

Slow Expectation-Maximization Convergence in Low-Noise Dynamic Factor Models*

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Abstract

This paper addresses the slow convergence of the Expectation-Maximization (EM) algorithm that arises in the estimation of low-noise dynamic factor models, which are commonly used in macroeconomic forecasting and nowcasting applications. We show both analytically and in Monte Carlo simulations how the EM algorithm stagnates in a low-noise environment, leading to inaccurate factor loadings and latent factor estimates. We then demonstrate that an adaptive version of the EM algorithm is able to speed up the rate of convergence, producing improvements in estimation accuracy by up to 57% for the loadings and 23% for the factors compared to the baseline EM. Furthermore, modestly increasing the noise level additionally speeds up the convergence rate for both EM and Adaptive EM. Lastly, we conduct a nowcasting exercise of euro area GDP growth and show that the Adaptive EM leads to nowcasting gains up to 13% relative to the conventional EM.

Keywords: Dynamic factor models, EM algorithm, artificial noise, convergence speed, nowcasting

JEL Classification: C32, C51, C53, E37

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1 Introduction

Dynamic factor models have become a powerful tool for many economic and financial applications, ranging from financial forecasting (Ludvigson and Ng, 2009; Neely et al., 2014), macroeconomic forecasting (Stock and Watson, 1999, 2002a,b) and nowcasting (Giannone et al., 2008; Bańbura et al., 2011) to the construction of economic and financial activity indices (Stock and Watson, 1989, 1991; Aruoba et al., 2009; Brave and Butters, 2011) and uncertainty indices (Jurado et al., 2015; Scotti, 2016). In particular, dynamic factor models facilitate a straightforward approach to summarize the (co)variation of a large number of time series into a few latent common factors (see, for example, Poncela et al., 2021, for a recent survey on factor extraction in dynamic factor models). However, the number of parameters in the model becomes excessively large when the number of time series included increases.¹ This implies that conventional estimation based on direct numerical optimization of the likelihood in combination with the Kalman filter (see, among others, Engle and Watson, 1981; Stock and Watson, 1989) becomes unfeasible for large-scale dynamic factor models.

To overcome this issue, the Expectation-Maximization (EM) algorithm of Dempster et al. (1977) has become a popular alternative estimation approach in high-dimensional settings (see, among others, Quah and Sargent, 1993; Doz et al., 2012; Barigozzi and Luciani, 2022).² The EM algorithm has initially been adapted for dynamic factor models in state-space form by Shumway and Stoffer (1982) and Watson and Engle (1983). More recently, Bańbura and Modugno (2014) show that the EM algorithm is also easily modified to include serially correlated idiosyncratic components. Their approach even remains applicable under arbitrary patterns of missing data, which is particularly relevant for forecasting and nowcasting applications in which the included time series typically have different publication delays (the so-called ‘ragged edge’), different sampling frequencies and different initial availability.

More specifically, Bańbura and Modugno (2014) treat the serially correlated idiosyn-

¹The number of parameters increases linearly with the number of time series for an exact factor model (with cross-sectionally uncorrelated idiosyncratic components) and quadratically for an approximate factor model (with cross-sectionally correlated idiosyncratic components).

²Naturally, several alternative solutions have been proposed to deal with high-dimensional data in dynamic factor models (see, among others, Doz et al., 2011; Jungbacker and Koopman, 2015; Bräuning and Koopman, 2014). For a recent survey on high-dimensional dynamic factor models, see Lippi et al. (2022).

cratic components as additional latent states and introduce an artificial error term with small variance in the measurement equation. The latter is necessary in order to apply the EM algorithm in its usual form. Yet, it has been shown that the EM algorithm becomes inefficient in such a low-noise environment ([Bermond and Cardoso, 1999](#); [Petersen et al., 2005](#)), causing extremely slow convergence, especially for the factor loading estimates. Unfortunately, this issue seems to have been overlooked by [Bańbura and Modugno \(2014\)](#) and subsequent applications of their approach (see, among others, [Coroneo et al., 2016](#); [Scotti, 2016](#); [Alvarez et al., 2016](#); [Bok et al., 2018](#); [Barigozzi and Luciani, 2019](#); [Cascaldi-Garcia et al., 2021](#); [Caruso and Coroneo, 2023](#)). Moreover, these low-noise issues could also arise more naturally whenever the series exhibit a strong factor structure with a high signal-to-noise ratio. An example of this situation concerns the term structure of interest rates, for which three factors explain almost all of their variation ([Litterman and Scheinkman, 1991](#)).

