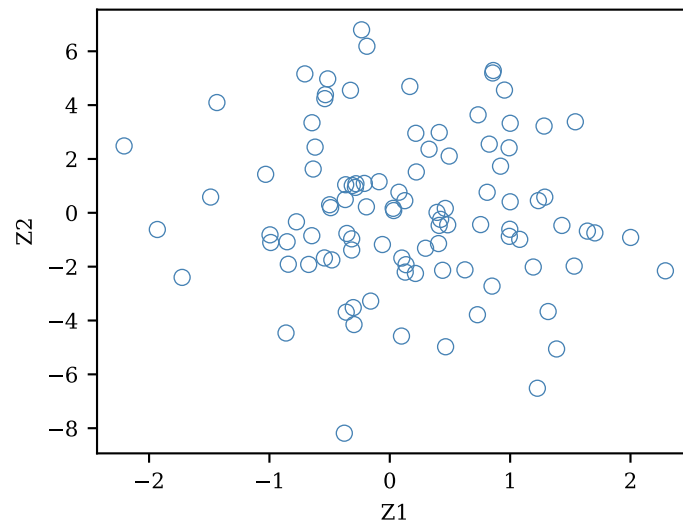
```
Z = rng.normal(size=(N, 2)) * sigma
```

We can plot the columns of Z against each other to verify that they don't seem to exhibit any particular dependence structure.

```
[12]: import matplotlib.pyplot as plt

plt.scatter(Z[:, 0], Z[:, 1], color='none', edgecolors='steelblue', lw=0.5)
plt.xlabel('Z1')
plt.ylabel('Z2')
```

```
[12]: Text(0, 0.5, 'Z2')
```



Next, we create the transformation matrix A . You can do this in various ways, so we simply choose to draw the elements of A from a standard normal distribution.

```
[13]: A = rng.normal(size=(Z.shape[1], K))

# Print first three columns of A in transposed form
A.T[:3]
```

```
[13]: array([[ -0.93706677,  2.62894657],
             [-0.80933814,  0.45287643],
             [-0.41213169,  0.23403931]])
```

The above coefficients show us how the columns of X are formed: the first column is obtained as

$$X[:, 0] = -0.937 * Z[:, 0] + 2.629 * Z[:, 1]$$

and so on.

```
[14]: # Compute X as linear combinations of Z
X = Z @ A
```

By construction, the columns of X are highly correlated. We can illustrate this using pairwise scatter plots as follows:

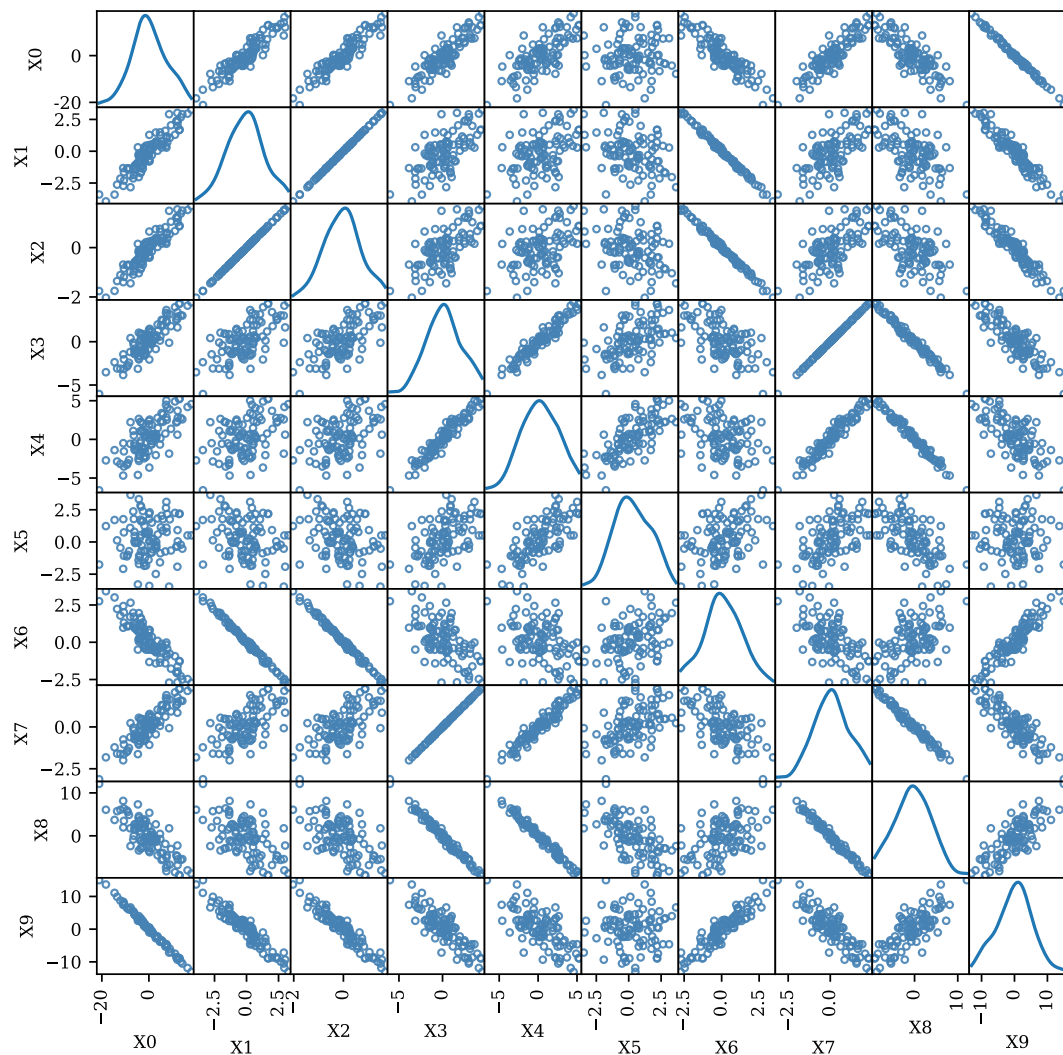
```
[15]: from pandas.plotting import scatter_matrix

df = pd.DataFrame(X, columns=[f'X{k}' for k in range(K)])

axes = scatter_matrix(df, figsize=(8, 8),
                      alpha=0.9, color='none', edgecolor='steelblue',
```



```
diagonal='kde')
```



