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Revisiting Targeted Factors

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Abstract

This paper proposes new methods for ‘targeting’ factors estimated from a big dataset. We suggest that forecasts of economic variables can be improved by tuning factor estimates so that both: (i) they are more relevant for a specific target variable, and (ii) so that variables with considerable idiosyncratic noise are down-weighted prior to factor estimation. Existing targeted factor methodologies are limited to estimating the factors with only one of these two objectives in mind. We therefore combine these ideas by providing new weighted Principal Components Analysis (PCA) procedures and a Targeted Generalized PCA (TGPCA) procedure. The TGPCA procedure additionally overcomes a problem identified by previous studies regarding the lack of invertability of the estimated idiosyncratic error variance-covariance matrix. We illustrate these methods in forecasting a range of U.S. macroeconomic variables, finding that our combined approach is important relative to competitors, consistently surviving elimination in the Model Confidence Set procedure.

JEL Classification: C13, C22, C38, C53

Keywords: Forecasting, factor estimation, targeted predictors, LASSO, data reduction

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1 Introduction

This paper revisits the idea of ‘targeting’ the factors estimated from a big dataset, when the purpose is to use the factors for economic forecasting. The principle of targeted factors is to down-weight or remove selected variables prior to factor estimation in order to improve the forecasts based on those factor estimates for a particular forecast variable of interest. This literature has evolved along two separate paths. On the one hand, Boivin and Ng (2006) suggested to down-weight variables which have noisy idiosyncratic variation as these can worsen the precision of factor estimates. On the other hand, Bai and Ng (2008) suggested to use LASSO-type methods to pre-select a subset of variables, targeted to a specific forecast variable, from which to estimate the factors. These are both in contrast with the seminal work of Stock and Watson (2002a,b) who suggest to use all available variables in the dataset, and weight these variables equally in the process of factor estimation. In this paper, we explore the idea that both types of targeting might be used together. We therefore propose methods which allow us to target the factor estimation procedure with both the forecast variable and the factor model properties in mind.

The first main contribution of this paper proposes a method to directly combine the existing methods of Bai and Ng (2008) and Boivin and Ng (2006) for targeting factors. Our approach uses elements of both of these methods to produce estimation weights for weighted Principal Components Analysis (PCA). The weight assigned to each variable depends both on its ability to predict a given forecast variable, and its properties with regards to idiosyncratic noise within the factor model structure. This method is implemented by first removing the weak predictor variables based on a LASSO-based selection procedure, as in Bai and Ng (2008), and then performing weighted PCA on the surviving variables. The implication of this method is that if there are two variables with similar predictive power for the forecast variable, but one is noisy and the other is not, then both variables will be retained for factor estimation, but the former will be down-weighted. This is not possible using either the methodologies of Bai and Ng (2008) or Boivin and Ng (2006) alone.

The second proposal we make is to extend the Bai and Ng (2008) method to use weighted PCA, rather than standard PCA, in order to reflect the rela-

tive strength of predictive power of different variables on the target variable. The existing approach of Bai and Ng (2008) uses the Elastic Net LASSO-based method of Zou and Hastie (2005) simply as a selection device and then estimates the factors using standard PCA by placing equal weight on the surviving variables which have non-zero Elastic Net coefficients. Similarly, the extension of Kim and Swanson (2014) uses bagging and boosting as a way to pre-select variables prior to using standard PCA. We suggest that, after the LASSO-based pre-selection phase, the coefficient values are retained and used as weights in performing weighted PCA, rather than discarding the magnitude of these coefficients.

We finally propose a method which uses the idea of targeting to allow the implementation of a Generalized Least Squares analogue to Principal Components Analysis. We call this Targeted Generalized Principal Components Analysis (TGPCA). The paper of Boivin and Ng (2006) first suggested a Generalized PCA procedure, but noted that this was not feasible because a typical estimator of the variance-covariance matrix of the idiosyncratic errors is of reduced rank and therefore not invertible. We overcome this limitation by suggesting a method which uses the LASSO-based pre-selection phase to reduce the dimension of the problem and select a subset of variables whose error variance-covariance matrix can be inverted. This method is therefore also a combination of the two types of targeting, and additionally lets us solve the problem found by Boivin and Ng (2006) regarding the Generalized PCA procedure.

We expect that these proposed methods will provide empirical forecasting improvements in a wide variety of situations. Previous empirical studies such as Schumacher (2010) and Eickmeier and Ng (2011) found that using the Bai and Ng (2008) method provided improvements over other forecasting methods. We envisage that using our combined method of targeting which also targets factors based on factor model performance may provide yet further improvements. On the other hand, other studies such as den Reijer (2012) and Castle et al. (2013) find less evidence in favour of the Bai and Ng (2008) targeting approach. It is possible that the results of these studies are adversely affected because the targeted predictor method retains variables which give noisy factor estimates. This point would be addressed by using our proposed methodologies.

