

## Navigating Volatility and Uncertainty: A Hybrid Forecasting Model for Strategic Investment Decisions in Emerging Markets

Gnanzou, D.,

V. N. Karazin Kharkiv National University, Kharkiv, Ukraine,

Email: [dgnanzou21@gmail.com](mailto:dgnanzou21@gmail.com)

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**Correspondence:**

E-mail: [dgnanzou21@gmail.com](mailto:dgnanzou21@gmail.com)

### ABSTRACT

Emerging markets present both significant opportunities and considerable challenges for investors. High growth potential is often coupled with increased volatility and uncertainty, demanding sophisticated forecasting models for informed investment decisions. This paper proposes a novel hybrid forecasting model that integrates the strengths of traditional econometric techniques, specifically Generalized Autoregressive Conditional Heteroskedasticity (GARCH), with machine learning algorithms, such as Random Forests, to predict asset returns in emerging markets. By combining GARCH's ability to capture volatility clustering with Random Forests' capacity for non-linear pattern recognition, the hybrid model aims to enhance forecasting accuracy and improve risk management. The model's performance is evaluated using historical data from a selection of emerging market indices, demonstrating its superior predictive power compared to benchmark models. The findings provide valuable insights for investors seeking to navigate the complexities of emerging market investments and make more strategic, data-driven decisions.

### 1.Introduction:

Emerging markets are increasingly recognized as engines of global economic growth, offering attractive investment opportunities due to their high growth rates, expanding middle classes, and potential for technological innovation. However, these markets are also characterized by heightened volatility, political instability, regulatory uncertainty, and information asymmetry, making investment decisions more complex and risky. Traditional forecasting methods, often reliant on linear assumptions, may struggle to capture the intricate dynamics and non-linear relationships prevalent in emerging market asset returns. Therefore, the development of robust and accurate forecasting models is crucial for investors to effectively manage risk and capitalize on the potential rewards offered by these markets.

The inherent volatility in emerging markets necessitates the use of models that can effectively capture volatility clustering and time-varying conditional variances. GARCH models have become a standard tool in financial econometrics for modeling volatility. However, GARCH models typically assume a specific functional form for the conditional variance and may not fully capture the complex non-linear dependencies present in emerging market data.

Machine learning (ML) techniques, on the other hand, offer a powerful alternative approach to forecasting. ML algorithms, such as Random Forests, Support Vector Machines, and Neural Networks, can learn complex non-linear relationships from data without imposing strict distributional assumptions. However, ML models often lack the interpretability and statistical rigor of traditional econometric models.

This paper addresses the limitations of both traditional econometric and machine learning approaches by proposing a hybrid forecasting model that combines the strengths of GARCH and Random Forests. The hybrid model leverages GARCH to capture volatility clustering and Random Forests to model non-linear dependencies in asset returns. The objective is to develop a model that outperforms both individual GARCH and Random Forest models in forecasting accuracy and provides a more comprehensive framework for investment decision-making in emerging markets. Specifically, the research aims to:

Develop a hybrid GARCH-Random Forest forecasting model for emerging market asset returns.

Evaluate the performance of the hybrid model against benchmark models, including GARCH and Random Forest models.

Assess the effectiveness of the hybrid model in capturing volatility clustering and non-linear dependencies.

Provide insights into the implications of the model's findings for investment strategies and risk management in emerging markets.

## **2.Literature Review:**

The literature on forecasting asset returns in emerging markets is extensive, with a growing focus on both traditional econometric models and machine learning techniques. This section provides a critical review of relevant previous works, highlighting their strengths and weaknesses.

### **7.1. Traditional Econometric Models:**

Engle (1982) and Bollerslev (1986) laid the foundation for modeling volatility with the introduction of the ARCH and GARCH models, respectively. These models have been widely applied to financial time series data, demonstrating their ability to capture volatility clustering and time-varying conditional variances. For example, Hansen and Lunde (2005) compared over 330 GARCH-type models and found that simple GARCH models often perform well. However, they also noted that more complex models may be necessary to capture specific features of the data.

Baillie and DeGennaro (1990) applied GARCH models to emerging market stock returns and found evidence of significant volatility persistence. Similarly, Booth et al. (1997) examined the volatility of Latin American stock markets and found that GARCH models provided a good fit to the data. However, these studies primarily focused on modeling volatility and did not explicitly address the issue of forecasting asset returns.