Moreover, we can compute the pairwise correlation coefficients using pandas's `corr()` method which computes the correlation matrix between all columns of a DataFrame.

```
[16]: # Print only three decimal places
pd.set_option('display.precision', 3)

# Compute and print correlation matrix
df.corr()
```

```
[16]:
```

	X0	X1	X2	X3	X4	X5	X6	X7	X8	X9
X0	1.000	0.931	0.933	0.893	0.739	0.067	-0.900	0.891	-0.824	-0.997
X1	0.931	1.000	1.000	0.667	0.443	-0.301	-0.997	0.665	-0.561	-0.955
X2	0.933	1.000	1.000	0.671	0.448	-0.295	-0.997	0.669	-0.565	-0.956
X3	0.893	0.667	0.671	1.000	0.963	0.510	-0.608	1.000	-0.991	-0.858
X4	0.739	0.443	0.448	0.963	1.000	0.722	-0.372	0.964	-0.991	-0.689
X5	0.067	-0.301	-0.295	0.510	0.722	1.000	0.373	0.513	-0.621	0.004
X6	-0.900	-0.997	-0.997	-0.608	-0.372	0.373	1.000	-0.605	0.495	0.929
X7	0.891	0.665	0.669	1.000	0.964	0.513	-0.605	1.000	-0.991	-0.857
X8	-0.824	-0.561	-0.565	-0.991	-0.991	-0.621	0.495	-0.991	1.000	0.782
X9	-0.997	-0.955	-0.956	-0.858	-0.689	0.004	0.929	-0.857	0.782	1.000

PCA with manually selected number of principle components

We now use scikit-learn's PCA to perform the principal component analysis just as we did in the bivariate case.

```
[17]: from sklearn.decomposition import PCA

# Create PCA using max. available components
pca = PCA()

# Perform PCA on input data
PC = pca.fit_transform(X)
```