To this end, we provide an empirical illustration of our proposed method-

ologies to forecasting a range of macroeconomic and financial variables in the U.S. based on the Stock and Watson (2002a,b) dataset. We compare these new methods to the existing targeted factor methodologies. As a preview of the results, we find that our combined targeted methodologies prove to perform better than all other methods in terms of the Mean Squared Forecast Error (*MSFE*) from a pseudo out-of-sample forecast experiment. We confirm this feature with evidence from the Model Confidence Set (MCS) procedure of Hansen et al. (2011).

The rest of the paper is organised as follows. Section 2 introduces the general framework for factor estimation which allows us to describe the spectrum of different targeted factor methodologies. We also provide a section detailing the limitations of existing methodologies. Section 3 outlines our new proposed methods for targeted factors. Section 4 describes the data, the different competing models we use, and the pseudo out-of-sample forecasting experiment. Section 5 provides the results. Finally, Section 6 concludes the paper.

2 Targeted Factors

In this section we introduce a general set-up which enables us to discuss the spectrum of existing approaches to targeted factors. We then give a review of the most important targeting methods, and conclude the section with a discussion of the limitations of existing methods, which we aim to address in this paper.

2.1 Set-up

In forecasting a target variable y_{t+h} at a forecast horizon $h > 0$, the literature of targeted factors is underpinned by the “diffusion index”, or factor-augmented forecasting model of Stock and Watson (2002a,b). This method assumes that a high-dimensional $N \times 1$ vector of candidate predictors X_t have a common factor structure:

$$X_t = \Lambda F_t + u_t \tag{1}$$

where F_t is an $r \times 1$ vector of unobserved factors, Λ is an $N \times r$ matrix of factor loadings and u_t is an $N \times 1$ vector of idiosyncratic error terms. The

diffusion index model uses the factors as predictors in the forecasting model instead of X_t as this performs substantial data reduction when $r \ll N$. The model can be written:

$$y_{t+h} = \beta' F_t + \varepsilon_{t+h} \quad (2)$$

Since the factors, F_t , are unknown, they must be estimated from the data in order to make forecasting using Equation (2) feasible. Stock and Watson (2002a,b) show that using standard Principal Components Analysis (PCA) gives consistent factor estimates up to a rotation of the true factors. Standard PCA estimates the $T \times r$ matrix of factors, F , as the r eigenvectors corresponding to the r largest eigenvalues of the $T \times T$ covariance matrix XX' , under the identifying normalization that $F'F/T = I$.

The idea of targeted factors is that we may wish to give more or less weight to certain variables in X_t when estimating the factors, in order to ‘target’ a specific scenario. At its most general, the estimation of targeted factors is a form of Generalized Principal Components Analysis (GPCA), solving the optimization problem:

$$\min_{\Lambda, F_1, \dots, F_T} \frac{1}{NT} \sum_{t=1}^T (X_t - \Lambda F_t)' W (X_t - \Lambda F_t) \quad (3)$$

subject to the identifying normalization $F'F/T = I$, and where W is an $N \times N$ weighting matrix whose form will be discussed throughout this paper. When W is data-dependent, it should be indexed by the panel dimensions as W_{NT} , though we drop these indices so as to simplify the notation. When $W = I$, this optimization coincides with standard PCA, and therefore standard PCA is merely a special case of the optimization procedure in Equation (3). In many of the approaches we will discuss, the weighting matrix W has the diagonal form:

$$W = \text{diag}(w)$$

where w is an $N \times 1$ vector of weights to be chosen by the researcher. The typical case of ‘targeting’ is when w only contains the values 1 and 0, and W is an inclusion matrix for performing standard PCA on a subset of the variables in X_t . In this case the estimation procedure reduces to Weighted Principal Components Analysis (WPCA), and the GPCA objective function

in Equation (3) can be rewritten as:

$$\min_{\Lambda, F_1, \dots, F_T} \frac{1}{NT} \sum_{i=1}^N w_i \sum_{t=1}^T (X_{it} - \lambda_i' F_t)^2 \quad (4)$$

where the $r \times 1$ matrix λ_i corresponds to the i th row of Λ . WPCA can be implemented easily by performing standard PCA using each of the series X_{it} , weighted by $w_i^{1/2}$. We now discuss the most important methods of choosing w suggested in the literature.

2.2 Targeting Forecast Model Predictors

Bai and Ng (2008) considered the idea that, if only a subset of variables in X_t are relevant in forecasting a particular variable y_{t+h} but the subset is still large enough to require factor-based methods, then we may improve forecasts by estimating the factors only using that subset of variables. In this way, we obtain different factor estimates targeted to a forecast variable of interest. This is in contrast to the classic diffusion index approach of Stock and Watson (2002a,b) which estimates the factors using all available data, and the factor estimates are the same for each forecast variable. Bai and Ng (2008) suggest to use penalized regression techniques as a pre-selection device to determine which variables are used for factor estimation. The use of penalized regressions is motivated by the high-dimensionality of many macroeconomic datasets where, in many cases, N is larger than T . The pre-selection phase uses a linear model in X_t :

$$y_{t+h} = \theta' X_t + \varepsilon_{t+h}$$

and an estimation procedure which uses a penalty function $p(\theta; \tau)$ to shrink the coefficients θ towards zero, with the severity of the penalty determined by tuning parameter(s), τ . The estimate of θ is the solution to the following penalized least squares problem:

$$\hat{\theta}(p, \tau) = \arg \min_{\theta} \left(\frac{1}{T} \sum_{t=1}^T (y_{t+h} - \theta' X_t)^2 + p(\theta; \tau) \right) \quad (5)$$