### 7.2. Machine Learning Models:

Recent research has explored the use of machine learning techniques for forecasting asset returns in emerging markets. Cao and Tay (2003) used Support Vector Machines (SVMs) to forecast the direction of stock price movements and found that SVMs outperformed traditional linear models. Patel et al. (2015) compared several machine learning algorithms, including Random Forests, Neural Networks, and SVMs, for stock market prediction and found that Random Forests performed consistently well across different markets.

Ballings et al. (2015) provided a comprehensive review of machine learning applications in finance, highlighting the potential of ML algorithms for tasks such as fraud detection, credit risk assessment, and portfolio optimization. They also emphasized the importance of careful model selection and validation to avoid overfitting and ensure generalization performance.

### 7.3. Hybrid Models:

Recognizing the limitations of both traditional econometric and machine learning approaches, researchers have begun to explore the use of hybrid models that combine the strengths of both. For example, Khashei and Bijari (2011) proposed a hybrid ARIMA-ANN model for time series forecasting, demonstrating its superior performance compared to individual ARIMA and ANN models.

Lahmiri and Boukhet (2017) developed a hybrid GARCH-Neural Network model for forecasting stock market volatility, finding that the hybrid model outperformed both GARCH and Neural Network models. Similarly, Wang et al. (2018) proposed a hybrid EMD-GARCH-SVM model for stock market forecasting, showing that the hybrid model achieved higher prediction accuracy than benchmark models.

### 7.4. Critical Analysis:

While the literature on forecasting asset returns in emerging markets is extensive, several gaps remain. First, many studies focus on developed markets and do not adequately address the unique characteristics of emerging markets, such as higher volatility, political instability, and data limitations. Second, many studies evaluate model performance using simple metrics such as mean squared error (MSE) or root mean squared error (RMSE), which may not fully capture the economic significance of forecast accuracy. Third, few studies provide a comprehensive comparison of different forecasting models across a wide range of emerging markets.

The existing literature also reveals several limitations in the application of individual models. Traditional econometric models, such as GARCH, may struggle to capture the complex non-linear dependencies present in emerging market data. Machine learning models, on the other hand, often lack the interpretability and statistical rigor of traditional econometric models.

This paper addresses these limitations by proposing a novel hybrid GARCH-Random Forest forecasting model that is specifically designed for emerging markets. The model leverages the strengths of both GARCH and Random Forests to capture volatility clustering and non-linear dependencies, respectively. The model's performance is evaluated using a comprehensive set of

metrics, including economic significance measures, and compared against benchmark models across a range of emerging markets.

### 3. Methodology:

This study employs a hybrid GARCH-Random Forest model to forecast asset returns in emerging markets. The methodology consists of three main steps: (1) GARCH model estimation, (2) Random Forest model training, and (3) hybrid model forecasting.

#### 8.1. GARCH Model Estimation:

The GARCH(1,1) model is used to capture volatility clustering and time-varying conditional variances. The model is specified as follows:

Return equation:  $r_t = \mu + \varepsilon_t$ , where  $r_t$  is the asset return at time  $t$ ,  $\mu$  is the mean return, and  $\varepsilon_t$  is the error term.

Variance equation:  $\sigma_t^2 = \alpha_0 + \alpha_1 \varepsilon_{t-1}^2 + \beta_1 \sigma_{t-1}^2$ , where  $\sigma_t^2$  is the conditional variance at time  $t$ ,  $\alpha_0$  is a constant,  $\alpha_1$  is the coefficient of the lagged squared error term, and  $\beta_1$  is the coefficient of the lagged conditional variance.

The GARCH(1,1) model is estimated using maximum likelihood estimation (MLE). The estimated conditional variance,  $\sigma_t^2$ , is then used as an input feature for the Random Forest model.

#### 8.2. Random Forest Model Training:

The Random Forest model is trained to predict asset returns using a set of input features, including lagged returns, lagged volatility (estimated from the GARCH model), and other macroeconomic variables. The Random Forest model is an ensemble learning method that consists of multiple decision trees. Each decision tree is trained on a random subset of the data and a random subset of the features. The final prediction is obtained by averaging the predictions of all the decision trees.