To get some intuition for the transformed data, we plot the first principal component (which captures most of the variation by construction) against some of the other principal components. As you can see in the code below, there is some variation left in the 2nd principal component, while for the 3rd and 4th components the data along these dimension is basically constant (this is also the case for the remaining principal components).

```
[18]: fig, axes = plt.subplots(3, 1, figsize=(3, 5), sharex=True, sharey=True)

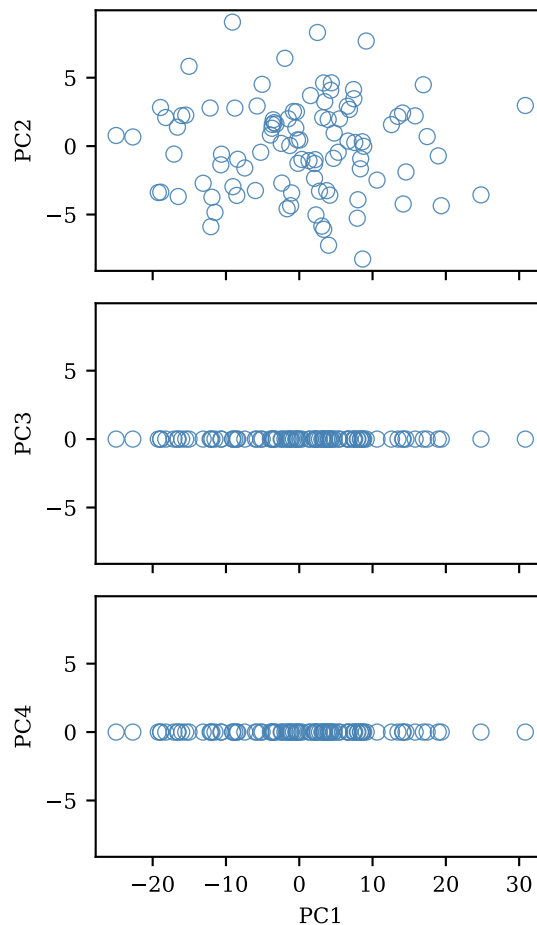
# Dictionary of common keyword arguments for scatter() function
kw = dict(color='none', alpha=0.9, edgecolor='steelblue', lw=0.5)

# Indices of PCs to plot against 1st PC
yi = [1, 2, 3]

for i, k in enumerate(yi):
    axes[i].scatter(PC[:, 0], PC[:, k], **kw)
    axes[i].set_ylabel(f'PC{k+1}')

axes[-1].set_xlabel('PC1')

fig.tight_layout()
```



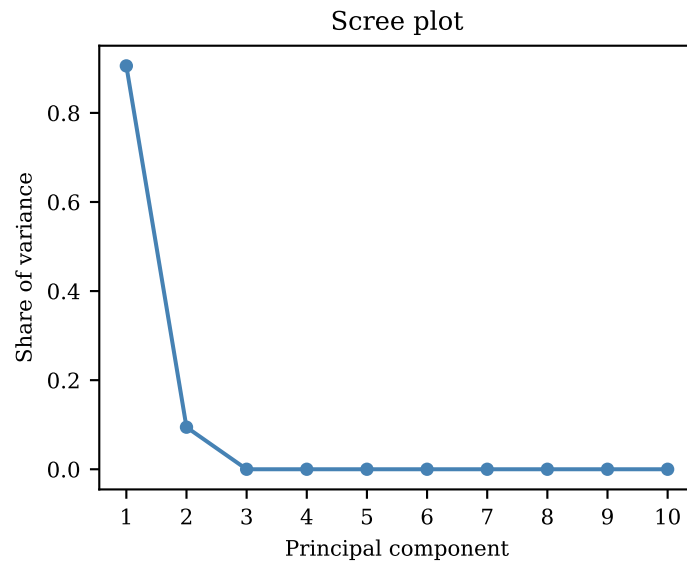
To see what's going in, we create a graph that plots the share of total variance captured by each component. This type of plot is called a *scree plot* and is occasionally used to visually pin down the number of principal components to use.

The plot below shows that for principal components beyond the 2nd one, this share is zero. This should come as no surprise since we generated the higher-dimensional data in **X** from only two dimensions of independent data.

```
[19]: import matplotlib.pyplot as plt

xvalues = np.arange(K)
plt.plot(xvalues, pca.explained_variance_ratio_, color='steelblue',
        marker='o', ms=4)
plt.xticks(xvalues, xvalues + 1)
plt.xlabel('Principal component')
plt.ylabel('Share of variance')
plt.title('Scree plot')
```

```
[19]: Text(0.5, 1.0, 'Scree plot')
```



PCA with automatically selected number of principal components

Previously, we manually selected the number of principle components when constructing an instance of PCA (or we used the default, which takes the minimum of the number of rows and columns of X). Alternatively, we can tell `scikit-learn` to automatically determine the number of components for us. For example, when the argument `n_components` is a floating-point number in $(0, 1)$, `scikit-learn` interprets this as the minimum fraction of variance that should be explained and chooses the required number of principal components accordingly. To illustrate, let's perform PCA and request that the number of components should capture at least 90% of the variance:

```
[20]: # Perform PCA, select components to capture 90% of variance
      pca = PCA(n_components=0.9)

      # Perform PCA on input data
      PC = pca.fit_transform(X)
```

This selects only the first principal component which is what we would suspect when looking at the previous graph.

```
[21]: print(f'Number of components: {pca.n_components_}')
```