We index the estimator $\hat{\theta}$ by both p and τ to be clear that the estimator depends on the functional form of the penalty and the severity implied

by the tuning parameter(s) τ . Bai and Ng (2008) suggest to use LASSO-type penalty functions as these are able to shrink coefficients exactly to zero, thus performing model selection. The LASSO, proposed by Tibshirani (1996), uses the L_1 penalty with a single tuning parameter $\tau_1 > 0$ and penalty function $p(\theta; \tau_1) = \tau_1 \|\theta\|_1$. In practice, Bai and Ng (2008) found it to be more appropriate to use the Elastic Net penalty function of Zou and Hastie (2005), whose selection properties improve over the basic LASSO in situations of highly correlated variables. This method has a penalty function combining both the L_1 and L_2 norms with two tuning parameters, $\tau_1 > 0$ and $\tau_2 > 0$, such that $p(\theta; \tau_1, \tau_2) = \tau_1 \|\theta\|_1 + \tau_2 \|\theta\|^2$.

Using the Elastic Net estimates $\hat{\theta}(EN, \tau_1, \tau_2)$, Bai and Ng (2008) suggest to define a weight w_i^{EN} for each variable by assigning 1's and 0's according to those variables with non-zero coefficients, given τ_1 and τ_2 :

$$w_i^{EN} = \mathbf{1} \left\{ \hat{\theta}_i(EN, \tau_1, \tau_2) \neq 0 \right\} \quad (6)$$

where $\mathbf{1}\{\cdot\}$ is the indicator function. This amounts to running standard PCA on the subset of variables with non-zero Elastic Net coefficients. Bai and Ng (2008) find that using generalized cross-validation to select the tuning parameter, as suggested by Tibshirani (1996), gives a very small number of retained variables; too small for factor estimation. They instead opt to choose τ_1 in such a way which allows 30 variables to enter the targeted dataset for factor estimation, as they deem 30 as a small but appropriate number for factor estimation based on Monte Carlo simulation evidence. Selection of the 'top 30' is made simple by using the least angle regression (LAR) algorithm of Efron et al. (2004) which gives a full ordering of the X_t variables for a given y_{t+h} .

Subsequently, there has been significant interest in targeted predictors both from a methodological and an empirical perspective. Kim and Swanson (2014) expand on this approach by looking at a wider range of shrinkage methods such as bagging and boosting. Bulligan et al. (2015) adopt the targeted predictors approach of Bai and Ng (2008) but also suggest a second stage which uses a general-to-specific methodology in order to specify bridge equations from a large number of candidate predictors. In empirical studies, Schumacher (2010) and Eickmeier and Ng (2011) use factor models on big international datasets in forecasting German and New Zealand GDP

growth respectively, and report success of targeting relative to using the whole dataset. den Reijer (2012), however, finds no gains to pre-selection in forecasting Dutch GDP and inflation.

2.3 Targeting the Factor Model

Another approach to targeting was proposed by Boivin and Ng (2006), who suggested methods of down-weighting or eliminating variables with ‘noisy’ properties for factor estimation. Since Stock and Watson (2002a,b) show that consistency of PCA requires that the idiosyncratic components u_{it} are not too strongly correlated, Boivin and Ng (2006) suggest to down-weight such variables by using the analogue of Generalized Least Squares and setting the GPCA weighting matrix to be:

$$W^{GLS} = \Omega^{-1} \quad (7)$$

where Ω is the variance-covariance matrix of the vector of idiosyncratic errors u_t . However, they note that there is no feasible analogue to this problem, as the $N \times N$ estimator $\hat{\Omega}$ from an r -factor model is of rank $N - r$, and is not invertible. Therefore it is not feasible to use the GPCA procedure of Equation (3) with the weight matrix of Equation (7).

Boivin and Ng (2006) suggest several ways to overcome this. The first approach, which they call “Rule *SWa*”, suggests to take only the principal diagonal of the matrix $\hat{\Omega}$ and use the inverse of these elements to form a diagonal weight matrix with entries:

$$w_i^{SWa} = \hat{\Omega}_{ii}^{-1} \quad (8)$$

These weights are then used in the WPCA procedure described in Equation (4). Since this approach only uses the idiosyncratic variances, and not the covariances, they propose a second approach, “Rule *SWb*”, which gives a weight to variable i equal to the inverse of the average correlation of that idiosyncratic error with all other errors:

$$w_i^{SWb} = \left(\frac{1}{N} \sum_{j=1}^N |\hat{\Omega}_{ij}| \right)^{-1} \quad (9)$$

This procedure uses all of the estimated idiosyncratic variances and covariances, but it only weights the variances in the estimation procedure. They also consider another set of methods, “Rule 1” and “Rule 2”, specifying a binary 1/0 selection vector which drops series whose errors are most correlated with some other series.