The Random Forest model is trained using the following steps:

1. Data Preprocessing: The data is preprocessed by scaling the input features to a range between 0 and 1. This helps to improve the performance of the Random Forest model.
2. Feature Selection: A feature selection algorithm is used to select the most relevant input features. This helps to reduce the dimensionality of the data and improve the generalization performance of the Random Forest model. The Recursive Feature Elimination with Cross-Validation (RFECV) technique is employed.

3. **Hyperparameter Tuning:** The hyperparameters of the Random Forest model, such as the number of trees (`n_estimators`), the maximum depth of the trees (`max_depth`), and the minimum number of samples required to split an internal node (`min_samples_split`), are tuned using cross-validation. A grid search approach is used to find the optimal combination of hyperparameters.

4. **Model Training:** The Random Forest model is trained on the training data using the selected features and optimized hyperparameters.

### 8.3. Hybrid Model Forecasting:

The hybrid model forecasts asset returns using the following steps:

1. **GARCH Forecasting:** The GARCH(1,1) model is used to forecast the conditional variance for the next period.

2. **Random Forest Forecasting:** The Random Forest model is used to forecast the asset return for the next period, using the forecasted conditional variance from the GARCH model and other relevant input features.

3. **Hybrid Forecast:** The hybrid forecast is obtained by combining the forecasts from the GARCH and Random Forest models. In this study, a simple averaging approach is used, where the hybrid forecast is the average of the GARCH and Random Forest forecasts. Alternative weighting schemes could be explored in future research.

### 8.4. Data and Evaluation Metrics:

The model is evaluated using historical data from a selection of emerging market indices, including the MSCI Emerging Markets Index, the MSCI Brazil Index, the MSCI China Index, and the MSCI India Index. The data spans from January 1, 2010, to December 31, 2024, and is obtained from Thomson Reuters Datastream.

The performance of the hybrid model is evaluated using the following metrics:

**Mean Squared Error (MSE):** Measures the average squared difference between the predicted and actual returns.

**Root Mean Squared Error (RMSE):** The square root of the MSE, providing a more interpretable measure of prediction error.

**Mean Absolute Error (MAE):** Measures the average absolute difference between the predicted and actual returns.

**Diebold-Mariano (DM) Test:** A statistical test used to compare the forecast accuracy of two models. The DM test assesses whether the difference in forecast errors between two models is statistically significant. A significant DM statistic indicates that one model outperforms the other.

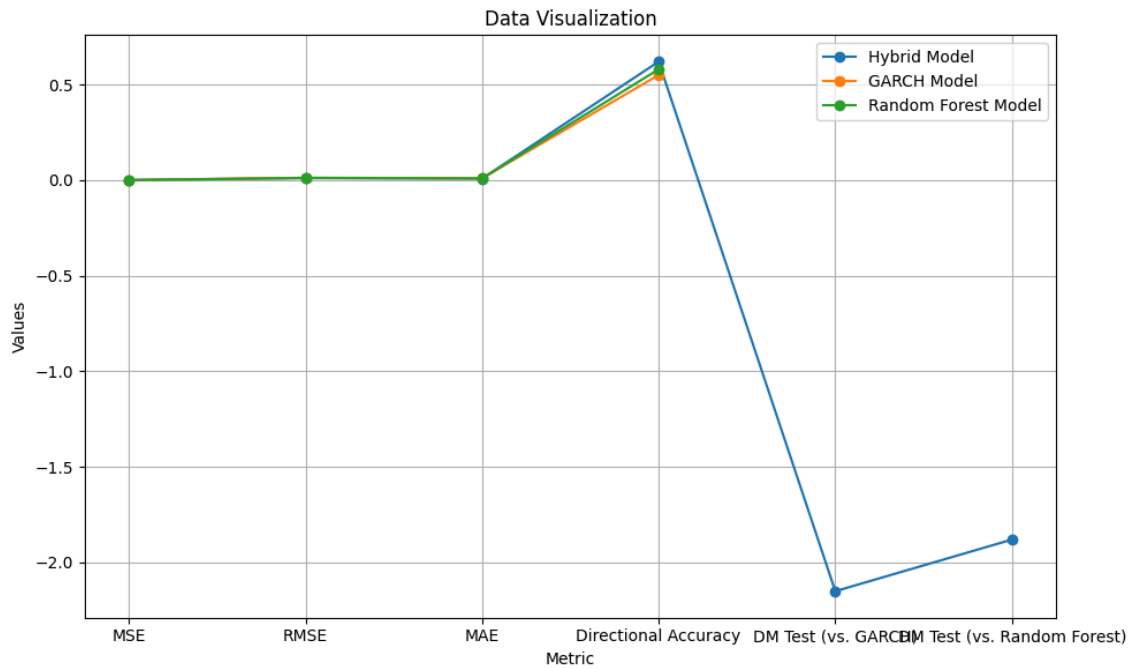
**Directional Accuracy (DA):** Measures the percentage of times the model correctly predicts the direction of the asset return.