In this paper, we address this slow EM convergence issue in low-noise dynamic factor models in three different ways. First, we show both analytically and in Monte Carlo simulations how the EM algorithm fails in the estimation of the factor loadings. We demonstrate that the key issue concerns the learning rate of the M-step for the factor loadings, which is proportional to the variance of the artificial error term in the measurement equation. Hence, small artificial noise leads to slow convergence of the EM algorithm in the estimation of these loadings. Subsequently, our simulation study shows that the smoothed factors and other parameter estimates are also negatively affected by this slow convergence. We find that this failure of EM under low noise persists for different sample sizes and different model (mis)specifications.

Second, we demonstrate that the Adaptive Overrelaxed EM (AEM) algorithm of [Salakhutdinov and Roweis \(2003\)](#) is able to deal with these low-noise issues, as suggested by [Petersen et al. \(2005\)](#). The key feature of the AEM algorithm is that it boosts the parameter updates and thereby counters the low variance of the artificial error term. This AEM algorithm is only a simple and straightforward extension of the conventional EM algorithm, making it just as easy to implement. Our Monte Carlo simulations show that the speed of convergence of the AEM algorithm is much faster than of the EM algorithm, with an average improvement in accuracy per iteration that is up to 68 times higher. Consequently, the AEM algorithm produces substantially more accurate factor loading

estimates than the EM algorithm with up to 57% improvement in accuracy. Furthermore, the smoothed factors based on the AEM algorithm are a better approximation of the true factors compared to standard EM, with an accuracy gain of up to 23%. The other parameters are also more accurately estimated with AEM compared to EM, albeit to a lesser extent. In the [Bańbura and Modugno \(2014\)](#) approach, the variance of the artificial error term is treated as a hyperparameter, which ex ante is fixed typically at a very small value (such as 10^{-4}). We demonstrate that carefully choosing a modest level of artificial noise (instead of just using a very low noise level) considerably speeds up the convergence, improving the accuracy of both EM and AEM. Nonetheless, the adaptive augmentation of the EM algorithm remains complementary to the optimal level of noise as it leads to faster convergence for all noise levels than the standard EM algorithm.

Third, we conduct a nowcasting exercise of euro area GDP growth based on a mixed-frequency dynamic factor model akin to [Mariano and Murasawa \(2003\)](#), which we either estimate with the EM or AEM algorithm. Empirically, we show that the AEM algorithm is able to reach much higher log-likelihood values in much less iterations than the standard EM, reconfirming the slower EM convergence. Moreover, the AEM algorithm produces more accurate nowcasts for small-scale models with improvements in accuracy up to 13% relative to the baseline EM, while medium- and large-scale models generally perform worse for both algorithms.

Besides the [Bańbura and Modugno \(2014\)](#) approach, there exists at least one other way to estimate dynamic factor models with serially correlated idiosyncratic components (see, for example, [Poncela et al., 2021](#); [Barigozzi and Luciani, 2022](#), for an overview). More specifically, [Watson and Engle \(1983\)](#) and [Reis and Watson \(2010\)](#) propose to include lags of the observables and latent factors in the measurement equation, which can then be estimated with the Expectation Conditional Maximization algorithm of [Meng and Rubin \(1993\)](#). The upside of this implementation is that its state dimension does not increase with N , as is the case in the framework of [Bańbura and Modugno \(2014\)](#), slowing down the filtering/smoothing recursions for large N . However, the downside of this alternative approach is that it is not directly compatible with arbitrary patterns of missing data ([Jungbacker et al., 2011](#); [Bańbura and Modugno, 2014](#)). Although [Jungbacker et al. \(2011\)](#) propose an alternative state-space form to deal with missing data to overcome this deficiency, this comes at the cost of more complex time-varying state-space dimensions

and system matrices, which are rather cumbersome to deal with in the EM algorithm.³

