In-sample Inference and Forecasting in Misspecified Factor Models

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December 9, 2015

Abstract

This paper considers in-sample prediction and out-of-sample forecasting in regressions with many exogenous predictors. We consider four dimension reduction devices: principal components, Ridge, Landweber Fridman, and Partial Least Squares. We derive the rate of convergence of the prediction error for two representative models: a mildly sparse model and an approximate factor model. The theory is developed for a large cross-section and a large time-series. We also propose data-driven selection methods based on cross-validation and establish their optimality. Monte Carlo simulations and an empirical application to forecasting inflation and output growth in the U.S. show that data-reduction methods outperform conventional methods in several relevant settings, and might effectively guard against instabilities in predictors’ forecasting ability.

Keywords: Forecasting, regularization methods, factor models, Ridge, partial least squares, principal components, sparsity, large datasets, variable selection, GDP forecasts, inflation forecasts.

J.E.L. Codes: C22, C52, C53.1

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