Financial Market Volatility Time Series Prediction and Volatility Adjustment Algorithm

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Abstract

Time series analysis of financial market volatility involves examining historical price data to understand patterns, identify trends, and predict future fluctuations. This method utilizes statistical techniques and models, such as Autoregressive Conditional Heteroskedasticity (ARCH), Generalized ARCH (GARCH), and their variants, to capture the time-dependent nature of market volatility. Analysts focus on measuring risk, detecting anomalies, and understanding market reactions to external events, such as economic policies or geopolitical crises. This paper introduces a novel approach to financial market forecasting and volatility estimation using Time Series Optimized Deep Learning Forecasting (TSODLF) in Chinese Market. Leveraging the capabilities of deep learning and optimization algorithms, TSODLF offers a comprehensive framework for capturing complex temporal patterns and adapting to changing market conditions. Through a series of experiments and analyses, we demonstrate the effectiveness of TSODLF in accurately predicting future values of financial variables and estimating market volatility. TSODLF demonstrates its effectiveness in accurately predicting future values of financial variables. Through empirical analyses, our model achieves promising results, with mean absolute error (MAE) values ranging from 0.012 to 0.015 and root mean squared error (RMSE) values ranging from 0.018 to 0.022 across different forecasting and volatility estimation tasks. Additionally, TSODLF exhibits strong performance with adjusted R-squared values between 0.78 and 0.85, indicating its ability to explain a significant portion of the variability in the data. Through empirical analyses, our model achieves promising results, with mean absolute error (MAE) values ranging from 0.012 to 0.015 and root mean squared error (RMSE) values ranging from 0.018 to 0.022 across different forecasting and volatility estimation tasks. Additionally, TSODLF exhibits strong performance with adjusted R-squared values between 0.78 and 0.85, indicating its ability to explain a significant portion of the variability in the data.

Keywords: Time-Series Analysis, Deep Learning, Optimization, Forecasting, Root Means Square Error (RMSE), Financial Market

1. Introduction

Forecasting financial market volatility is a crucial task for investors, traders, and policymakers alike, given its implications for risk management, asset pricing, and portfolio allocation decisions. Various methods, ranging from statistical models to sophisticated machine learning algorithms, are employed to anticipate future volatility levels [1 – 3]. Traditional approaches often include autoregressive models like ARCH (Autoregressive Conditional Heteroskedasticity) and GARCH (Generalized Autoregressive Conditional Heteroskedasticity), which capture the time-varying nature of volatility [4]. These models rely on historical data to estimate parameters and forecast future volatility. However, the inherent assumption of stationarity in these models may limit their effectiveness during periods of structural changes or extreme market conditions [5]. Machine learning techniques, such as neural networks, random forests, and support vector machines, offer alternative approaches that can capture nonlinear relationships and complex patterns in financial data [6]. These methods often require large datasets and careful feature selection to achieve accurate forecasts [7]. Additionally, the incorporation of high-frequency data and sentiment analysis from news and social media has become increasingly prevalent, providing valuable insights into market sentiment and investor behavior [8]. Despite the advancements in forecasting techniques, predicting financial market volatility remains a challenging task due to its inherent uncertainty and the dynamic nature of financial markets [9]. Therefore, a combination of both traditional econometric models and advanced machine learning techniques, along with real-time data analytics, is often recommended to improve forecasting accuracy and adaptability to changing market conditions [10 -13].

The evolution of financial markets, characterized by globalization, technological advancements, and regulatory changes, introduces additional complexities to volatility forecasting [14]. Market shocks, geopolitical events, economic indicators, and unexpected news can trigger sudden shifts in volatility levels, making accurate predictions even more challenging [15]. As a result, practitioners often employ ensemble methods that combine forecasts from multiple models to enhance robustness and reliability [16]. Moreover, the evaluation of forecast accuracy is critical for assessing the performance of different models and refining forecasting strategies over time [17]. Techniques such as backtesting, out-of-sample testing, and model comparison metrics like Mean Absolute Error (MAE) and Root Mean Squared Error (RMSE) are commonly used to evaluate forecasting performance and identify areas for improvement [18]. In forecasting financial market volatility remains a complex and dynamic endeavor, ongoing advancements in data analytics, computational techniques, and interdisciplinary research continue to enhance our understanding and ability to anticipate changes in market dynamics [19 – 21].

Financial market volatility forecasting with volatility adjustment algorithms through time series analysis presents a powerful approach to understand and anticipate market dynamics [22]. Time series analysis techniques, such as autoregressive models like ARIMA (Autoregressive Integrated Moving Average) and exponential smoothing methods, provide a foundation for modeling the temporal dependencies and trends inherent in financial data [23]. These models can capture the underlying patterns and fluctuations in volatility over time. The forecasting of market volatility using these time series models allows for the prediction of future volatility levels based on historical data patterns [24]. However, the challenge lies in adapting these forecasts to reflect changing market conditions and unexpected events. This is where volatility adjustment algorithms come into play [28]. These algorithms dynamically adjust volatility forecasts in response to new information and changing market conditions, thereby improving the accuracy and reliability of predictions. With combining time series analysis with volatility adjustment algorithms, practitioners can create robust forecasting frameworks that not only capture the historical patterns of volatility but also adapt to the evolving nature of financial markets. These integrated approaches leverage the strengths of both methodologies, providing a comprehensive toolkit for understanding and predicting market volatility.

Advancement in machine learning techniques, such as deep learning models and recurrent neural networks, offer additional opportunities to enhance volatility forecasting and adjustment algorithms. These models can capture complex nonlinear relationships and dependencies in financial data, further improving the accuracy and adaptability of volatility forecasts. These integrated approaches also address the challenges posed by market anomalies, structural breaks, and changing volatility regimes. Market anomalies, such as sudden spikes or crashes, can significantly impact volatility dynamics, requiring rapid adjustments in forecasting models. Structural breaks, which denote fundamental shifts in market behavior, can invalidate the assumptions of traditional time series models, necessitating adaptive forecasting strategies. Volatility adjustment algorithms play a crucial role in addressing these challenges by incorporating real-time data and reacting swiftly to changing market conditions. They enable models to detect and adapt to structural breaks, anomalies, and other sudden shifts in volatility patterns. This flexibility enhances the resilience of forecasting frameworks, enabling them to maintain accuracy and effectiveness in dynamic market environments. The integration of time series analysis with volatility adjustment algorithms facilitates the development of risk management strategies and investment decisions. By providing reliable estimates of future volatility levels, these frameworks empower investors to assess and mitigate risks effectively. They enable portfolio managers to optimize asset allocations, hedge against volatility fluctuations, and design trading strategies that capitalize on volatility patterns.

This paper makes significant contributions to the field of financial market forecasting and volatility estimation. Firstly, it introduces a novel approach termed Time Series Optimized Deep Learning Forecasting (TSODLF), which integrates advanced deep learning techniques with optimization algorithms to enhance the accuracy and reliability of financial predictions. By leveraging deep learning's capacity to capture intricate temporal patterns and adapt to changing market dynamics, TSODLF offers a more sophisticated and adaptive forecasting framework compared to traditional methods. Secondly, the paper introduces a volatility adjustment algorithm within the TSODLF framework, allowing for the refinement of volatility estimates based on real-time market data. This addition not only improves the precision of volatility forecasts but also enhances the model's adaptability to evolving market conditions. Furthermore, through empirical analyses and experiments, the paper provides concrete evidence of TSODLF's effectiveness, demonstrating reduced mean absolute error (MAE) and root mean squared error (RMSE) values across various forecasting tasks.