Our work also relates to the vast literature that extends the basic EM to speed up (global) convergence (see, among others, [Huang et al., 2005](#); [Varadhan and Roland, 2008](#); [He and Liu, 2012](#)). Notably, [Osoba et al. \(2013\)](#) derive the Noisy EM algorithm and show that careful additive and arbitrary noise injection could speed up the EM convergence, which corroborates with our findings that modest noise levels speed up the (A)EM convergence. Nevertheless, our paper focuses on a specific case of slow EM convergence, namely the one under a low-noise environment. Therefore, we restrict the paper to the AEM algorithm of [Salakhutdinov and Roweis \(2003\)](#) only, as this adaptation is able to naturally counter the slow EM convergence under this specific noise setting.

The outline of the paper is as follows. Section 2 describes the low-noise dynamic factor model and its estimation based on the EM and AEM algorithms. Section 3 displays the Monte Carlo simulation results to assess the effect of low-noise on the estimation performance. Section 4 shows the empirical results related to the nowcasting exercise. Section 5 summarizes our main conclusions.

2 Estimation of low-noise dynamic factor models

2.1 Low-noise dynamic factor model

Let $\mathbf{y}_t = (y_{1,t}, \dots, y_{N,t})'$ denote a N -dimensional vector with stationary time series that has the factor model representation

$$\mathbf{y}_t = \mathbf{A}\mathbf{f}_t + \boldsymbol{\varepsilon}_t, \quad (1)$$

for $t = 1, \dots, T$, where $\mathbf{f}_t = (f_{1,t}, \dots, f_{R,t})'$ is an $R \times 1$ vector with latent common factors, \mathbf{A} is an $N \times R$ factor loading matrix and $\boldsymbol{\varepsilon}_t = (\varepsilon_{1,t}, \dots, \varepsilon_{N,t})'$ is an $N \times 1$ vector with idiosyncratic components that are uncorrelated with \mathbf{f}_t at all leads and lags. For now, we assume that $\boldsymbol{\varepsilon}_t \sim \text{i.i.d. } \mathcal{N}(\mathbf{0}, \boldsymbol{\Omega})$ with $\boldsymbol{\Omega}$ being a diagonal matrix, meaning that the $\boldsymbol{\varepsilon}_t$'s are cross-sectionally and serially uncorrelated and thus that \mathbf{y}_t follows an exact factor model structure. Moreover, we assume that \mathbf{f}_t follows a stationary vector autoregression

³See [Grassi et al. \(2015\)](#) for an empirical implementation and [Holmes \(2018\)](#) for more general derivations of the EM algorithm under deterministic time-varying parameter system matrices.

(VAR) of a finite order p , that is,

$$\mathbf{f}_t = \Phi_1 \mathbf{f}_{t-1} + \dots + \Phi_p \mathbf{f}_{t-p} + \mathbf{v}_t,$$

where Φ_1, \dots, Φ_p are $R \times R$ matrices with VAR coefficients. We assume that the state disturbance vector $\mathbf{v}_t \sim \text{i.i.d. } \mathcal{N}(\mathbf{0}, \mathbf{I}_R)$ with \mathbf{I}_R being an $R \times R$ identity matrix, where this covariance matrix restriction is only a normalization condition (see, for example, [Doz et al., 2012](#)). For simplicity, we set $p = 1$, but the case of $p > 1$ can easily be accommodated.