Number of components: 1

We conclude this section by plotting the loadings for each principal component (which happens to be only one in this case). Since the data was generated randomly, this plot is not particularly insightful but will be much more useful with real data.

```
[22]: # Compute loadings for all PCs
      loadings = pca.components_.T * np.sqrt(pca.explained_variance_)

      # Number of selected PCs
      Ncomp = pca.n_components_

      fig, axes = plt.subplots(Ncomp, 1, figsize=(5, 2.5 * Ncomp),
                              sharex=True, sharey=True)

      # Plot loadings for each PC
      xvalues = np.arange(K)
      for i, ax in enumerate(np.atleast_1d(axes)):
          ax.bar(xvalues, loadings[:, i], color='steelblue')
```

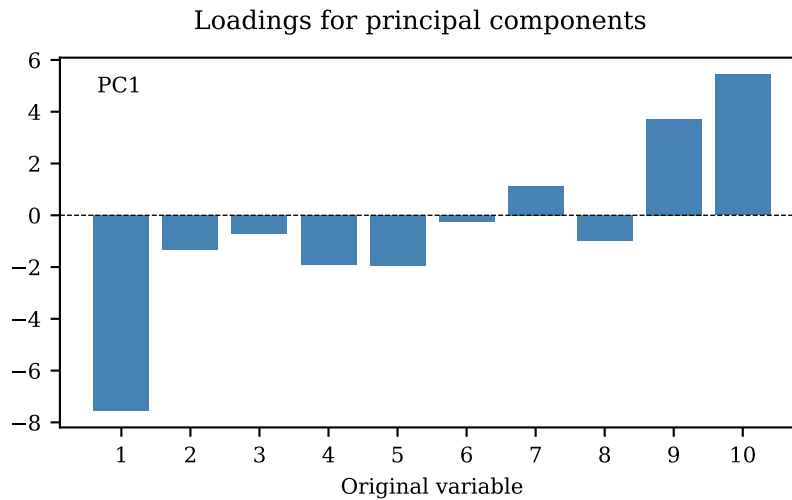
```

ax.set_xticks(xvalues, xvalues+1)
ax.set_xlabel('Original variable')
ax.text(0.05, 0.95, f'PC{i+1}', transform=ax.transAxes,
       ha='left', va='top')
ax.axhline(0.0, lw=0.5, ls='--', c='black')

fig.suptitle(f'Loadings for principal components')

```

```
[22]: Text(0.5, 0.98, 'Loadings for principal components')
```



9.3 Optional exercises

9.3.1 Exercise 1: PCA of uncorrelated variables

Imagine we have data \mathbf{X} with $N = 1000$ observations of a randomly drawn sample of $K = 5$ variables where each variable is standard-normally distributed. Assume that all variables are uncorrelated.

Since these variables are uncorrelated and identically distributed, we can simply draw an array of shape (N, K) from the univariate normal distribution as follows instead of using the multivariate normal distribution:

```

[23]: import numpy as np

rng = np.random.default_rng(123)

K = 5
Nobs = 1000

X = rng.normal(size=(Nobs, K))

```

Using this random sample, perform the following tasks:

1. Create pairwise scatter plots of all variables in \mathbf{X} .
2. Perform a principal component analysis on this sample using `scikit-learn`'s PCA implementation.
3. Create pairwise scatter plots of all principal components. Do these plots look any different from the ones you created earlier? Explain your finding!
4. Generate a scree plot showing the fraction of variance captured by each principal component.
5. Is it possible to reduce the dimensionality of this data without sacrificing too much information? Why or why not?

9.3.2 Exercise 2: PCA of quarterly business cycle indicators

In this exercise, we use the quarterly data from FRED on GDP, CPI and the unemployment rate (UNRATE) in the United States stored in the CSV file `FRED_QTR.csv` in the `data/` folder. To load the data, proceed as follows:

```
[24]: # Uncomment this to use files in the local data/ directory
DATA_PATH = '../data'

# Load data directly from GitHub
# DATA_PATH = 'https://raw.githubusercontent.com/richardfoltyn/MLFP-ECON5130/main/data'

import pandas as pd

file = f'{DATA_PATH}/FRED_QTR.csv'
df = pd.read_csv(file, sep=',')
```

Generate the following variables which serve as indicators for the business cycle (the cyclical state of the economy):

1. Compute GDP growth as the percentage change of GDP between two periods.
2. Compute inflation as the percentage change of the CPI between two periods.
3. Compute differences in the unemployment rate between two periods (this is measured in percentage points).

Note that you will need to drop the first row with missing observations. This can be done using `dropna()`.