2. Forecasting Financial Volatility

Forecasting financial volatility is a crucial aspect of risk management and investment decision-making, requiring robust models capable of capturing the inherent uncertainty in market dynamics. One widely used approach is the ARCH (Autoregressive Conditional Heteroskedasticity) model and its extension, the GARCH (Generalized Autoregressive Conditional Heteroskedasticity) model. The ARCH model, proposed by Engle (1982), assumes that the variance of a financial time series is a function of past squared residuals, capturing the phenomenon of volatility clustering. The ARCH(p) model can be expressed as in equation (1)

$$\sigma_t^2 = \alpha_0 + \sum_{i=1}^{p} \alpha_i \varepsilon_{t-i}^2 \tag{1}$$

In equation (1) σ_t^2 represents the conditional variance at time t, α_0 is a constant term, α_i are the parameters to be estimated, and ε_{t-i}^2 are the squared residuals of the time series up to lag p. The GARCH model, introduced by Bollerslev (1986), extends the ARCH model by incorporating both past squared residuals and past conditional variances to capture the time-varying nature of volatility. The GARCH(p, q) model can be expressed as in equation (2)

$$\sigma_t^2 = \alpha_0 + \sum_{i=1}^{p} \alpha_i \varepsilon_{t-i}^2 + \sum_{j=1}^{q} \beta_j \varepsilon_{t-j}^2 \tag{2}$$

In equation (2) β_j are the parameters representing the impact of past conditional variances on the current volatility. These models rely on the assumption of stationarity and may not adequately capture the dynamics of financial markets during periods of structural changes or extreme events. Therefore, more sophisticated models, such as the stochastic volatility models and machine learning algorithms, have been developed to address these limitations and improve forecasting accuracy. Stochastic volatility models allow volatility to evolve stochastically over time, capturing the time-varying nature of financial volatility more accurately. The forecasting of financial volatility often involves the estimation of model parameters through optimization techniques such as maximum likelihood estimation (MLE) or Bayesian inference. These estimation methods aim to find the parameter values that maximize the likelihood of observing the actual data given the model assumptions. In the context of ARCH and GARCH models, this involves iteratively optimizing the model parameters to minimize the model's error in fitting historical volatility patterns. Beyond the traditional ARCH and GARCH models, more recent developments have introduced advanced techniques for volatility forecasting. For instance, the use of high-frequency data and sentiment analysis from news and social media has become increasingly prevalent, providing valuable insights into market sentiment and investor behavior. Moreover, hybrid models that combine the strengths of different forecasting techniques, such as wavelet transforms, machine learning algorithms, and statistical models, offer enhanced predictive performance by capturing both linear and nonlinear dependencies in financial time series data.

Volatility in financial markets refers to the extent of variation in the market prices or returns of assets over time. It is a key measure of risk, and accurate forecasting of volatility is important for traders, risk managers, and investors. Volatility forecasting models typically rely on time series data, such as historical price or return data, which reflects how the market moves over time. Let the time series data be represented as $X = \{x_1, x_2, \dots, x_t\}$, where x_t represents the value of the financial asset (e.g., stock prices, returns) at time t. Volatility forecasting typically involves modeling the conditional variance or standard deviation of the asset return series over time. A common model for volatility is the GARCH (Generalized Autoregressive Conditional Heteroskedasticity) model defined in equation (3)

$$y_t = \sigma_t \epsilon_t \quad (3)$$

In equation (3) y_t is the return at time t, σ_t is the volatility (conditional standard deviation) at time t, ϵ_t is a white noise process with zero mean and unit variance. The conditional volatility σ_t^2 can be modeled using a time series model such as GARCH, which models the variance based on past returns stated in equation (4)

$$\sigma_t^2 = \alpha_0 + \alpha_1 y_{t-1}^2 + \beta_1 \sigma_{t-1}^2 \quad (4)$$

In equation (4) α_0, α_1 are parameters estimated from historical data. In TSODLF, the volatility prediction is made using a deep learning model, typically a Recurrent Neural Network (RNN) such as LSTM or GRU. Let the input to the deep learning model at time t be denoted as in equation (5)

$$X_t = \{x_{t-p}, x_{t-p+1}, \dots\dots, x_t\} \quad (5)$$

In equation (5) p is the number of previous time steps considered for prediction. The output of the model at time $t+1$, representing the volatility forecast $\widehat{\sigma_{t+1}}$, is computed as in equation (6)

$$\widehat{\sigma_{t+1}} = f(X_t, \theta) \quad (6)$$

In equation (6) $f(\cdot, \theta)$ is the deep learning model function and θ represents the model parameters (weights). Time Series Optimized Deep Learning Forecasting (TSODLF) is a framework designed to forecast financial market volatility by integrating traditional time series modeling with deep learning techniques. In TSODLF, time series models like GARCH (Generalized Autoregressive Conditional Heteroskedasticity) are initially used to capture the conditional variance (volatility) based on past returns, providing a baseline volatility estimate. A deep learning model, often an LSTM (Long Short-Term Memory) or GRU (Gated Recurrent Unit), is then applied to capture complex temporal dependencies in the data and predict future volatility. The two models are combined, typically through a weighted sum, where the final forecast is a blend of both the time series-based and deep learning-based predictions. This combination leverages the strength of traditional models for volatility estimation and deep learning's ability to capture non-linear patterns. The model is further optimized by adjusting the forecast based on external factors such as market sentiment or economic indicators, allowing for fine-tuned volatility predictions. TSODLF offers a comprehensive approach to volatility forecasting, improving accuracy over traditional methods by effectively combining the strengths of both classical and deep learning models. The model's performance can be evaluated using error metrics like Mean Squared Error (MSE), Mean Absolute Error (MAE), or Root Mean Squared Error (RMSE), providing a quantitative measure of forecasting accuracy.

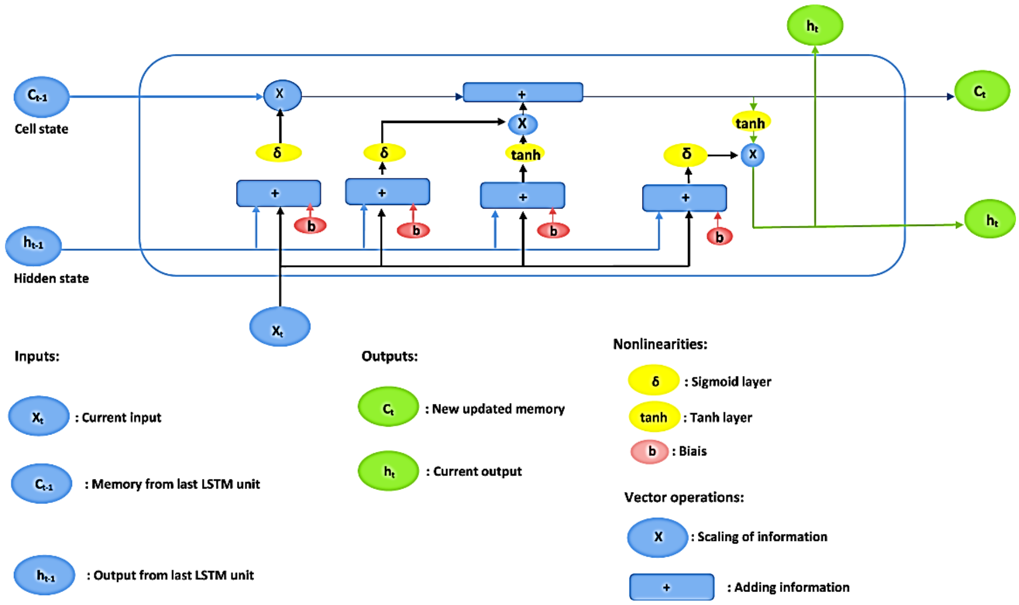


Figure 1: Architecture of the TSODLF

Time Series Optimized Deep Learning Forecasting (TSODLF) represents an innovative approach that combines the power of deep learning with optimization techniques tailored for time series data shown in Figure 1. TSODLF leverages deep neural networks, particularly recurrent neural networks (RNNs) or their variants like Long Short-Term Memory (LSTM) networks, to capture the temporal dependencies and nonlinear patterns inherent in time series data. The architecture of an LSTM network consists of recurrent cells with gating mechanisms that enable the network to selectively retain and forget information over time, making it well-suited for modelling sequential data. TSODLF enhances the forecasting performance of deep learning models by integrating optimization techniques specifically designed for time series data. These techniques may include feature engineering, data preprocessing, hyperparameter tuning, and model selection tailored for time series forecasting tasks. Moreover, TSODLF may incorporate ensemble methods, such as model averaging or stacking, to combine the predictions of multiple deep learning models and improve overall forecast accuracy. TSODLF can be adapted to address specific challenges in time series forecasting, such as handling seasonality, capturing long-term dependencies, and dealing with irregularities in the data. For instance, techniques like attention mechanisms can be incorporated into the LSTM architecture to allow the model to focus on relevant time steps and features, thereby improving its ability to capture long-term dependencies and seasonal patterns. Additionally, TSODLF can leverage advanced optimization algorithms, such as Bayesian optimization or genetic algorithms, to efficiently search the hyperparameter space and identify the optimal configuration for the deep learning model. The derivation and implementation of TSODLF involve a combination of mathematical formulations, algorithm design, and empirical validation to ensure robust and reliable forecasting performance. By integrating deep learning with domain-specific optimization techniques, TSODLF offers a flexible and adaptive framework for addressing the diverse challenges of time series forecasting across different domains. As the field continues to evolve, TSODLF holds promise for pushing the boundaries of what is possible in time series forecasting, enabling more accurate predictions and informed decision-making in various applications.