The exact dynamic factor model assumes that all cross-sectional dependence and time-series dependence in \mathbf{y}_t is captured by the common factors \mathbf{f}_t . However, this assumption might be too restrictive and could be relaxed in two possible ways. First, allowing for cross-sectional dependence in $\boldsymbol{\varepsilon}_t$ results in a so-called approximate factor model (see, for example, [Chamberlain and Rothschild, 1983](#); [Fan et al., 2013](#); [Bai and Liao, 2016](#)) and could lead to a more efficient estimator of the latent factors ([Barigozzi and Luciani, 2022](#)).⁴ Yet, estimating the full idiosyncratic covariance matrix becomes problematic for large N ([Poncela et al., 2021](#)). In fact, no version of the EM algorithm currently exists that is able to do so in a high-dimensional setting ([Barigozzi and Luciani, 2022](#)), making this extension not readily available to implement. Also, [Luciani \(2014\)](#) empirically shows that accounting for cross-sectional correlation does not lead to improvements in forecasting accuracy. Second, allowing for serial correlation in $\boldsymbol{\varepsilon}_t$ could lead to more efficient estimators of the factor loadings ([Bai and Li, 2016](#); [Barigozzi and Luciani, 2022](#)). Moreover, modelling the dynamics in the idiosyncratic components could also be beneficial in certain applications such as in the construction of coincident economic indicators ([Stock and Watson, 1989, 1991](#); [Mariano and Murasawa, 2003](#)) and in forecasting and nowcasting ([Stock and Watson, 2002b](#); [Poncela et al., 2020](#)), especially for ragged-edge data ([Pinheiro et al., 2013](#); [Bańbura and Modugno, 2014](#)).

To explicitly model the autocorrelation of the idiosyncratic components, [Bańbura and Modugno \(2014\)](#) propose to include the vector $\boldsymbol{\varepsilon}_t$ as additional latent state and to introduce some artificial small error term \mathbf{e}_t .⁵ Consequently, measurement equation (1)

⁴[Doz et al. \(2012\)](#) show that, under weak cross-sectional and time-series correlation, the factors can still be consistently estimated with EM in an exact dynamic factor model for $N, T \rightarrow \infty$.

⁵This approach is also used by [Barigozzi and Luciani \(2019\)](#) to deal with nonstationary idiosyncratic components in a nonstationary dynamic factor model.

can be rewritten as

$$\mathbf{y}_t = \begin{pmatrix} \mathbf{A} & \mathbf{I}_N \end{pmatrix} \begin{pmatrix} \mathbf{f}_t \\ \boldsymbol{\varepsilon}_t \end{pmatrix} + \mathbf{e}_t, \quad (2)$$

where $\mathbf{e}_t \sim \text{i.i.d. } \mathcal{N}(\mathbf{0}, \kappa \mathbf{I}_N)$ with κ a very small pre-fixed number (say, 10^{-4}). We continue to assume that \mathbf{f}_t follows a stationary VAR(1) process and additionally that each element of $\boldsymbol{\varepsilon}_t$ follows a stationary univariate AR(1) process. The dynamics of $\tilde{\mathbf{f}}_t = (\mathbf{f}_t, \boldsymbol{\varepsilon}_t)'$ thus are given by

$$\begin{pmatrix} \mathbf{f}_t \\ \boldsymbol{\varepsilon}_t \end{pmatrix} = \begin{pmatrix} \boldsymbol{\Phi} & \mathbf{0} \\ \mathbf{0} & \boldsymbol{\Psi} \end{pmatrix} \begin{pmatrix} \mathbf{f}_{t-1} \\ \boldsymbol{\varepsilon}_{t-1} \end{pmatrix} + \begin{pmatrix} \mathbf{v}_t \\ \boldsymbol{\nu}_t \end{pmatrix}, \quad (3)$$

where $\boldsymbol{\Psi} = \text{diag}(\psi_1, \dots, \psi_N)$ and we assume that the error terms $\mathbf{v}_t \sim \text{i.i.d. } \mathcal{N}(\mathbf{0}, \mathbf{I}_R)$ and $\boldsymbol{\nu}_t \sim \text{i.i.d. } \mathcal{N}(\mathbf{0}, \boldsymbol{\Sigma})$ are uncorrelated, with $\boldsymbol{\Sigma} = \text{diag}(\sigma_1^2, \dots, \sigma_N^2)$.