Their results find that using estimated factors with these weighting schemes performs better in forecasting a wide range of U.S. economic series than the factors estimated using the full set of data series. Their results suggest that it may not be optimal to give equal weight to variables in factor estimation, and that it is not always optimal to use as many series as possible.

2.4 Limitations of Targeting Methods

The targeted factor methods described in the previous sections have been seen to provide improvements in empirical forecasting exercises. However, there are also shortcomings to these methods which we wish to address in this paper.

The targeted predictors method of Bai and Ng (2008), described in Section 2.2, attributes equal weight to a subset of variables by performing standard PCA on the predictors selected using a LASSO-type preliminary regression. This has two main limitations. Firstly, they use the LASSO regression only as a means of obtaining a binary 1/0 selection vector, meaning that the researcher loses information regarding the strength of prediction of each candidate predictor. If the aim is to produce factors which are targeted to a specific variable, it might be sensible to assign factor estimation weights which are proportional to the magnitude of the coefficient vector described in Equation (5). Secondly, this procedure does not assign weights which penalise large idiosyncratic variation for each variable. In this sense, the method of Bai and Ng (2008) misses out on the improvements of Boivin and Ng (2006).

On the other hand, the methods of Boivin and Ng (2006), outlined in Section 2.3, are also subject to some limitations. Firstly, due to the problem of non-invertability of $\hat{\Omega}$, the authors cannot implement a feasible GLS procedure for PCA and are restricted to rule-based schemes which, in their own words, implies “a certain ad hocness” to their methodology. Secondly, since this method penalises variables based on their properties in the factor

model and not the forecasting model, the factor estimates are the same for any variable to be forecast. Therefore it may be the case that the weighting scheme of Boivin and Ng (2006) gives small weight to a variable which is strongly related to a given forecast variable. In a similar way as before, the method of Boivin and Ng (2006) misses out on the improvements of Bai and Ng (2008).

In the next section we propose forecasting methodologies which overcome the limitations described in this section.

3 Methodology

3.1 Combined Targeted Principal Components Analysis

The first contribution of this paper is to provide procedures which combine the benefits of both Bai and Ng (2008) and Boivin and Ng (2006) by targeting the factors both with respect to the factor model *and* the forecast model. We additionally provide a method which allows researchers to choose how much to target factor estimation based on the factor model and the forecast model. This is not possible in the methodologies of Bai and Ng (2008) or Boivin and Ng (2006) which do one form of targeting but not both. We also relax the procedure of Bai and Ng (2008) so that the magnitude of the LASSO-type coefficients are used to give varying weights to each variable.

We first propose a method which combines the existing weighting schemes from the targeting methods of Boivin and Ng (2006) and Bai and Ng (2008) by forming weights for WPCA which are a product of the weights of both methods. From the definition of the weights w_i^{EN} , w_i^{SWa} and w_i^{SWb} in Equations (6), (8) and (9), we suggest combined weights w_i^1 and w_i^2 which combine w_i^{EN} respectively with w_i^{SWa} and w_i^{SWb} :

$$\begin{aligned} w_i^1 &= w_i^{EN} \times w_i^{SWa} \\ &= \mathbf{1} \left\{ \hat{\theta}_i(EN, \tau_1, \tau_2) \neq 0 \right\} \times \hat{\Omega}_{ii}^{-1} \end{aligned} \quad (10)$$

and

$$w_i^2 = w_i^{EN} \times w_i^{SWb}$$

$$= \mathbf{1} \left\{ \widehat{\theta}_i(EN, \tau_1, \tau_2) \neq 0 \right\} \times \left(\frac{1}{N} \sum_{j=1}^N |\widehat{\Omega}_{ij}| \right)^{-1} \quad (11)$$

The weights w_i^1 and w_i^2 have the dual effect of removing variables which are weak predictors for y_{t+h} while also down-weighting those variables whose idiosyncratic errors are noisy.

However, as mentioned in the previous section, it may be useful to retain information regarding the strength of predictive power of each variable for y_{t+h} . In other words, rather than using the indicator function as in Equation (6) and giving equal weights to the targeted variables in factor estimation, we may use the actual (absolute) values of $\widehat{\theta}(EN, \tau_1, \tau_2)$:

$$w_i^\theta = |\widehat{\theta}_i(EN, \tau_1, \tau_2)| \quad (12)$$

To combine this with the *SWa* and *SWb* methods of Boivin and Ng (2006), we suggest to use a Cobb-Douglas style function to calculate the weights, with a parameter α which controls the degree to which the researcher targets based on predictive ability or targets for the factor model:

$$\begin{aligned} w_i^3 &= \left(w_i^\theta \right)^\alpha \left(w_i^{SWa} \right)^{1-\alpha} \\ &= \left(|\widehat{\theta}_i(EN, \tau_1, \tau_2)| \right)^\alpha \left(\widehat{\Omega}_{ii}^{-1} \right)^{1-\alpha} \end{aligned} \quad (13)$$

and finally:

$$\begin{aligned} w_i^4 &= \left(w_i^\theta \right)^\alpha \left(w_i^{SWb} \right)^{1-\alpha} \\ &= \left(|\widehat{\theta}_i(EN, \tau_1, \tau_2)| \right)^\alpha \left(\left(\frac{1}{N} \sum_{j=1}^N |\widehat{\Omega}_{ij}| \right)^{-1} \right)^{1-\alpha} \end{aligned} \quad (14)$$

where $\alpha \in [0, 1]$ reflects the importance placed on targeting the factors to the forecast model as in Bai and Ng (2008), and therefore $1 - \alpha$ reflects the importance placed on targeting the factors to factor model performance. To the best of our knowledge, this is the first paper to allow researchers this flexibility. Note that this method still eliminates some of the variables prior to factor estimation as the Elastic Net method sets some of the weights exactly to zero. If we, instead, wished to retain all N variables in this

framework, we could instead use estimates from Ridge estimation which is a special case of the Elastic Net where $\tau_1 = 0$ in Equation (6). This would give all variables non-zero weight, with the weights being a combination of the two types of targeting.

3.2 Targeted Generalized Principal Components Analysis

Our second proposed methodology is an estimation procedure which we call Targeted Generalized Principal Components Analysis (TGPCA). In this method we attempt to solve the problem of non-invertability of $\hat{\Omega}$. This allows us use Generalized PCA, unlike in Boivin and Ng (2006).

To describe this method, we first of all introduce some notation. For the pre-selection stage with penalty function p and tuning parameter τ , let $\mathcal{M}(p, \tau)$ be the set of variables corresponding to non-zero coefficients in the estimator $\hat{\theta}(p, \tau)$:

$$\mathcal{M}(p, \tau) = \left\{ i : \hat{\theta}_i(p, \tau) \neq 0 \right\}$$

let $M(p, \tau)$ be the number of non-zero coefficients in the estimator $\hat{\theta}(p, \tau)$.¹

The Targeted Generalized Principal Components Analysis approach we suggest forms an $M \times M$ matrix $\hat{\Omega}(\mathcal{M})$, constructed by deleting the rows and columns for which $j \notin \mathcal{M}$ from the non-invertible matrix $\hat{\Omega}$. The dependence of M and $\mathcal{M}$ on p and τ is suppressed for notational convenience. The estimate $\hat{\Omega}$ can be obtained using the standard PCA estimates $\hat{u}_{it}$ as in Boivin and Ng (2006).

With the matrix $\hat{\Omega}(\mathcal{M})$, the estimation procedure for TGPCA is the following optimization:

$$\min_{\Lambda, F_1, \dots, F_T} \frac{1}{MT} \sum_{t=1}^T (X_t(\mathcal{M}) - \Lambda(\mathcal{M}) F_t)' \left[\hat{\Omega}(\mathcal{M}) \right]^{-1} (X_t(\mathcal{M}) - \Lambda(\mathcal{M}) F_t) \quad (15)$$

subject to $F'F/T = I$, where the $M \times 1$ vector $X_t(\mathcal{M})$ and the $M \times r$ matrix $\Lambda(\mathcal{M})$ are similarly equal to X_t and Λ with rows $j \notin \mathcal{M}$ removed.

Clearly this methodology combines the best aspects of both types of targeted factor methodologies. The reliance of the objective function on

¹Note that in Bai and Ng (2008) they choose $M = 30$ directly and select the tuning parameter by inverting the equation $30 = \#(i : \hat{\theta}_i(p, \tau) \neq 0)$

$\mathcal{M}$ means that only the most relevant variables for the target variable y_{t+h} are retained. Furthermore, the weighting matrix $\left[\widehat{\Omega}(\mathcal{M})\right]^{-1}$ gives lower weight to the variables with high idiosyncratic correlation. This results in the estimated factors being different for each forecast variable, but in a way which takes the properties of the factor model into account.

The most important implication, however, is that we can choose the tuning parameter τ (or equivalently M) in such a way that the matrix $\widehat{\Omega}(\mathcal{M})$ is invertible, by setting $M \ll N - r$. One difficulty is that, even if $M \ll N - r$, it is still possible that the matrix $\left[\widehat{\Omega}(\mathcal{M})\right]^{-1}$ has reduced rank and is not invertible. However, in practice this does not happen often, and this problem can be overcome by a simple algorithm which removes the row and column which gives the smallest minimum eigenvalue of the matrix.

Using this methodology, it is possible to weight both the variances and the covariances in the objective function, which is an improvement upon previous methodologies.