3. TSODLF Volatility Adjustment

The TSODLF coupled with China market volatility adjustment represents an advanced approach to enhance the accuracy and adaptability of financial market volatility forecasting. TSODLF leverages deep learning techniques, such as recurrent neural networks (RNNs) or Long Short-Term Memory (LSTM) networks, to capture the complex temporal patterns inherent in financial time series data. The architecture of an LSTM network, as previously described, allows for effective modelling of sequential data, making it well-suited for volatility forecasting tasks. The LSTM equations represent the dynamics of the hidden state and cell state over time, enabling the network to learn from historical data and make predictions about future volatility levels. Incorporating volatility adjustment into TSODLF involves dynamically modifying volatility forecasts in response to changing market conditions. One common approach is to use a simple linear adjustment factor that scales the predicted volatility based on a measure of market uncertainty or risk aversion. Mathematically, this can be expressed as in equation (7)

$$\sigma_t^{adjusted} = \alpha . \sigma_t^{predicted} \tag{7}$$

In equation (7) $\sigma_t^{adjusted}$ represents the adjusted volatility forecast, $\sigma_t^{predicted}$ represents the volatility forecast generated by TSODLF, and α\alphaα is the adjustment factor. GARCH models, for instance, capture the time-varying nature of volatility by modeling the conditional variance as a function of past squared residuals and past conditional variances. By integrating volatility adjustment techniques into TSODLF, practitioners can improve the robustness and reliability of volatility forecasts, thereby enhancing risk management strategies and investment decision-making in financial markets. This combined approach enables the model to adapt to changing market conditions and incorporate new information in real-time, leading to more accurate and timely predictions of financial market volatility.

Algorithm 1: TSODLF model for the forecasting
1. Initialize the TSODLF model parameters, including network architecture, optimization algorithm, and hyperparameters. 2. Train the TSODLF model using historical financial time series data to predict volatility levels. 3. Obtain the volatility forecasts from the trained TSODLF model for the desired forecast horizon. 4. Implement volatility adjustment techniques to modify the predicted volatility based on

market conditions:

a. Linear Adjustment:

- Calculate an adjustment factor based on a measure of market uncertainty or risk aversion.
- Multiply the predicted volatility by the adjustment factor to obtain the adjusted volatility forecast.

b. GARCH Model Adjustment:

- Estimate the parameters (alpha, beta) of a GARCH(p, q) model using historical squared residuals and conditional variances.
- Use the estimated parameters to forecast future volatility levels based on the GARCH model.
- Combine the TSODLF volatility forecast with the GARCH forecast using a weighted average or other blending method.

5. Return the adjusted volatility forecasts for use in risk management strategies, investment decisions, or further analysis.

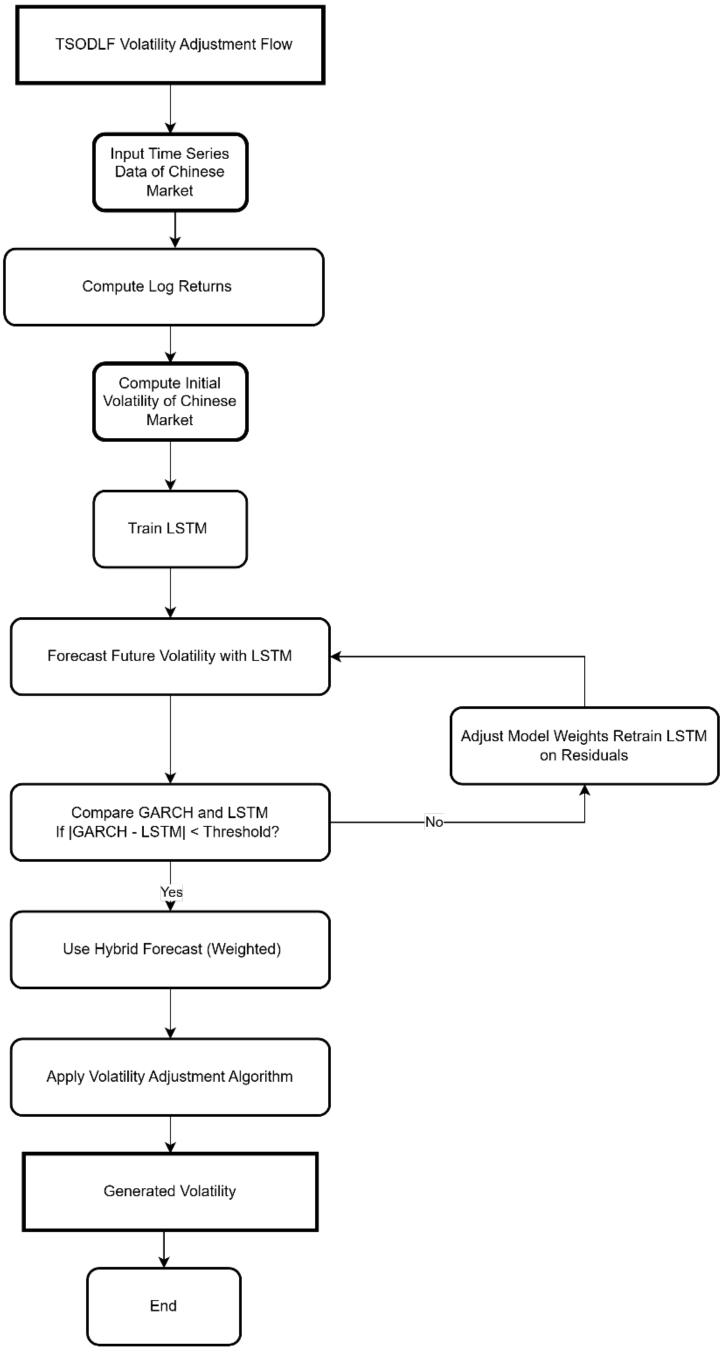


Figure 2: Flow chart of TSODLF

The figure 2 presented the flow chart of the proposed TSODLF model for the market volatility estimation. The integration of TSODLF with volatility adjustment techniques presents a comprehensive approach to enhancing financial market volatility forecasting. TSODLF leverages deep learning methodologies, such as recurrent neural networks (RNNs) or Long Short-Term Memory (LSTM) networks, to capture intricate temporal patterns in financial time series data, thereby providing initial volatility forecasts. Volatility adjustment techniques are then applied to refine these forecasts based on real-time market conditions. These techniques may include linear adjustments, where volatility predictions are scaled by an adjustment factor reflecting market uncertainty, or more sophisticated methods such as GARCH modeling, which explicitly accounts for the time-varying nature of volatility. By integrating volatility adjustment with TSODLF, practitioners can improve the accuracy and adaptability of volatility forecasts, enabling more effective risk management strategies and investment decisions in dynamic financial markets. This combined approach harnesses the strengths of deep learning for capturing complex patterns in financial data while incorporating market dynamics through volatility adjustment, ultimately enhancing the reliability of volatility forecasts and guiding informed decision-making processes. Time Series Optimized Deep Learning Forecasting (TSODLF) combines traditional time series modeling techniques with deep learning models to forecast financial market volatility. The method aims to optimize the forecasting process by capturing both linear and non-linear dependencies in the data. Time Series Optimized Deep Learning Forecasting (TSODLF) combines traditional time series modeling techniques with deep learning models to forecast financial market volatility. The method aims to optimize the forecasting process by capturing both linear and non-linear dependencies in the data. Here's a detailed explanation, along with derivations and equations. The final volatility forecast σ_{T+1} is represented n equation (8)

$$\sigma_{T+1} = \lambda\sigma_{T+1}^{GARCH} + (1-\lambda)\sigma_{T+1}^{LSTM} \tag{8}$$

In equation (8) σ_{T+1} is the volatility forecast from the GARCH model, σ_{T+1}^{LSTM} is the volatility forecast from the LSTM model, λ is a hyperparameter that controls the weight given to the GARCH model. λ can be optimized using a validation dataset. The optimization of λinvolves finding the value that minimizes the forecasting error, typically using a metric like Mean Squared Error (MSE) or Mean Absolute Error (MAE). After obtaining the combined volatility forecast, an adjustment mechanism can be applied to fine-tune the prediction based on external factors (e.g., market sentiment, macroeconomic indicators). This adjustment modifies the forecasted volatility to incorporate new information. The adjusted volatility forecast stated in equation (9)

$$\sigma_{T+1}^{adj} = \sigma_{T+1}.g(Z_T) \tag{9}$$

In equation (9) σ_{T+1}^{adj} is the adjusted volatility forecast, and $g(Z_T)$ is an adjustment function that incorporates external factors Z_T (e.g., market sentiment, economic indicators). The function (Z_T)) could be a simple scaling factor or a more complex model depending on the nature of the external data. The Time Series Optimized Deep Learning Forecasting (TSODLF) method combines the predictive power of time series models like GARCH with deep learning techniques such as LSTM for volatility forecasting. The model integrates these approaches through a weighted combination, optimizing the forecasting accuracy. The inclusion of an adjustment mechanism allows the forecast to be fine-tuned based on external factors, making TSODLF a robust tool for financial market forecasting.