Perform the following tasks using the data you just created:

1. Compute and report the correlation matrix for all three business cycle indicators. Which variables are particularly highly correlated?
2. Create pairwise scatter plots of all three business cycle indicators.
3. Perform a principal component analysis using `scikit-learn`'s PCA implementation.
4. Tabulate the loadings for each component.
5. Create a scree plot showing the fraction of variance explained by each component. How many components would one need to capture 90% of the sample variance?

9.4 Solutions

9.4.1 Solution for exercise 1

We generate the random sample as instructed:

```
[25]: import numpy as np

rng = np.random.default_rng(123)

K = 5
Nobs = 1000

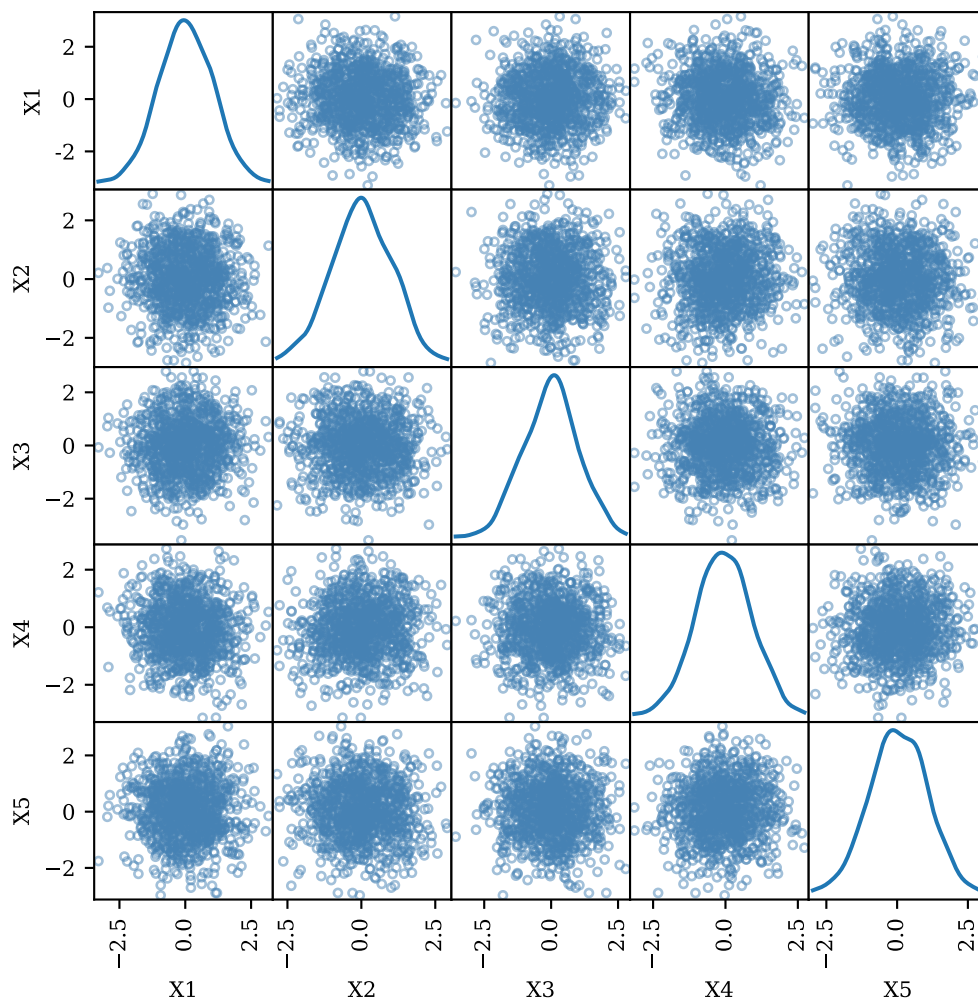
X = rng.normal(size=(Nobs, K))
```

We use the function `scatter_matrix()` provided in `pandas.plotting` to create pairwise scatter plots for all 5 variables. As can be seen, these variables look uncorrelated since this is how we constructed them in the first place.

```
[26]: from pandas.plotting import scatter_matrix

# Create temporary DataFrame for scatter plots
df = pd.DataFrame(X, columns=[f'X{i}' for i in range(1, K+1)])
```

```
_ = scatter_matrix(df, figsize=(6,6), diagonal='kde',
    edgcolor='steelblue', color='none', alpha=0.5)
```