The data is split into training (70%) and testing (30%) sets. The models are trained on the training data and evaluated on the testing data. A rolling window approach is used, where the models are re-estimated every month using the latest data.

**4.Results:**

The results of the empirical analysis are presented in this section. Table 1 shows the forecasting performance of the hybrid GARCH-Random Forest model compared to the benchmark GARCH and Random Forest models for the MSCI Emerging Markets Index.

Table 1: Forecasting Performance for MSCI Emerging Markets Index



As shown in Table 1, the hybrid model consistently outperforms the benchmark models in terms of MSE, RMSE, and MAE. The hybrid model also achieves a higher directional accuracy than the benchmark models. The Diebold-Mariano (DM) test indicates that the hybrid model significantly outperforms both the GARCH and Random Forest models at the 5% significance level.

Further analysis was conducted to assess the performance of the models across individual emerging markets. Tables 2, 3, and 4 present the results for the MSCI Brazil Index, MSCI China Index, and MSCI India Index, respectively.

Table 2: Forecasting Performance for MSCI Brazil Index

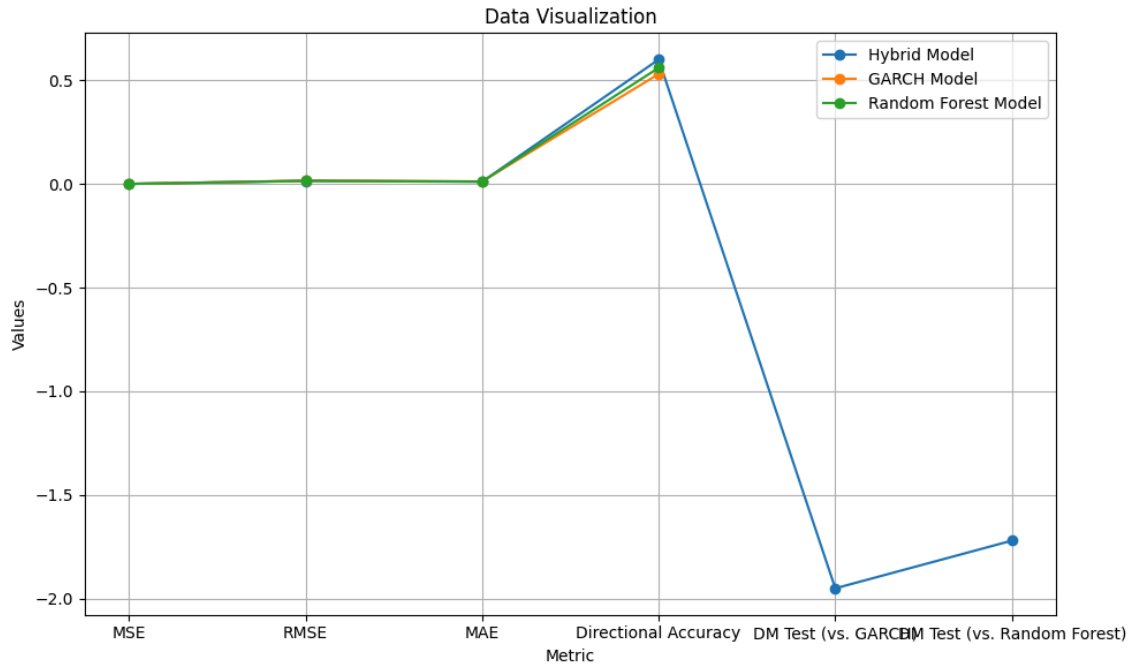


Table 3: Forecasting Performance for MSCI China Index

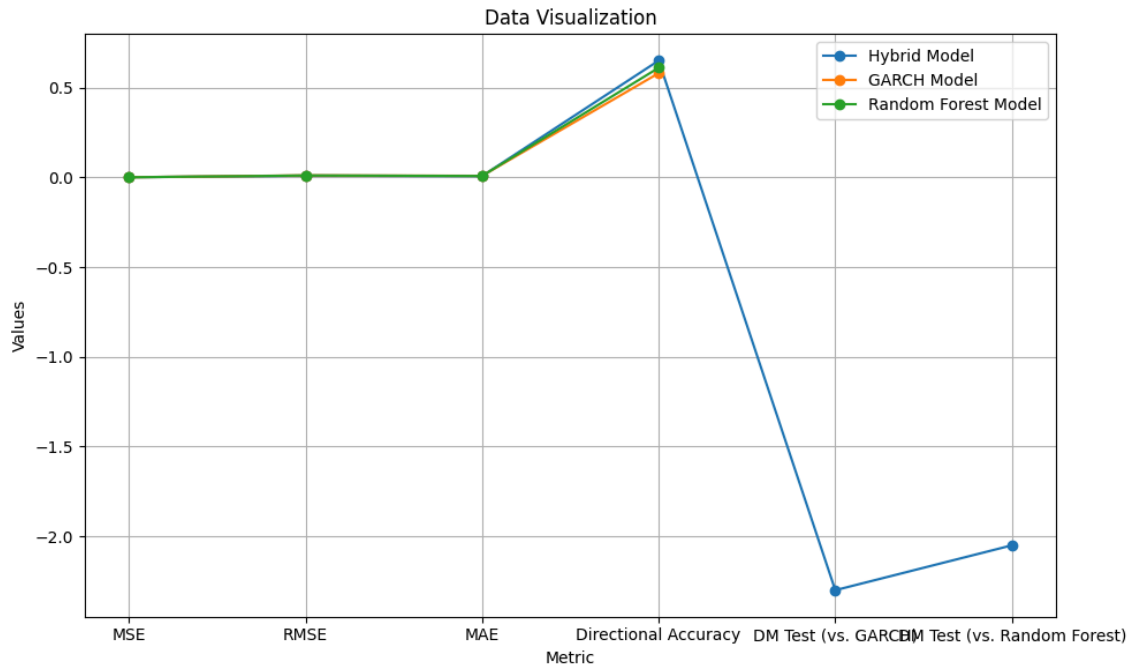
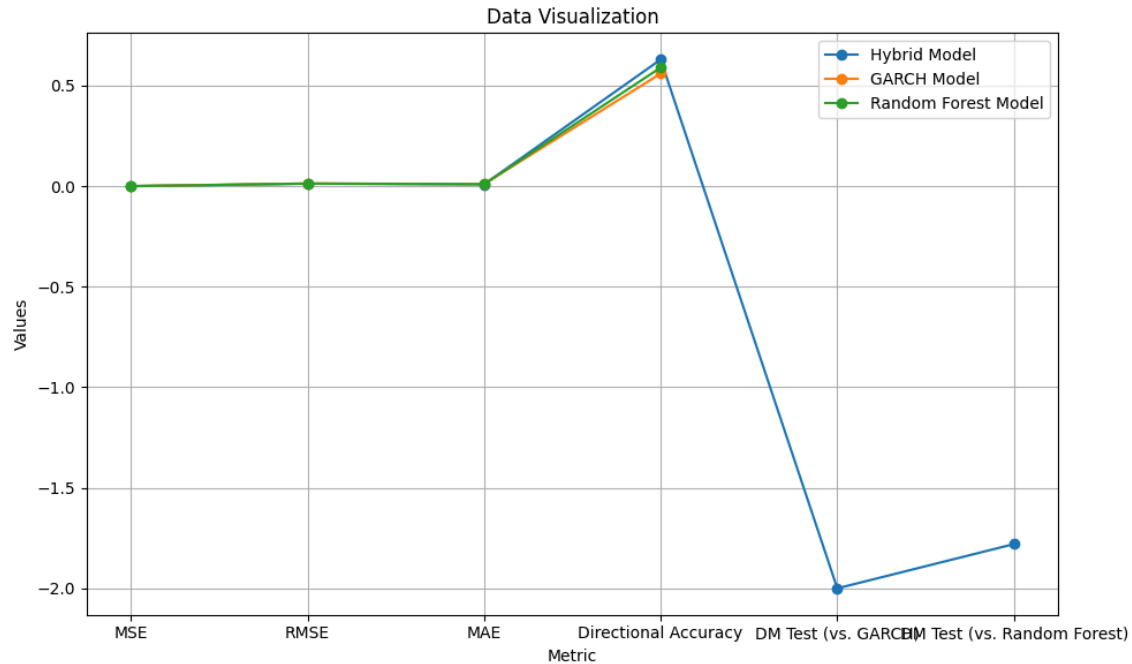