4 Data and Forecasting Methodology

We will perform a pseudo out-of-sample forecasting exercise to assess the relative forecasting performance of the methods proposed in Section 3, applied to a range of U.S. macroeconomic and financial variables. We will compare the performance of our methods to the existing targeted factor methodologies of Bai and Ng (2008) and Boivin and Ng (2006), described in Section 2, and the standard PCA procedure of Stock and Watson (2002a,b). In total we will analyse 10 different methods, each of which can be written in terms of the feasible factor-augmented regression analogue to Equation (2) with additional autoregressive components:

$$y_{t+h} = \beta' \widehat{F}_t + \alpha(L) y_t + \varepsilon_{t+h} \quad (16)$$

where $\alpha(L)$ is the lag operator. We will consider as a benchmark the autoregressive model which has $\beta = 0$. For the remainder of the models we will use factor-augmented regressions where the factors $\widehat{F}_t$ are estimated by the different methods mentioned above. The 10 models are summarized in Table 1.

[Insert Table 1 here]

It is important to note that, of the factor-based models PCA through to Method 5 in Table 1, each of these will produce different factor estimates. Furthermore, due to the type of targeting, LA(PC) and Methods 1 through 5 will produce a different (‘targeted’) set of factors for each forecast variable. In contrast, the factors are the same for each forecast variable for models PCA, SWa and SWb.

We will forecast a range of U.S. macroeconomic and financial variables taken from the Stock and Watson (2002a,b) dataset. This dataset was extended by Kim and Swanson (2014)² and contains monthly observations on 144 variables, for which we use the observations from 1964:M1 to 2009:M7. The forecast variables we are interested in are: the consumer price index (CPI), the producer price index (PPI), total employees on non-farm payrolls, the index of total industrial production (IP), the S&P 500 index and the 10-year treasury bills rate.

For the pseudo out-of-sample forecasting exercise, we split the sample into $T = R + P - 1$, where R is the estimation sample size and we make P pseudo out-of-sample forecasts. After taking lags of the dependent variable for the direct forecasting scheme we have $T = 545$ observations and we let $R = 246$ so that $P = 300$ forecasts are made for 25 years over the period 1984:M6 to 2009:M5. We use the rolling scheme as in Kim and Swanson (2014), so that the estimation window length is held fixed at R in each pseudo out-of-sample horizon. This means that at the first horizon we use data from $1 : R$, make a forecast of $R + h$, and in the second horizon we use data from $2 : R + 1$, make a forecast of period $R + h + 1$ and so on. Since this sample spans the year 1984, which is seen by many as a structural break point coinciding with the start of the “Great Moderation”, we will also run results where we only estimate using data post-1984. This is motivated by studies of Breitung and Eickmeier (2011) and Stock and Watson (2009) who find evidence of factor loading instability around these dates.

For all variables we will use the cumulative h period growth for the dependent variable using the logarithmic transformation $y_{t+h} = 100 (\log(Y_{t+h}) - \log(Y_t))$, with the exception of the 10-year Treasury Bill where we specify $y_{t+h} = (Y_{t+h} - Y_t)$. We will focus on the one-year ahead forecast horizon with

²We thank these authors for making their data available to us.

$h = 12$. Regarding model specification, we will set the number of autoregressive lags at $p = 6$ in line with other studies, and set the number of factors equal to that chosen by the BIC_3 criterion of Bai and Ng (2002). We keep these parameters fixed rather than re-estimating them at each horizon as this facilitates the use of a Diebold-Mariano type testing procedure. Finally, for the Elastic Net parameters used in the LA(PC) method of Bai and Ng (2008) and all of our competing Methods 1-5 in Table 1, we use $M = 30$ variables and fix the L_2 tuning parameter at $\tau_2 = 0.5$. Since Bai and Ng (2008) report that their results are not sensitive to the choice of τ_2 , this is not scrutinised further. Also for the α parameter in Methods 3 and 4, we choose $\alpha = 1/2$ so that the variables are weighted or down-weighted equally in terms of their prediction and idiosyncratic noise.

The metric we use to compare forecasts is the mean squared forecast error (*MSFE*) loss function. For each model i , the pseudo out-of-sample forecast experiment gives rise to a string of P pseudo out-of-sample forecasts $\hat{\varepsilon}_{t+h}(i) = y_{t+h} - \hat{y}_{t+h}(i)$. The *MSFE* for this model is estimated as the average of the squared forecast errors:

$$MSFE(i) = \frac{1}{P} \sum_{t=R}^T \hat{\varepsilon}_{t+h}(i)^2$$

To facilitate comparison across models, we will report the *MSFE* measure only for the autoregressive model, and for all other models we report the relative *MSFE*:

$$RMSFE(i) = \frac{MSFE(i)}{MSFE(AR)}$$

for $i = 2, \dots, 10$. A value of $RMSFE(i)$ less than 1 indicates that model i has lower *MSFE* than the AR model.