To perform the principal component analysis, we use the `sklearn.decomposition.PCA` implementation. Note that `PCA.fit()` automatically centres the data (which is not needed here since it is already mean zero).

```
[27]: from sklearn.decomposition import PCA

pca = PCA()

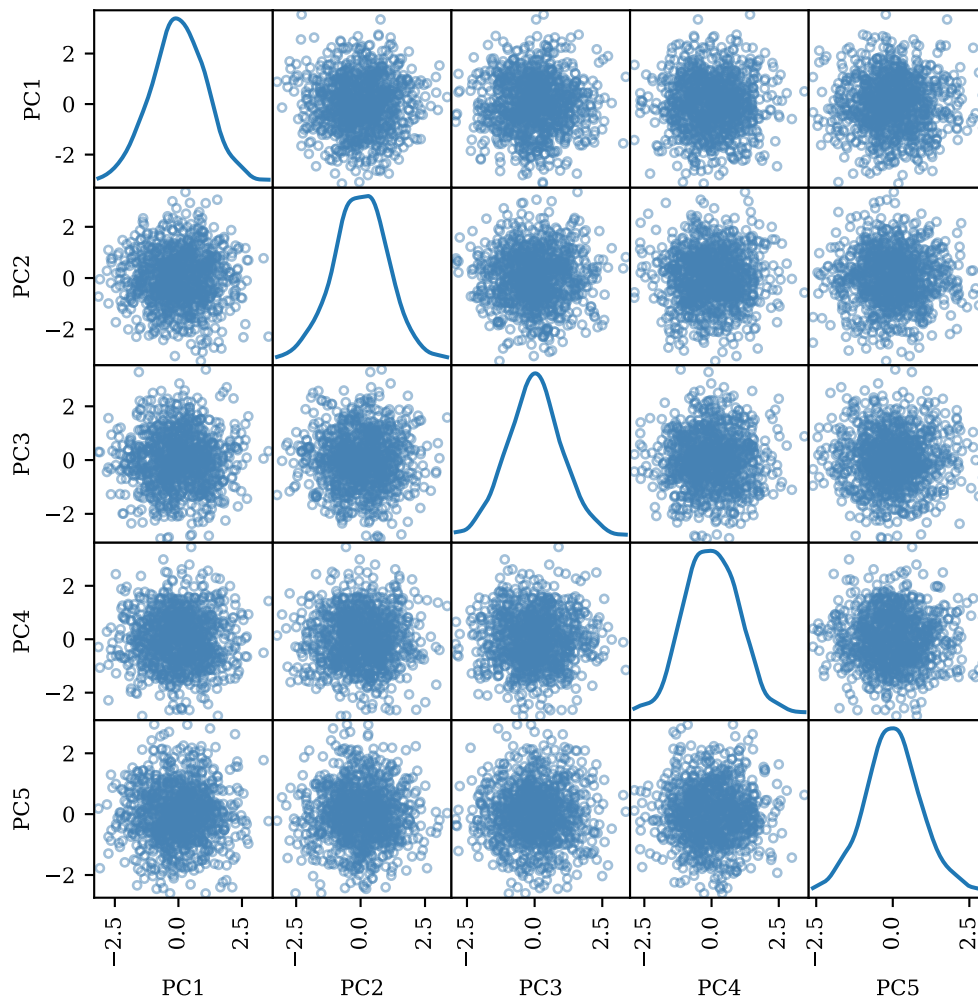
# Fit principal components, apply transformation to generate PCs
PC = pca.fit_transform(X)
```

As before, we use the `scatter_matrix()` function to create pairwise scatter plots of all principal components. Note that the principal components are uncorrelated by construction, even if the original data was correlated (which was not the case here).

```
[28]: from pandas.plotting import scatter_matrix

# Store PCs in DataFrame
df = pd.DataFrame(PC, columns=[f'PC{i}' for i in range(1, K+1)])

_ = scatter_matrix(df, figsize=(6,6), diagonal='kde',
    edgcolor='steelblue', color='none', alpha=0.5)
```