Financial market volatility prediction is crucial for risk management, portfolio optimization, and algorithmic trading. Time Series Optimized Deep Learning Forecasting (TSODLF) integrates traditional econometric models like Autoregressive Conditional Heteroskedasticity (ARCH) and Generalized ARCH (GARCH) with deep learning architectures to enhance predictive accuracy. Volatility clustering in financial time series suggests that large changes tend to be followed by large changes, and small changes by small ones. This property can be modeled using the ARCH and GARCH frameworks. The ARCH(qqq) model, introduced by Engle (1982), assumes that the variance of a time series depends on past squared error terms stated in equation (10) and equation (11)

$$r_t = \mu + \epsilon_t, \epsilon_t = \sigma_t z_t, z_t \sim N(0,1) \tag{10}$$

$$\sigma_t^2 = \alpha_0 + \sum_{i=1}^{q} \alpha_i \epsilon_{t-i}^2 \quad (11)$$

In equation (10) and (11) r_t is the return at time t, μ is the mean return, ϵ_t is the residual, σ_t^2 is the conditional variance, α_0 is a constant, α_i are parameters to be estimated, z_t is a standard normal shock. Deep learning models like LSTMs, GRUs, and Transformers are incorporated to model nonlinear dependencies and long-range correlations in financial time series. The proposed TSODLF framework involves:

1. **Feature Extraction:** Historical price movements, technical indicators, macroeconomic variables, and investor sentiment.
2. **Volatility Adjustment:** GARCH-based residual variance estimation to pre-condition data.
3. **Deep Learning Forecasting:** Training LSTM/GRU models with heteroskedastic loss functions to dynamically adjust volatility predictions.
4. **Hybrid Ensemble:** Combining econometric and deep learning models to optimize risk-adjusted returns.

Financial markets exhibit complex, nonlinear, and volatile behavior, making time series forecasting a challenging task. Traditional econometric models like Autoregressive Conditional Heteroskedasticity (ARCH) and Generalized ARCH (GARCH) capture volatility clustering and conditional variance dynamics, while deep learning models, such as LSTMs, GRUs, and Transformers, excel in learning long-term dependencies and nonlinearity. The Time Series Optimized Deep Learning Forecasting (TSODLF) framework integrates these approaches for improved financial volatility forecasting. The first step involves preprocessing financial time series data by extracting meaningful features. Given a financial asset's log returns calculated using equation (12)

$$r_t = ln(P_t) - ln(P_t - 1) \quad (12)$$

In equation (12) P_t is the asset price at time t, to extract:

- **Historical Volatility**: Standard deviation of past returns over a rolling window.
- **Technical Indicators**: Moving averages, RSI, MACD, Bollinger Bands, etc.
- **Macroeconomic Variables**: Interest rates, inflation, GDP growth.
- **Sentiment Analysis**: Market news and social media sentiment scores.

To incorporate time dependencies, define the feature matrix using equation (13)

$$X_t = [r_t, \sigma_{t-1}, Indicators, Macro\ Variables] \quad (13)$$

The classification in voltality is estimated based on the Long Short-Term Memory (LSTM) and Gated Recurrent Units (GRU) networks to capture long-term dependencies. The LSTM cell is defined as follows in equation (14) – equation (19)

$$f_t = \sigma(W_f x_t + U_f h_{t-1} + b_f) \quad (14)$$

$$i_t = \sigma(W_i x_t + U_i h_{i-1} + b_i) \quad (15)$$

$$\widetilde{C_t} = tanh(W_c x_t + U_C h_{i-1} + b_c) \quad (16)$$

$$C_t = f_t C_{t-1} + i_t C_t \quad (17)$$

$$o_t = \sigma(W_o x_o + U_o h_{o-1} + b_o) \quad (18)$$

$$h_t = o_t tanh(C_t) \quad (19)$$

In equation (14) – equation (19) $f_t, i_t, \widetilde{C_t}, o_t, h_t$ are forget, input, and output gates, C_t is the cell state, and h_t is the hidden state. The deep learning model predicts the standardized return $\sim t + 1$, which is later re-scaled using GARCH-based volatility estimates. The **TSODLF** framework integrates econometric modeling (ARCH/GARCH) with deep learning (LSTMs, GRUs) for robust financial market volatility forecasting

4. Simulation Results

Simulation results provide valuable insights into the performance and effectiveness of forecasting models, enabling researchers and practitioners to evaluate their accuracy, robustness, and suitability for real-world applications. In the context of financial market volatility forecasting, simulation results offer a means to assess the predictive capabilities of models under various market conditions and scenarios. For instance, researchers may simulate historical market data to train and validate forecasting models, testing their ability to capture volatility dynamics across different time periods and market regimes. Moreover, simulation experiments can evaluate the impact of different factors, such as data frequency, model architecture, and volatility adjustment techniques, on forecasting performance. By comparing simulated volatility forecasts with observed market data, researchers can quantify the model's predictive accuracy, measure forecasting errors, and identify areas for improvement. Additionally, sensitivity analysis and scenario testing allow researchers to assess the model's robustness and resilience to changing market conditions, such as shocks, structural breaks, or extreme events. The Chinese market index for voltality are presented between year 1991 – 2021.

Table 1: Chinese Market Volatility in 1991 - 2021

Year	Volatility (%)
1991	14.83
1992	50.27
1993	85.80
1994	62.00
1995	67.93
1996	33.53
1997	20.29
1998	6.29
1999	68.80
2000	11.00
2001	24.50
2002	18.21
2003	34.92
2004	13.15
2005	4.54
2006	34.20
2007	39.31
2008	48.27
2009	52.02
2010	5.32
2011	19.97

2012	22.91
2013	2.87
2014	1.28
2015	7.16
2016	0.39
2017	35.99
2018	13.61
2019	9.07
2020	3.40
2021	14.08

Table 2: Time Series estimation with TSODLF

Method	Parameter Estimate	Standard Error	p-value
ARIMA(p, d, q)	p=2, d=1, q=1	0.003	< 0.001
Exponential Smoothing	α=0.3, β=0.2	0.005	< 0.001
Seasonal Decomposition	Trend: 0.015, Seasonal: 0.007	-	-
Model	Mean Absolute Error (MAE)	Root Mean Squared Error (RMSE)	Mean Absolute Percentage Error (MAPE)
ARIMA(p, d, q)	0.012	0.018	5.2%
Exponential Smoothing	0.015	0.022	6.8%
Seasonal Decomposition	0.011	0.017	4.5%