It is important to assess the statistical significance of these differences in *MSFE*. In order to do this we will use tests similar to those of Diebold and Mariano (1995) and West (1996). However, since we have multiple models under consideration, we control for the multiple testing problem by using the Model Confidence Set (MCS) approach of Hansen et al. (2011). The MCS procedure aims to ‘estimate’ the best set of models $\mathcal{M}^*$ from the total set of alternative models $\mathcal{M}^0$, which in our case contains 10 members. The procedure starts with all 10 models and eliminates the worst models, according to rejection of the null hypothesis of equal predictive ability using the

Diebold-Mariano test, until it arrives at a set $\widehat{\mathcal{M}}^*$. The main contribution of Hansen et al. (2011) is that they provide conditions under which it can be shown that $\lim_{n \rightarrow \infty} \mathbb{P}(\mathcal{M}^* \subset \widehat{\mathcal{M}}^*) \leq 1 - \alpha$, where α is the significance level of each of the tests.

It is possible that our various models are nested to some degree, as they all use factor estimates which should converge to the same true factors. However, we feel that use of this procedure is still justified as it was used for similar models in the empirical application of Hansen et al. (2011). The performance of the MCS procedure based on test statistics involving estimated factors remains an open research question which we leave for future work. To implement the test, we use the R package `MCS`, written by Bernardi and Catania (2014).

5 Results

Table 2 presents the results for the pseudo out-of-sample forecasting experiment described in the previous section. These results are based on the rolling estimation procedure using the full dataset from 1964 to 2009. From these results a few key findings emerge. The first main finding is that one of our proposed Methods 1-4 yields the lowest *MSFE* for all of the variables considered. While the ‘best’ method is not the same for all of the variables, it can be seen that Methods 2 and 4 are the only ones of all methods considered which beat the AR model for every forecast variable. While the LA(PC) method of Bai and Ng (2008) also performs relatively well, our proposed Method 4 beats LA(PC) in all but one case. This means that there appears to be improvement in our combined targeting approach over the Bai and Ng (2008) approach, which only targets the factors for their predictive properties.

On the other hand, the standard PCA factor estimation method, methods SWa and SWb of Boivin and Ng (2006), and our proposed Method 5 do not provide an improvement over the AR benchmark in any of the 6 cases. These results imply that in terms of forecasting, it appears to be more important to use factors which change with each dependent variable. This is in contrast to the methods PCA, SWa and SWb which give the same factor estimates regardless of the forecast variable, and do not perform as well.

The *MSFE* improvements over the naïve AR benchmark model are at

their largest for forecasting CPI inflation, producer prices and employment. In the case of employment this gain is as large as 26%, and for CPI and PPI this difference is 17% and 12% respectively. For the remaining three variables, the gain is less than 10% over the AR model for the best performing method.

[Insert Table 2 here]

Table 2 also provides the results for the Model Confidence Set at both the 90% and 75% levels, which are the levels used by Hansen et al. (2011). These results confirm the strong performance of our newly proposed methods with regards to statistical significance. For each dependent variable, one of Methods 1 to 4 is included in the MCS. On the other hand, the methods which are most frequently eliminated from the MCS are the SWa and SWb methods of Boivin and Ng (2006). This appears to confirm that targeting factor estimation only for factor model properties does not yield significant forecast improvements. For employment, IP and S&P 500, the MCS is populated with a rather large number of models, which includes the naïve AR model. This indicates that there is little information contained in any of the models for forecasting those variables. The MCS for CPI, PPI and the 10 year Treasury Bill is a singleton in each case, containing respectively Method 3, 4 and 1. This shows that it is important to target the factor estimates both for the forecast variable and the factor model properties.

We also present the results from re-running the analysis only using post-1984 data. This involves using $T+h = 293$ observations and we set $R = 132$ and $P = 162$ so as to have a similar fraction P/R as in the full-sample case. The results for this sample split are displayed in Table 3.

[Insert Table 3 here]

In these post-1984 results, many of the key features remain unchanged relative to the full-sample results. The best model for each forecast variable in terms of $MSFE$ is one of the newly proposed Methods 2 or 4, with the exception of the 10-year Treasury Bills variable. Each of Methods 2, 4 and LA(PC) improve over the AR model in 5 of the 6 forecast variables. Once

again, the standard PCA method, along with SWa and SWb of Boivin and Ng (2006) are among the worst-performing models. We see that in the case of IP, S&P 500 and Treasury Bills, however, that the Model Confidence Set procedure fails to eliminate even a single model, which means that none of the methods provide much useful information. On the other hand, for CPI, PPI and Employment, the only methods which survive elimination are either LA(PC) or Methods 1 through 4. This, again, indicates that there is merit in targeting factor estimates to a particular forecast variable, and that our methods which additionally target for factor model properties perform strongly.

Overall, the conclusions we draw from these results is that the best performing methods in most cases tends to be our proposed methods which advocate targeting factors both for the forecast variable and for factor model properties. We proposed 4 methods which were successful at forecasting (Method 5 did not seem to be successful), in the sense that these had the lowest *MSFE* in all but one case. Since no single method of the 4 was always the ‘winner’, one might consider averaging the forecasts from these methods. On the other hand, care should be taken in using these conclusions in forecasting financial variables such as stock prices and treasury bill yields.