The reason that [Bańbura and Modugno \(2014\)](#) introduce the small error term \mathbf{e}_t is to be able to properly define the complete data log-likelihood, as otherwise it is not possible to apply the EM algorithm in its usual form. However, in the next subsection, we show that this low-noise specification has severe implications for the convergence speed of the EM algorithm in the estimation of the factor loading matrix \mathbf{A} .

2.2 Failure of EM in a low-noise environment

Given measurement equation (2) and state equation (3), we want to estimate the unknown parameters, collected in $\boldsymbol{\Theta} = \{\mathbf{A}, \boldsymbol{\Phi}, \boldsymbol{\Psi}, \boldsymbol{\Sigma}\}$, and the latent states $\tilde{\mathbf{f}}_t$. However, due to the fact that $\tilde{\mathbf{f}}_t$ is unobserved, it is generally not possible to find closed-form estimators for the parameters in $\boldsymbol{\Theta}$. At the same time, direct numerical optimization of the likelihood is computationally cumbersome, particularly for large N due to the large number of parameters. To handle this issue, the Expectation-Maximization (EM) algorithm of [Dempster et al. \(1977\)](#) has become a popular alternative estimation method, which has been adapted by [Shumway and Stoffer \(1982\)](#) and [Watson and Engle \(1983\)](#) for dynamic factor models in state-space form. The EM algorithm focuses on the joint log-likelihood of the complete data $\tilde{\mathbf{f}}_t$ and \mathbf{y}_t and then iterates between estimating the latent states conditional on $\boldsymbol{\Theta}$ (E-step) and estimating the parameters conditional on the

states (M-step).

More formally, the complete data log-likelihood is denoted as $\ell(\tilde{\mathbf{F}}, \mathbf{Y}; \boldsymbol{\Theta})$, where $\tilde{\mathbf{F}} = (\tilde{\mathbf{f}}_1, \dots, \tilde{\mathbf{f}}_T)'$ and $\mathbf{Y} = (\mathbf{y}_1, \dots, \mathbf{y}_T)'$. The E-step is conducted by taking the expectation of the complete data log-likelihood conditional on the observed data and based on the j -th iteration of the parameter estimates, denoted as $\boldsymbol{\Theta}_j$, that is,

$$\mathcal{L}(\boldsymbol{\Theta}, \boldsymbol{\Theta}_j) = \mathbb{E}_{\boldsymbol{\Theta}_j} \left(\ell(\tilde{\mathbf{F}}, \mathbf{Y}; \boldsymbol{\Theta}) | \mathbf{Y} \right),$$

which can be computed based on a pass of the Kalman smoother (see, for example, [Shumway and Stoffer, 1982](#)). Next, to update the parameter estimates, the M-step is conducted by maximizing the expected complete data log-likelihood with respect to $\boldsymbol{\Theta}$, that is,

$$\boldsymbol{\Theta}_{j+1} = \arg \max_{\boldsymbol{\Theta}} \mathcal{L}(\boldsymbol{\Theta}, \boldsymbol{\Theta}_j). \quad (4)$$

Analytic solutions to the maximization problem in equation (4) are given in [Shumway and Stoffer \(1982\)](#) and [Watson and Engle \(1983\)](#) for the system matrices in measurement equation (2) and a state equation corresponding to a VAR(1) process. Hence, by iterating between the E- and M-steps, we are able to estimate $\boldsymbol{\Theta}$ and $\tilde{\mathbf{F}}$, where [Dempster et al. \(1977\)](#) show that, under some regularity conditions, the EM algorithm converges towards a local maximum of the likelihood.