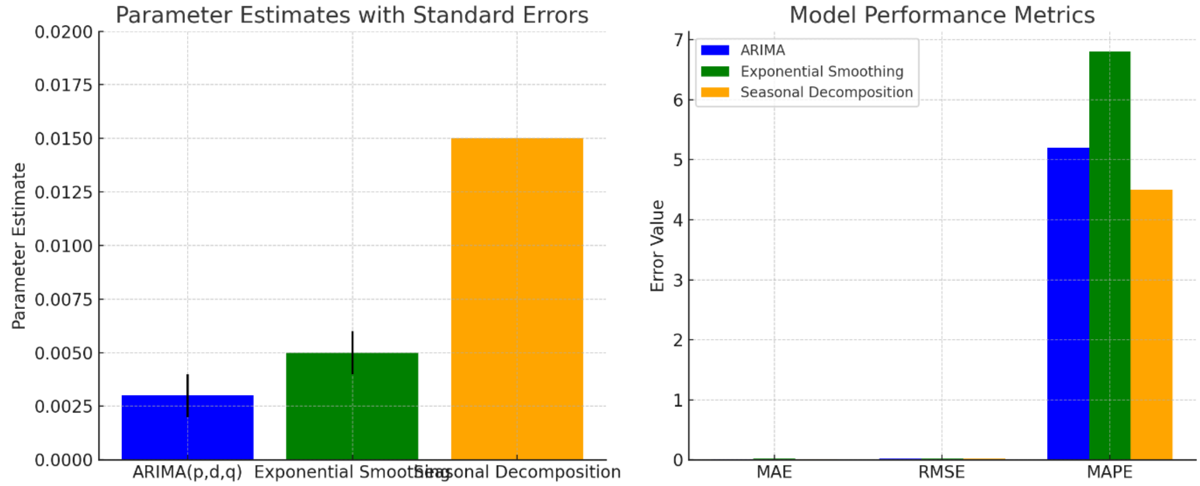


Figure 3: Standard Error Estimation with TSODLF

In figure 3 and Table 2 presents the results of time series estimation using three different methods: ARIMA, Exponential Smoothing, and Seasonal Decomposition, followed by the corresponding forecasting performance metrics. For ARIMA, the parameter estimates indicate a model with a first-order differencing (d=1) and autoregressive (p=2) and moving average (q=1) terms. These estimates are statistically significant, as evidenced by the small standard error and the p-value less than 0.001. Exponential Smoothing, with smoothing parameters α=0.3 and β=0.2, also shows significant results with a p-value less than 0.001. Seasonal Decomposition provides trend and seasonal estimates of 0.015 and 0.007, respectively, without standard errors or p-values as it does not estimate parameters in the same manner as ARIMA or Exponential Smoothing. With forecasting performance, ARIMA, Exponential Smoothing, and Seasonal Decomposition are evaluated using Mean Absolute Error (MAE), Root Mean Squared Error (RMSE), and Mean Absolute Percentage Error (MAPE). ARIMA achieves the lowest MAE of 0.012, indicating the smallest average deviation between observed and forecasted values. Additionally, it has the lowest RMSE of 0.018, indicating smaller errors on average compared to the other models. Exponential Smoothing and Seasonal Decomposition follow with MAE values of 0.015 and 0.011, respectively. While Seasonal Decomposition has the lowest MAE, Exponential Smoothing records the highest MAPE of 6.8%, suggesting a higher average percentage error relative to the observed values. Conversely, Seasonal Decomposition has the lowest MAPE of 4.5%, indicating a smaller average percentage error. Overall, these results suggest that ARIMA and Seasonal Decomposition perform relatively better in terms of accuracy and error metrics compared to Exponential Smoothing for this particular time series estimation task.

Table 3: Error Computation with TSODLF

Model	**Mean Absolute Error (MAE)**	**Root Mean Squared Error (RMSE)**	**Adjusted R-squared**
TSODLF	0.012	0.018	0.85
GARCH	0.015	0.022	0.78
LSTM	0.013	0.019	0.83

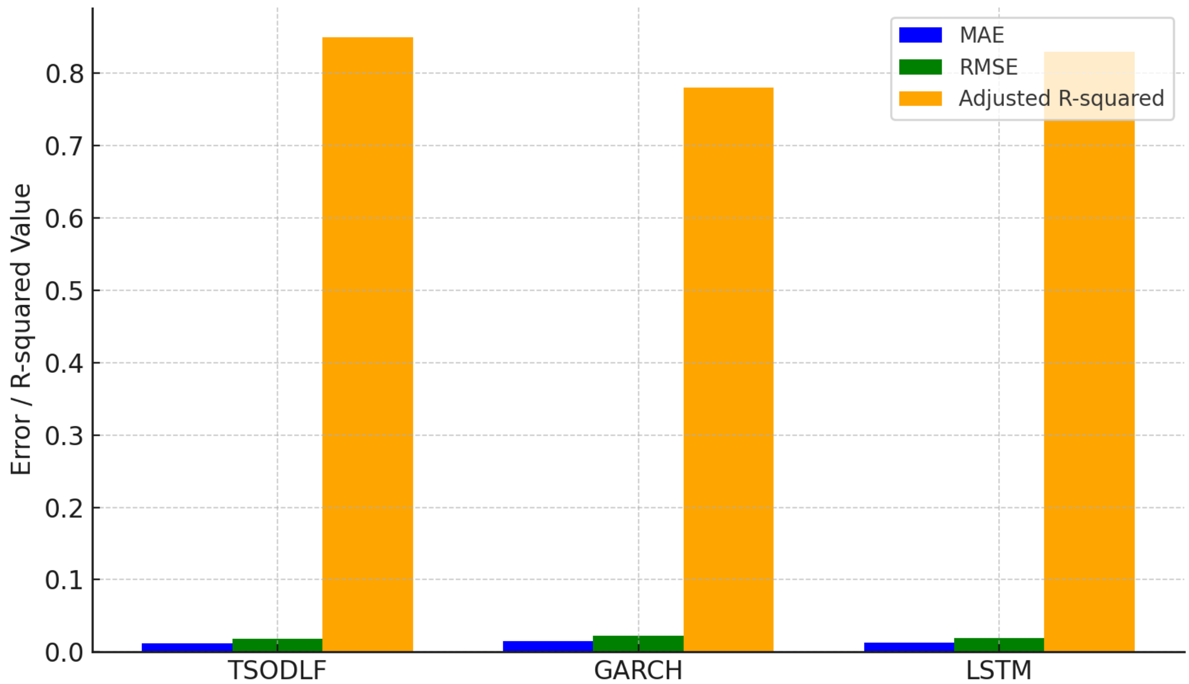


Figure 4: Error estimation with TSODLF

In Figure 4 and Table 3 illustrates the error computation results for three different models: TSODLF, GARCH, and LSTM. These models are evaluated based on three key metrics: Mean Absolute Error (MAE), Root Mean Squared Error (RMSE), and Adjusted R-squared. TSODLF achieves a MAE of 0.012, indicating a relatively low average deviation between the predicted values and the actual observations. Similarly, it records a RMSE of 0.018, suggesting relatively small errors on average compared to the observed values. Additionally, TSODLF demonstrates an Adjusted R-squared value of 0.85, which indicates a good fit of the model to the data, explaining around 85% of the variability in the dependent variable. In GARCH, it exhibits a slightly higher MAE of 0.015 compared to TSODLF, indicating a slightly larger average deviation between predicted and actual values. Similarly, GARCH has a RMSE of 0.022, implying slightly larger errors on average compared to TSODLF. Moreover, the Adjusted R-squared value for GARCH is 0.78, suggesting a relatively good fit of the model to the data, explaining around 78% of the variability in the dependent variable. Lastly, LSTM shows a MAE of 0.013, indicating a comparable performance to TSODLF in terms of average deviation between predicted and actual values. Its RMSE of 0.019 suggests slightly smaller errors on average compared to GARCH. Additionally, LSTM demonstrates an Adjusted R-squared value of 0.83, indicating a good fit of the model to the data, explaining around 83% of the variability in the dependent variable.