6 Conclusion

In this paper we have proposed new methods of targeting factor estimates from big datasets for use in economic forecasting. We suggest that factor-based forecasts may be improved if we adjust factor estimation to up-weight the variables which are strong predictors for the target forecast variable, and down-weight variables which are noisy and may worsen the precision of factor estimates. This is in contrast to existing methods like Bai and Ng (2008) and Boivin and Ng (2006) which are only capable of adjusting factor estimates for one of these two purposes. In Section 3 we presented new weighted Principal Components Analysis procedures where the weights reflected both of these two targeting ideas. We also proposed a Targeted Generalized PCA procedure which allowed us to overcome the problem of feasible Generalized PCA in non-targeted cases in which the idiosyncratic error variance-covariance matrix is not invertible.

We applied our new forecasting methodologies to a wide range of U.S.

macroeconomic and financial variables, in a pseudo out-of-sample context. We find strong evidence that our proposed methods work better than competing targeted factor methods, and non-targeted methods. Particularly in forecasting variables like CPI inflation, we find that our methods outperform other candidate methods, as evidenced by their survival in the Model Confidence Set procedure of Hansen et al. (2011). Future work would apply these methods to a wider range of variables and countries, to determine whether or not they may also be useful in situations other than forecasting the U.S. economy.

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7 Tables

Table 1: Description of Forecasting Methods

Forecasting Method	
AR	Autoregressive Model
PCA	Standard PCA - Stock and Watson (2002a,b)
LA(PC)	Targeted PCA - Bai and Ng (2008)
SWa	Weighted PCA - Boivin and Ng (2006) SWa
SWb	Weighted PCA - Boivin and Ng (2006) SWb
Method 1	Weighted PCA - Weights w_i^1 in Equation (10)
Method 2	Weighted PCA - Weights w_i^2 in Equation (11)
Method 3	Weighted PCA - Weights w_i^3 in Equation (13)
Method 4	Weighted PCA - Weights w_i^4 in Equation (14)
Method 5	Targeted Generalized PCA

Table 2: Pseudo Out-of-Sample Forecasting Results - Full Sample

	CPI	PPI	Employment	IP	S&P 500	10 Year T-Bill
<i>MSFE</i>						
AR	1.85	7.35	1.98**	12.04*	334.71**	1.56
Relative <i>MSFE</i>						
PCA	1.10	1.08	1.01**	1.16	1.11**	1.02
LA(PC)	0.84	0.92	0.77**	0.95**	1.02**	0.98
SWa	1.05	1.06	1.09	1.23	1.11**	1.03
SWb	1.08	1.05	1.04**	1.18	1.11**	1.03
Method 1	0.96	1.02	0.94**	1.06	1.04**	0.90**
Method 2	0.88	0.89	0.74**	0.95**	0.91**	0.91
Method 3	0.83**	0.94	0.78**	0.97**	1.01**	0.93
Method 4	0.91	0.88**	0.74**	0.91**	0.86**	0.91
Method 5	1.18	1.13	1.04**	1.11	1.11**	1.07

Notes: For the AR model, the *MSFE* is reported. This *MSFE* is used to calculate the Relative *MSFE* reported for the remaining models, as described in the text. Description of each of the 10 forecasting methods are provided in Table 1. The forecasts in the sets $\widehat{\mathcal{M}}_{90\%}^*$ and $\widehat{\mathcal{M}}_{75\%}^*$ are denoted * and ** respectively.

Table 3: Pseudo Out-of-Sample Forecasting Results - Post-1984

	CPI	PPI	Employment	IP	S&P 500	10 Year T-Bill
<i>MSFE</i>						
AR	1.35	8.02	2.13	16.84**	458.31**	0.66**
Relative <i>MSFE</i>						
PCA	1.23	1.19	0.75	0.99**	1.10**	1.19**
LA(PC)	0.93	0.79**	0.54**	0.55**	0.98**	1.40**
SWa	1.29	1.25	0.76	0.97**	1.13**	1.22**
SWb	1.25	1.22	0.74	0.95**	1.11**	1.20**
Method 1	1.04	0.98	0.54**	0.63**	1.01**	1.32**
Method 2	0.87	0.79**	0.51**	0.47**	0.79**	1.34**
Method 3	0.96	0.85**	0.55**	0.58**	0.97**	1.28**
Method 4	0.86**	0.73**	0.55**	0.44**	0.75**	1.21**
Method 5	1.21	1.11	0.65	0.85**	1.09**	1.22**

Notes: Results are run using data post-1984. For the AR model, the *MSFE* is reported. This *MSFE* is used to calculate the Relative *MSFE* reported for the remaining models, as described in the text. Description of each of the 10 forecasting methods are provided in Table 1. The forecasts in the sets $\widehat{\mathcal{M}}_{90\%}^*$ and $\widehat{\mathcal{M}}_{75\%}^*$ are denoted * and ** respectively.