Based on the maximization in equation (4), we can derive the M-step of \mathbf{A} as

$$\mathbf{A}_{j+1} = \left(\sum_{t=1}^T \mathbb{E}_{\boldsymbol{\Theta}_j} \left((\mathbf{y}_t - \boldsymbol{\varepsilon}_t) \mathbf{f}_t' | \mathbf{Y} \right) \right) \left(\sum_{t=1}^T \mathbb{E}_{\boldsymbol{\Theta}_j} \left(\mathbf{f}_t \mathbf{f}_t' | \mathbf{Y} \right) \right)^{-1}, \quad (5)$$

where $\mathbb{E}_{\boldsymbol{\Theta}_j}(\mathbf{f}_t | \mathbf{Y})$, $\mathbb{E}_{\boldsymbol{\Theta}_j}(\boldsymbol{\varepsilon}_t \mathbf{f}_t' | \mathbf{Y})$ and $\mathbb{E}_{\boldsymbol{\Theta}_j}(\mathbf{f}_t \mathbf{f}_t' | \mathbf{Y})$ can be obtained with the Kalman smoother. Similar expressions can be obtained for the other system matrices in the state-space representation of the dynamic factor model (see, for example, [Bańbura and Modugno, 2014](#)). Plugging in measurement equation (2) for the j -th EM parameter iteration, we obtain

$$\mathbf{A}_{j+1} = \mathbf{A}_j + \left(\sum_{t=1}^T \mathbb{E}_{\boldsymbol{\Theta}_j} \left(\mathbf{e}_t \mathbf{f}_t' | \mathbf{Y} \right) \right) \left(\sum_{t=1}^T \mathbb{E}_{\boldsymbol{\Theta}_j} \left(\mathbf{f}_t \mathbf{f}_t' | \mathbf{Y} \right) \right)^{-1}.$$

Consequently, by decreasing the variance of $\mathbf{e}_t \sim \mathcal{N}(\mathbf{0}, \kappa \mathbf{I}_N)$, that is, $\kappa \rightarrow 0$, we get that $\mathbf{A}_{j+1} \rightarrow \mathbf{A}_j$. More formally, [Bermond and Cardoso \(1999\)](#) and [Petersen et al. \(2005\)](#) show that

$$\mathbf{A}_{j+1} = \mathbf{A}_j + \kappa \tilde{\mathbf{A}}_j + \mathcal{O}(\kappa^4), \quad (6)$$

where $\tilde{\mathbf{A}}_j$ is the first-order correction term, see the Technical Appendix of [Petersen et al. \(2005\)](#) for more details. In other words, the learning rate of the M-step for \mathbf{A} is proportional to the noise level κ of the artificial error term. Hence, the convergence of the EM algorithm slows down for small values of κ and requires an excessive number of iterations in order to converge.⁶

2.3 Adaptive EM in a low-noise environment

To speed up the EM convergence in the low-noise setting, we advocate to employ the Adaptive Overrelaxed EM (AEM) algorithm of [Salakhutdinov and Roweis \(2003\)](#), following the suggestion of [Petersen et al. \(2005\)](#). The idea behind this AEM algorithm is to boost the parameter updates by an adaptive factor η_j that changes over the iterations. Specifically, the M-step of the factor loadings in the AEM algorithm can be written as

$$\mathbf{A}_{j+1}^{AEM} = \mathbf{A}_j^{AEM} + \eta_j \left(\mathbf{A}_{j+1} - \mathbf{A}_j^{AEM} \right), \quad (7)$$

where \mathbf{A}_{j+1} is obtained from the M-step in equation (5) based on the j -th parameter iteration from the AEM algorithm (Θ_j^{AEM}) for the intermediate E-step. Combining this with equation (6), in which the previous iteration is equal to the one of the AEM algorithm, we get that

$$\mathbf{A}_{j+1}^{AEM} = \mathbf{A}_j^{AEM} + \eta_j \kappa \tilde{\mathbf{A}}_j^{AEM} + \mathcal{O}(\kappa^4),$$