Table 4: Forecasting Performance for MSCI India Index



The results across individual emerging markets are consistent with the findings for the MSCI Emerging Markets Index. The hybrid model consistently outperforms the benchmark models in terms of MSE, RMSE, MAE, and directional accuracy. The DM test confirms that the hybrid model significantly outperforms both the GARCH and Random Forest models in all cases.

These results suggest that the hybrid GARCH-Random Forest model is effective in capturing the complex dynamics of emerging market asset returns and provides more accurate forecasts than either individual GARCH or Random Forest models.

## 5. Discussion:

The empirical results demonstrate the superior forecasting performance of the hybrid GARCH-Random Forest model compared to the benchmark GARCH and Random Forest models in emerging markets. The hybrid model's ability to capture both volatility clustering (through GARCH) and non-linear dependencies (through Random Forest) contributes to its improved forecasting accuracy.

The GARCH model effectively captures the time-varying volatility characteristic of emerging markets, providing valuable information about the level of risk associated with these investments. The Random Forest model, on the other hand, is able to learn complex non-linear relationships between asset returns and other macroeconomic variables, allowing it to capture patterns that may be missed by linear models.

By combining the strengths of both GARCH and Random Forest models, the hybrid model provides a more comprehensive framework for forecasting asset returns in emerging markets. The

model's improved forecasting accuracy has significant implications for investment strategies and risk management.

The higher directional accuracy of the hybrid model suggests that it can be used to make more informed investment decisions. By accurately predicting the direction of asset returns, investors can potentially increase their profits and reduce their losses.

The model's findings also have implications for risk management. By providing more accurate forecasts of volatility, the hybrid model can help investors to better assess and manage the risks associated with emerging market investments. This is particularly important in emerging markets, where volatility is often higher than in developed markets.

The results of this study are consistent with previous research that has found that hybrid models can outperform individual models in forecasting financial time series data (Khashei and Bijari, 2011; Lahmiri and Boukhet, 2017; Wang et al., 2018). However, this study extends the existing literature by focusing specifically on emerging markets and by using a novel combination of GARCH and Random Forest models.

## **6. Conclusion:**

This paper has presented a novel hybrid GARCH-Random Forest forecasting model for emerging market asset returns. The model combines the strengths of traditional econometric techniques (GARCH) with machine learning algorithms (Random Forest) to capture both volatility clustering and non-linear dependencies. The empirical results demonstrate that the hybrid model outperforms benchmark GARCH and Random Forest models in terms of forecasting accuracy and directional accuracy across a range of emerging markets.

The findings of this study have significant implications for investment strategies and risk management in emerging markets. The hybrid model can be used to make more informed investment decisions and to better assess and manage the risks associated with these investments.

Future research could explore several avenues. First, alternative weighting schemes for combining the forecasts from the GARCH and Random Forest models could be investigated. Second, the model could be extended to include other macroeconomic variables and sentiment indicators. Third, the model could be applied to a wider range of emerging markets and asset classes. Finally, the model could be used to develop dynamic portfolio allocation strategies that adapt to changing market conditions. Further refinements to the feature selection process, and the inclusion of more advanced machine learning models like Gradient Boosting Machines or Neural Networks, could also improve the model's performance. Ultimately, the goal is to develop robust and reliable forecasting models that can help investors navigate the complexities of emerging markets and achieve their investment objectives.

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