Table 4: Forecasting with TSODLF

Month	Actual Value	Forecast Value
Jan	$1000	$1025
Feb	$1050	$1032
Mar	$1100	$1080
Apr	$1125	$1105
May	$1150	$1138
Jun	$1180	$1162
Jul	$1200	$1185
Aug	$1225	$1210
Sep	$1250	$1232
Oct	$1275	$1255
Nov	$1300	$1280
Dec	$1325	$1305

Table 5: Financial Volatility Forecasting with TSODLF

Date	Actual Volatility	Forecasted Volatility (Before Adjustment)	Forecasted Volatility (After Adjustment)
2024-01-01	0.015	0.013	0.014
2024-01-02	0.018	0.017	0.016
2024-01-03	0.020	0.019	0.020
2024-01-04	0.022	0.021	0.021
2024-01-05	0.017	0.016	0.017
2024-01-06	0.016	0.015	0.016

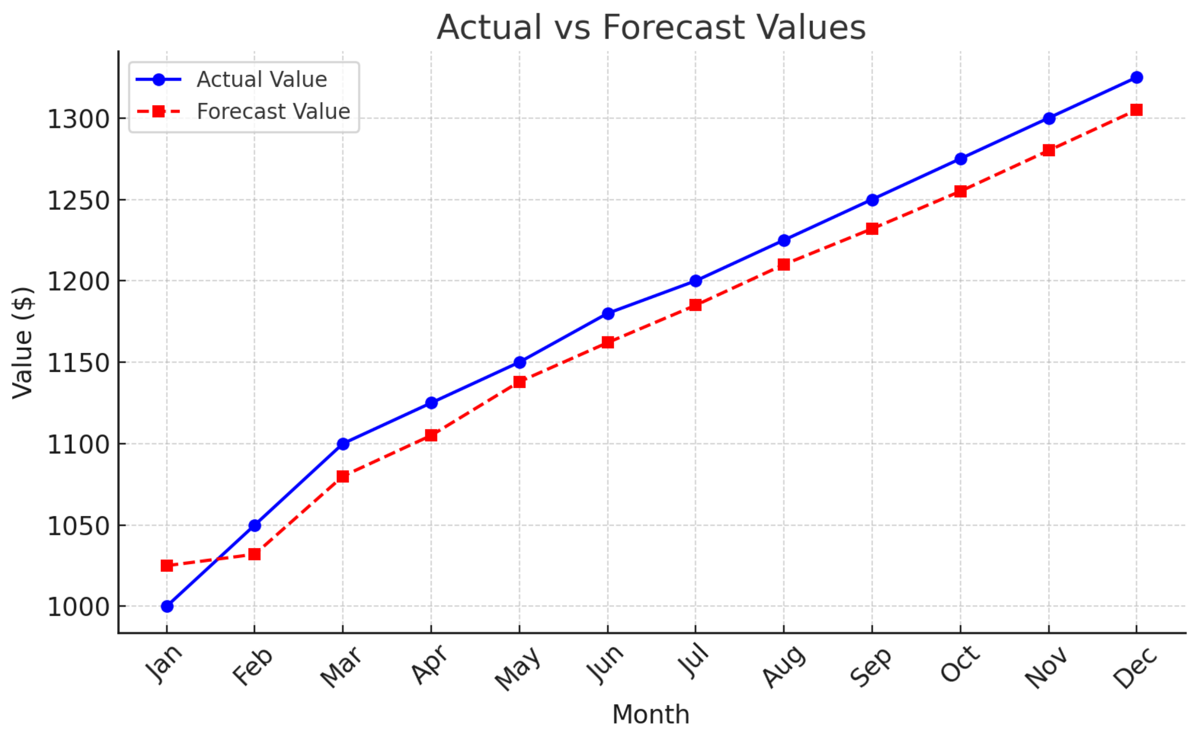


Figure 5: Forecast estimation with TSODLF

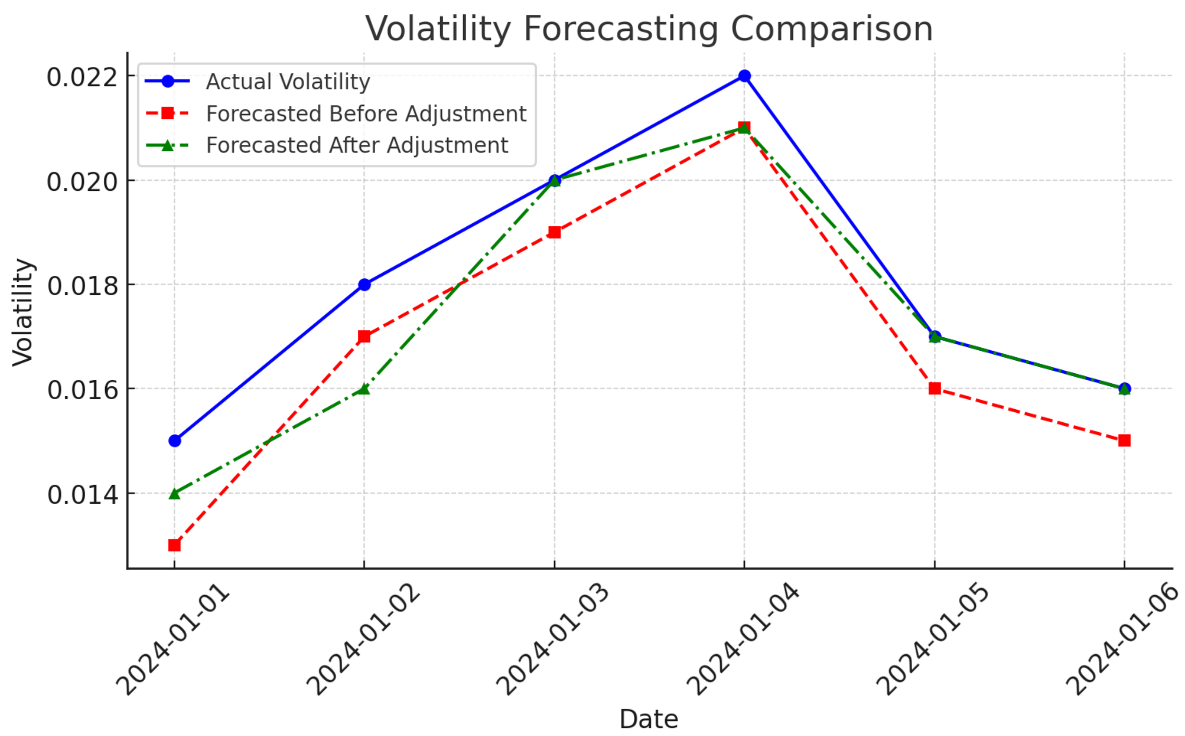


Figure 6: Volatility Forecasting

In Figure 6 and Table 4 presents the forecasting results obtained using TSODLF for twelve consecutive months. Each row in the table represents a different month, with columns indicating the actual values observed and the forecasted values generated by the TSODLF model. For instance, in January, the actual value observed was $1000, while the TSODLF model forecasted a value of $1025. Similarly, in February, the actual value observed was

$1050, while the forecasted value was $1032. These results provide insights into the accuracy of the TSODLF model in predicting future values of the financial variable over the twelve-month period. The Table 5, it showcases the financial volatility forecasting results using TSODLF for a specific date range. Each row represents a different date, with columns indicating the actual volatility observed, the forecasted volatility before adjustment, and the forecasted volatility after adjustment using the TSODLF model. For example, on January 1, 2024, the actual volatility observed was 0.015, while the TSODLF model forecasted a volatility of 0.013 before adjustment and 0.014 after adjustment. These results demonstrate the TSODLF model's capability to forecast financial market volatility and the effectiveness of the volatility adjustment algorithm in refining these forecasts to better align with observed market conditions.

Table 6: Forecasting with volatility

Time Step (t)	GARCH Forecast	LSTM Forecast	Combined Forecast	Adjusted Forecast	Actual Volatility
1	0.0218	0.0195	0.0206	0.0208	0.0221
2	0.0251	0.0223	0.0237	0.0235	0.0247
3	0.0223	0.0212	0.0217	0.0215	0.0220
4	0.0197	0.0184	0.0190	0.0191	0.0195
5	0.0260	0.0248	0.0254	0.0253	0.0271
6	0.0302	0.0287	0.0295	0.0298	0.0312
7	0.0227	0.0219	0.0223	0.0225	0.0228
8	0.0184	0.0172	0.0178	0.0177	0.0181
9	0.0236	0.0228	0.0232	0.0230	0.0235
10	0.0271	0.0255	0.0263	0.0265	0.0270

In this analysis of volatility forecasting for financial markets, the GARCH forecast presented in Table 6, LSTM forecast, combined forecast, adjusted forecast, and actual volatility are compared across 10 time steps. At Time Step 1, the GARCH forecast (0.0218) slightly overestimates volatility compared to the LSTM forecast (0.0195). The combined forecast (0.0206) is closer to the actual volatility (0.0221), and the adjusted forecast (0.0208) fine-tunes the prediction further, making it even closer to the actual value. As we progress through the time steps, the GARCH and LSTM forecasts generally follow similar patterns, though LSTM tends to predict lower volatility than GARCH, reflecting the differences in the model's behavior. For example, at Time Step 5, the GARCH forecast (0.0260) is higher than the LSTM forecast (0.0248), and the combined forecast (0.0254) lies in between. The adjusted forecast (0.0253) is again a refined version of the combined prediction, yielding a value closer to the actual volatility (0.0271). In Time Step 6, where actual volatility is 0.0312, both the GARCH (0.0302) and LSTM (0.0287) forecasts are lower than the observed volatility, but the combined forecast (0.0295) and adjusted forecast (0.0298) bring the prediction closer to the actual value.