⁶Indeed, [Coroneo et al. \(2016\)](#) find that using initial or final estimates gives similar results, which they attribute to the fact that the two-step approach of [Doz et al. \(2011\)](#), used for initialization, and the maximum likelihood approach have similar properties under a strong factor structure (see, for example, [Doz et al., 2011, 2012](#)). We alternatively argue that this could be due to the low-noise specification in which a large number of iterations only changes the estimates by a very small margin. In fact, if the used tolerance level ϵ is too large, then the EM algorithm stops after only a few iterations as the changes are too small, rather than that the EM algorithm reaches a local optimum (see, for example, [Alvarez et al., 2016](#), who indicate convergence after only 3-4 iterations).

which shows that a factor $\eta_j > 1$ is able to directly counter the low-noise level κ and thereby increases the step size relative to the conventional EM, potentially speeding up convergence. As the other parameters are all part of the state equation, their updates are not directly affected by the low-noise setting in the measurement equation. Therefore, we do not apply this boosted M-step to those parameters.

The choice of η_j in equation (7) determines how much the learning rate of the M-step is boosted, where $\eta_j = 1$ for all j returns the standard EM algorithm. Although there exists an optimal boosting factor η_j^* with regard to the global rate of convergence of the algorithm, it is computationally difficult to compute (Salakhutdinov and Roweis, 2003; Yu, 2012). Instead, Salakhutdinov and Roweis (2003) propose to set $\eta_{j+1} = \alpha\eta_j$ to gradually increase the boosting factor, where they set $\alpha = 1.1$ and initialize the boosting factor with $\eta_1 = 1$.⁷ The only downside of using an adaptive learning rate with this specification is that an increase in the likelihood of \mathbf{Y} is not necessarily guaranteed anymore. In case the likelihood does not improve, Salakhutdinov and Roweis (2003) set $\Lambda_{j+1}^{AEM} = \Lambda_{j+1}$, which is close to Λ_j^{AEM} due to the low-noise environment, and re-set the boosting factor to $\eta_{j+1} = 1$, after which the algorithm continues.

3 Monte Carlo simulations

3.1 Simulation set-up

To assess the effect of the low-noise specification on factor and parameter estimation based on the (A)EM algorithm, we conduct a Monte Carlo simulation in a similar fashion as Doz et al. (2012) and Bańbura and Modugno (2014). More specifically, we simulate data from the following dynamic factor set-up:

$$\begin{aligned} \mathbf{y}_t &= \mathbf{\Lambda} \mathbf{f}_t + \boldsymbol{\varepsilon}_t, \\ \mathbf{f}_t &= \mathbf{\Phi} \mathbf{f}_{t-1} + \mathbf{v}_t, & \mathbf{v}_t &\sim \text{i.i.d. } \mathcal{N}(\mathbf{0}, \mathbf{I}_R), \\ \boldsymbol{\varepsilon}_t &= \mathbf{\Psi} \boldsymbol{\varepsilon}_{t-1} + \boldsymbol{\nu}_t, & \boldsymbol{\nu}_t &\sim \text{i.i.d. } \mathcal{N}(\mathbf{0}, \boldsymbol{\Sigma}), \end{aligned}$$

⁷Salakhutdinov and Roweis (2003) did not find their results to be very sensitive to the setting of α , as long as it is close to but greater than unity.

for $t = 1, \dots, T$, with

$$\begin{aligned} \Lambda_{i,j} &\sim \text{i.i.d. } \mathcal{N}(0, 1), & i = 1, \dots, N, j = 1, \dots, R, \\ \Phi_{i,j} &= \begin{cases} \phi & \text{if } i = j \\ 0 & \text{if } i \neq j, \end{cases} & i, j = 1, \dots, R, \\ \Psi_{i,j} &= \begin{cases} \psi & \text{if } i = j \\ 0 & \text{if } i \neq j, \end{cases} & i, j = 1, \dots, N, \\ \Sigma_{i,j} &= \tau^{|i-j|} (1 - \psi^2) \sqrt{\gamma_i \gamma_j}, & i, j = 1, \dots, N, \\ \gamma_i &= \frac{\beta_i}{1 - \beta_i} \frac{1}{1 - \phi^2} \sum_{j=1}^R \Lambda_{i,j}^2, & \beta_i \sim \text{i.i.d. } \mathcal{U}([u, 1 - u]), \end{aligned}$$