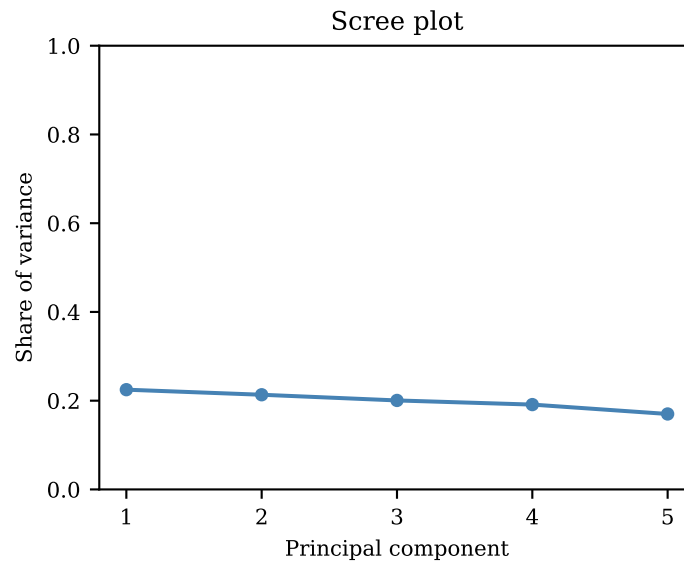



Lastly, we use the attribute `explained_variance_ratio_` to obtain the fraction of the variance captured by each individual principal component.

```
[29]: import matplotlib.pyplot as plt

# Create scree plot of explained variance for each component
xvalues = np.arange(1, K+1)
plt.plot(xvalues, pca.explained_variance_ratio_,
         marker='o', ms=4, c='steelblue')
plt.ylim((0.0, 1.0))
plt.xticks(xvalues)
plt.xlabel('Principal component')
plt.ylabel('Share of variance')
plt.title('Scree plot')
```

```
[29]: Text(0.5, 1.0, 'Scree plot')
```

As the plot shows, each principal component captures approximately the same share of variance. It therefore does not really make sense to apply dimensionality reduction to this data set, since all original variables were already uncorrelated.

9.4.2 Solution for exercise 2

We first load the CSV file and keep only the relevant columns GDP, CPI and UNRATE.

```
[30]: # Uncomment this to use files in the local data/ directory
DATA_PATH = '../data'

# Load data directly from GitHub
# DATA_PATH = 'https://raw.githubusercontent.com/richardfoltyn/MLFP-ECON5130/main/data'
```

```
[31]: import numpy as np
import pandas as pd

file = f'{DATA_PATH}/FRED_QTR.csv'

df = pd.read_csv(file, sep=',')

# Keep only columns of interest
df = df[['GDP', 'CPI', 'UNRATE']]

# Tabulate first 5 observations
df.head()
```

```
[31]:      GDP    CPI  UNRATE
0  2086.0  23.6    3.7
1  2120.4  24.0    3.7
2  2132.6  24.4    3.8
3  2135.0  24.2    3.8
4  2105.6  23.9    4.7
```

We apply the required transformations to obtain inflation from relative changes in CPI and the GDP growth from relative changes in GDP. We obtain changes in the unemployment rate (measured in percentage points) as a simple difference.

```
[32]: # Compute inflation
df['Inflation'] = df['CPI'].pct_change() * 100.0

# Compute GDP growth
df['GDP_growth'] = df['GDP'].pct_change() * 100.0

# Compute absolute change in unemployment rate
df['UNRATE_diff'] = df['UNRATE'].diff()
```

Next, we discard all other columns and drop observations with missing values using the `dropna()` method.

```
[33]: # Keep only (relative) changes, drop all other columns
variables = ['GDP_growth', 'Inflation', 'UNRATE_diff']
df = df[variables]

# Differences create missing values for first observation, drop these
df = df.dropna()
```

We compute the correlation matrix using the `corr()` method. The result shows that GDP growth is particularly (negatively) correlated with changes in unemployment, i.e., if the economy is growing, unemployment is going down. This is in line with economic intuition.

```
[34]: df.corr()
```