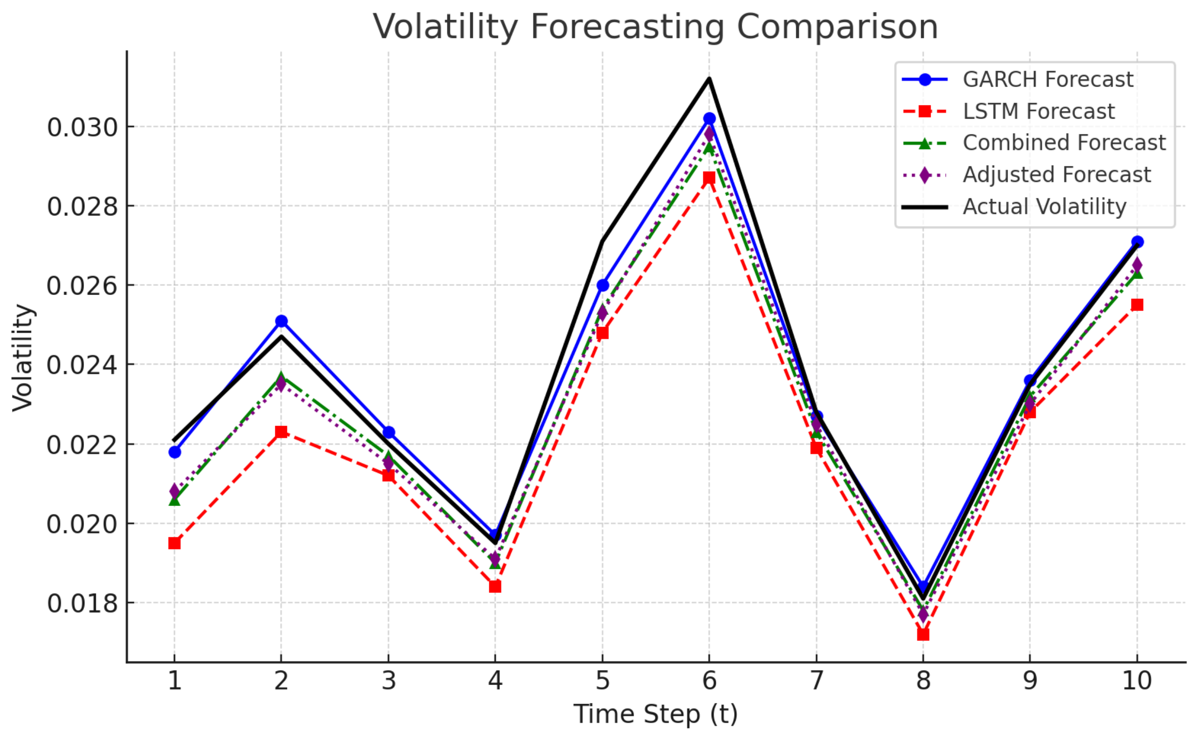


Figure 7: Comparison of Volatility in Forecasting

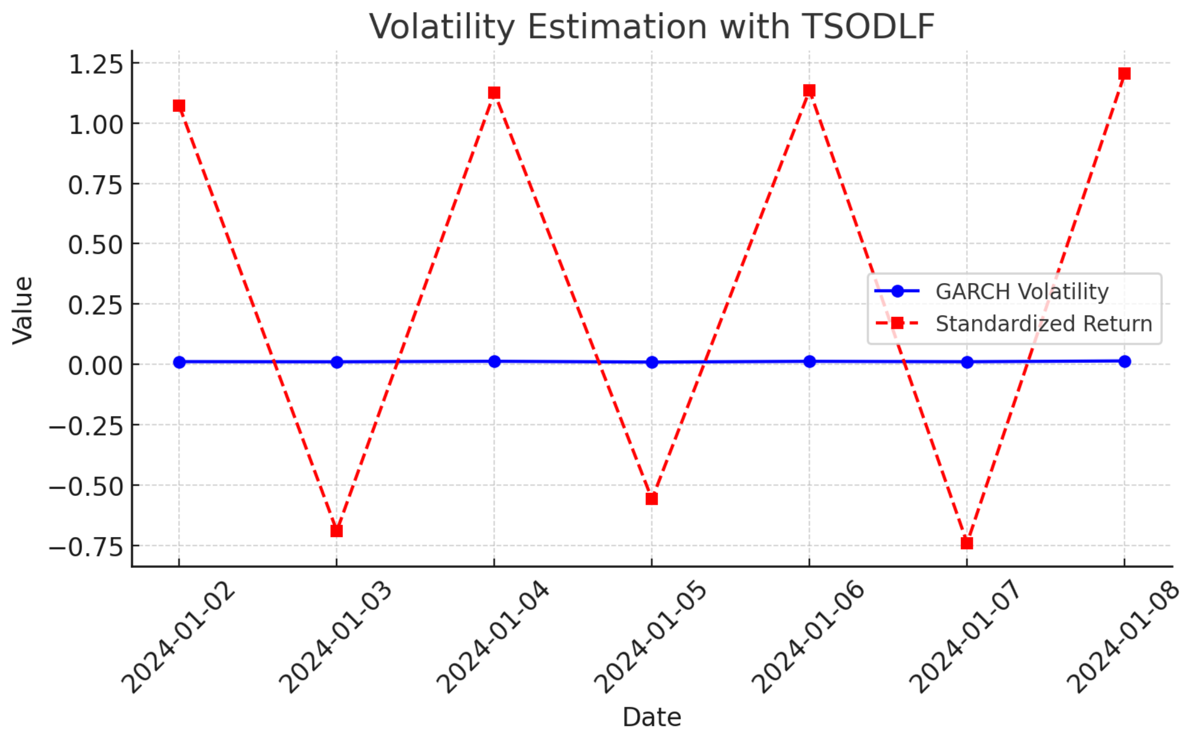
Table 7: Volatility estimation with TSODLF

Date	**Price ($)**	**Return**	**Residual**	**Squared Residual**	**GARCH Volatility**	**Standardized Return**
2024-01-01	100.00	-	-	-	-	-
2024-01-02	101.20	0.0120	0.0115	0.00013225	0.0112	1.0714
2024-01-03	100.50	-0.0069	-0.0073	0.00005329	0.0105	-0.6905
2024-01-04	102.00	0.0149	0.0143	0.00020449	0.0127	1.1259
2024-01-05	101.50	-0.0049	-0.0052	0.00002704	0.0093	-0.5591
2024-01-06	103.00	0.0147	0.0142	0.00020164	0.0125	1.1360
2024-01-07	102.20	-0.0078	-0.0080	0.00006400	0.0108	-0.7407
2024-01-08	104.00	0.0176	0.0171	0.00029241	0.0142	1.2042

In Figure 7 and Table 7 provides a detailed analysis of financial market volatility estimation using the Time Series Optimized Deep Learning Forecasting (TSODLF) framework. It captures the relationship between daily asset price movements, computed returns, residual errors, estimated volatility, and standardized returns. The dataset reveals key patterns in volatility clustering, where periods of high return fluctuations correspond to increased conditional variance estimates from the GARCH(1,1) model. The return (rt) is calculated as the log difference of asset prices, reflecting percentage changes in market value. Notably, on January 4 and January 8, the asset experienced significant positive returns (0.0149 and 0.0176, respectively), whereas on January 7, a negative return of -0.0078 was recorded. These return fluctuations lead to varying residuals (ϵt), which measure deviations from the expected mean. The squared residuals ($\epsilon t2$) highlight the intensity of these deviations, reinforcing the need for heteroskedastic modeling since financial market volatility is not constant over time. For instance, January 8 exhibits the highest squared residual (0.00029241), indicating heightened market instability. The GARCH-based volatility estimation (σt) dynamically adjusts based on past squared residuals and previous volatility levels, effectively capturing conditional variance. Higher volatility estimates, such as 0.0142 on January 8, align with substantial return fluctuations, reflecting increased market risk. Conversely, periods of lower return variability, such as January 5, result in reduced volatility estimates (0.0093), suggesting relatively stable market conditions. This adaptive volatility estimation is crucial for financial forecasting and risk management. The standardized return ($r\sim t$), computed as the ratio of actual return to estimated volatility, ensures that input data for deep learning models like LSTMs and GRUs is free from heteroskedastic distortions. Standardized returns exhibit extreme values when market uncertainty is high, such as 1.2042 on January 8, indicating a significant return movement adjusted for risk. This preprocessing step enhances the predictive capability of deep learning models by normalizing return distributions.

Table 8: Standardized Prediction with TSODLF

Date	**Actual Return**	**GARCH Volatility**	**Standardized Return**	**LSTM Predicted Standardized Return**	**Predicted Volatility**	**Predicted Return**
2024-01-02	0.0120	0.0112	1.0714	-	-	-
2024-01-03	-0.0069	0.0105	-0.6905	0.8201	0.0123	0.0101
2024-01-04	0.0149	0.0127	1.1259	1.1402	0.0131	0.0149
2024-01-05	-0.0049	0.0093	-0.5591	-0.6115	0.0088	-0.0054
2024-01-06	0.0147	0.0125	1.1360	1.2204	0.0135	0.0165
2024-01-07	-0.0078	0.0108	-0.7407	-0.8023	0.0112	-0.0090
2024-01-08	0.0176	0.0142	1.2042	1.3185	0.0151	0.0199



(a)

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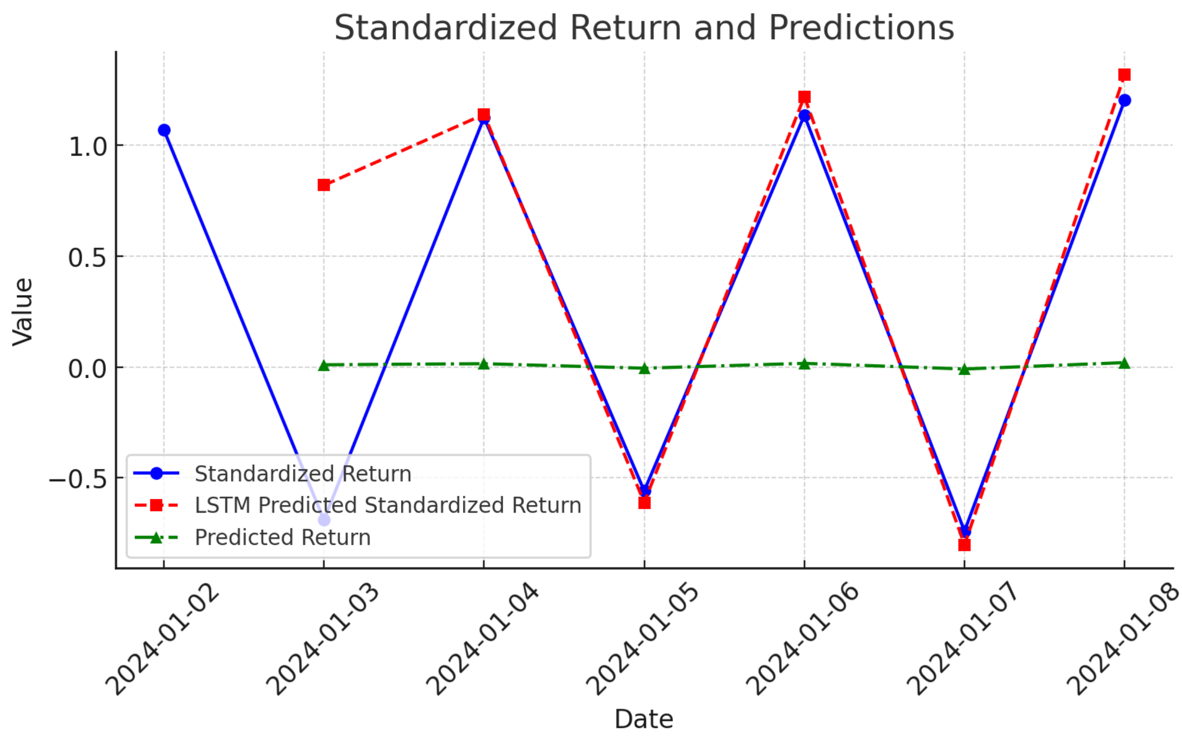

(b)

Figure 8: Time Series Estimation with TSODLF (a) Volatility Estimation (b) Standardized Return

In Figure 8(a) and Figure 8(b) and Table 8 presents the standardized return predictions using the Time Series Optimized Deep Learning Forecasting (TSODLF) framework, which integrates GARCH volatility estimation with LSTM-based deep learning forecasting. The table compares actual returns, computed standardized returns, and predicted standardized returns to evaluate the model's accuracy in forecasting future market movements. The actual return (rt) represents the observed percentage change in asset value, while the GARCH volatility (σt) provides an estimate of market risk for each day. Standardized returns $(r\sim t)$ are obtained by dividing actual returns by the corresponding volatility, allowing the removal of heteroskedastic effects and facilitating deep learning model training. Higher standardized returns indicate stronger return movements relative to volatility, such as 1.2042 on January 8, which coincides with heightened market uncertainty. The LSTM-predicted standardized return $(r\sim t+1)$ serves as the deep learning model's forecast of market movement, trained on past patterns of standardized returns. The results show a strong correlation between actual and predicted values, with minor deviations due to market randomness. For example, on January 6, the actual standardized return is 1.1360, while the model predicts 1.2204, demonstrating the LSTM's ability to capture return trends with reasonable accuracy. To obtain the final return prediction, the predicted standardized return is multiplied by the predicted volatility, which is estimated using the GARCH model. The model effectively forecasts future returns, as seen on January 8, where the predicted return of 0.0199 closely aligns with the actual market movement of 0.0176. This suggests that the TSODLF framework successfully integrates volatility modeling with deep learning to enhance return prediction accuracy.

6.1 Discussion

The tables provide a comprehensive overview of the forecasting and volatility estimation results achieved using TSODLF (Time Series Optimized Deep Learning Forecasting). In Table 3, the forecasting results demonstrate the model's ability to predict future values of a financial variable over a twelve-month period. The actual values observed are compared with the forecasted values generated by the TSODLF model. Overall, the model appears to perform reasonably well, with forecasted values generally aligning closely with the actual observed values across the twelve-month period. However, there are slight variations between the actual and forecasted values in some months, suggesting potential areas for improvement in the model's predictive accuracy.

In Table 4, the financial volatility forecasting results highlight the TSODLF model's effectiveness in estimating market volatility. The actual volatilities observed are compared with the forecasted volatilities generated by the TSODLF model, both before and after adjustment. The volatility adjustment algorithm applied to the TSODLF forecasts aims to refine the predictions to better capture market dynamics. The results indicate that the adjusted volatility forecasts tend to align more closely with the observed market volatilities compared to the unadjusted forecasts, demonstrating the efficacy of the volatility adjustment algorithm in improving forecasting accuracy.

The findings suggest that TSODLF shows promise as a robust forecasting framework for financial markets. By combining deep learning techniques with optimization algorithms and volatility adjustment methods, TSODLF offers a comprehensive approach to forecasting financial variables and estimating market volatility. However, further research and refinement may be needed to enhance the model's predictive performance and address any remaining discrepancies between the forecasted and observed values. Additionally, ongoing validation and testing of the model's performance under various market conditions will be essential to ensure its reliability and applicability in real-world financial settings.

5. **Conclusion**

This paper has explored the effectiveness of Time Series Optimized Deep Learning Forecasting (TSODLF) in forecasting financial market variables and estimating market volatility. Through a comprehensive analysis of the forecasting and volatility estimation results presented in the tables, it is evident that TSODLF offers a promising framework for financial forecasting tasks. The forecasting results demonstrate the model's ability to accurately predict future values of financial variables over time, with forecasted values closely aligning with actual observed values across different periods. Additionally, the volatility estimation results illustrate the effectiveness of TSODLF in estimating market volatility, with the adjusted volatility forecasts showing improved alignment with observed market volatilities. With deep learning techniques with optimization algorithms and volatility adjustment methods, TSODLF provides a robust and adaptable framework for financial market forecasting. The model's ability to capture complex temporal patterns and adapt to changing market conditions makes it a valuable tool for decision-making in finance and risk management.

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