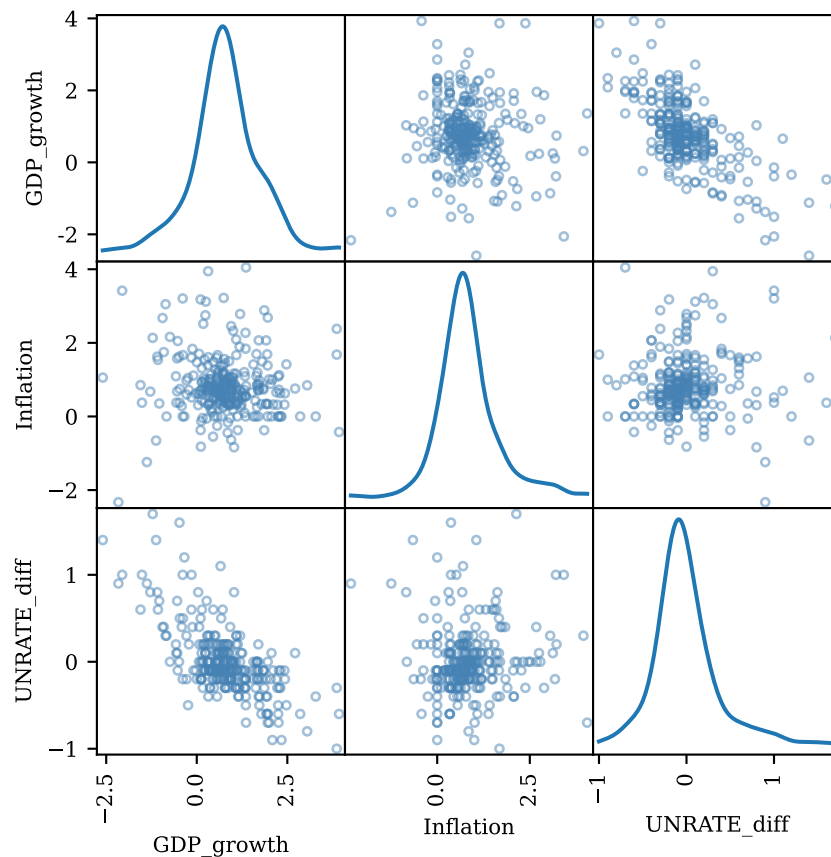
```
[34]:
```

	GDP_growth	Inflation	UNRATE_diff
GDP_growth	1.000	-0.065	-0.678
Inflation	-0.065	1.000	0.025
UNRATE_diff	-0.678	0.025	1.000

The pairwise scatter plots for all growth rates and relative changes can be obtained with `scatter_matrix()`, as usual.

```
[35]: from pandas.plotting import scatter_matrix

_ = scatter_matrix(df[variables], figsize=(5,5), diagonal='kde',
    edgecolor='steelblue', color='none')
```



We now perform the principal component analysis. To do this, we convert the DataFrame to a regular NumPy array.

```
[36]: from sklearn.decomposition import PCA

pca = PCA()

# perform PCA. Note that sklearn is programmed to work with NumPy arrays,
# so convert DataFrame to array
X = df.to_numpy()
pca.fit(X)
```

```
[36]: PCA()
```

The loadings for each principal component are obtained as follows. We see that the first PC load particularly strongly on (negative) GDP growth.

```
[37]: loadings = pca.components_.T * np.sqrt(pca.explained_variance_)

# Print pretty table with loadings
pd.DataFrame(loadings,
             columns=[f'PC{i}' for i in range(3)],
             index=variables,
             )
```

```
[37]:
```

	PC0	PC1	PC2
GDP_growth	-0.926	-0.112	0.080
Inflation	0.149	-0.785	0.003
UNRATE_diff	0.282	0.044	0.260

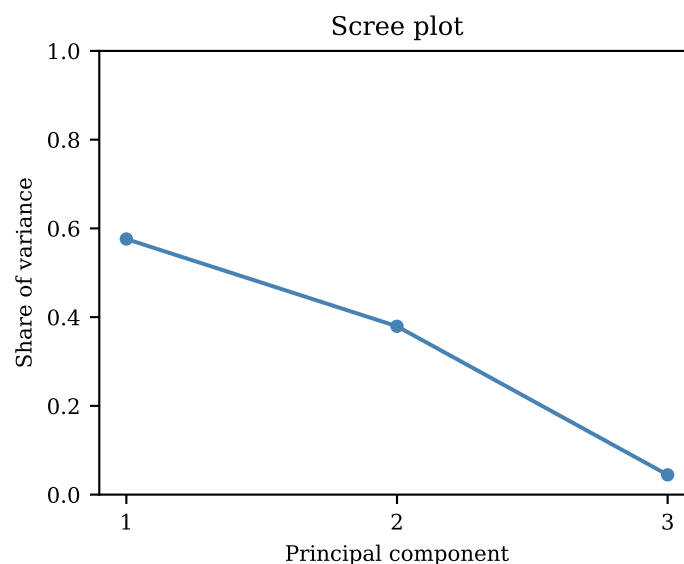
Lastly, we create the scree plot using the `explained_variance_ratio_` attribute. As you can see, the last principal component captures only a tiny fraction of the variance and could thus potentially be discarded.

```
[38]: import matplotlib.pyplot as plt

K = len(variables)
xvalues = np.arange(1, K+1)

# Create scree plot
plt.plot(xvalues, pca.explained_variance_ratio_,
         marker='o', ms=4, c='steelblue')
plt.ylim((0.0, 1.0))
plt.xticks(xvalues)
plt.xlabel('Principal component')
plt.ylabel('Share of variance')
plt.title('Scree plot')
```

```
[38]: Text(0.5, 1.0, 'Scree plot')
```



We can compute the cumulative variance explained by an increasing number of components as follows:

```
[39]: np.cumsum(pca.explained_variance_ratio_)
```

```
[39]: array([0.57606753, 0.9554459 , 1.         ])
```

To capture at least 90% of the variance, we only need the first two principal components.