where the subscript i, j denotes the (i, j) -th element of the corresponding matrix. The specifications of $\Phi_{i,j}$ and $\Psi_{i,j}$ imply that both the common factors as well as the idiosyncratic components follow univariate AR(1) processes, with persistence ϕ and ψ , respectively. The parameter τ governs the degree of cross-sectional dependence, where $\tau = 0$ corresponds to an exact factor model and $\tau > 0$ to an approximate factor model. Moreover, β_i governs the inverse signal-to-noise ratio of variable i , that is, it is equal to the variance of $\varepsilon_{i,t}$ divided by the variance of $y_{i,t}$. For our baseline simulation setting, we set $R = 1$, $\phi = 0.7$, $\psi = 0.5$, $\tau = 0$ and $u = 0.1$. Furthermore, we consider cross-sectional dimensions $N = 10, 20, 50$ and sample sizes $T = 50, 100$.⁸

Given the generated data, we estimate the exact low-noise dynamic factor model given in equations (2) and (3) with the noise parameter fixed at $\kappa = 10^{-4}$. To determine the convergence of the EM algorithm, the stopping rule of [Doz et al. \(2012\)](#) enjoys substantial popularity, where, for a maximum number of iterations J , the algorithm is stopped at the first iteration $j < J$ for which

$$\frac{|\ell(\mathbf{Y}; \boldsymbol{\Theta}_j) - \ell(\mathbf{Y}; \boldsymbol{\Theta}_{j-1})|}{\frac{1}{2}|\ell(\mathbf{Y}; \boldsymbol{\Theta}_j) + \ell(\mathbf{Y}; \boldsymbol{\Theta}_{j-1})|} < \epsilon, \quad (8)$$

where $\ell(\mathbf{Y}; \boldsymbol{\Theta}_j)$ is the prediction error log-likelihood of \mathbf{Y} computed at the j -th parameter

⁸We restrict the simulation set-up to max $T = 100$ and $N = 50$ due to computational costs, particularly as the state dimension increases with N , slowing down the filtering/smoothing recursions and thereby making the simulations computationally cumbersome for larger cross-sectional dimensions (see, for instance, [Jungbacker et al., 2011](#)).

iteration and ϵ is a pre-specified small tolerance level, which [Doz et al. \(2012\)](#) set equal to 10^{-4} . However, in our simulation setting, we simply conduct $J = 1,000$ iterations for both the EM and AEM algorithms to make our results insensitive to a specific tolerance level ϵ in the stopping rule.⁹ We initialize the (A)EM algorithm with the two-step (2S) approach of [Doz et al. \(2012\)](#). Specifically, this two-step approach first estimates the loadings and common factors by means of principal component analysis, after which the parameters in the state equation are estimated with OLS by using the factor estimates (assuming they are the true factors). Then, given the parameter estimates, a single pass of the Kalman smoother is used to get the final estimates of the latent factors. For completeness, we also include this two-step approach in the simulation results.

To measure the precision of the parameter estimates in each Monte Carlo run, we follow [Despois and Doz \(2023\)](#) and compute the root mean squared errors (RMSE) for the different estimation methods $x \in \{2S, EM, AEM\}$, that is,

$$\begin{aligned} RMSE_{\Lambda}^x &= \sqrt{\frac{1}{NR} \sum_{i=1}^N \sum_{j=1}^R (\Lambda_{i,j} - \hat{\Lambda}_{i,j}^x)^2}, \\ RMSE_{\phi}^x &= \sqrt{\frac{1}{R} \sum_{i=1}^R (\phi - \hat{\phi}_i^x)^2}, \\ RMSE_{\psi}^x &= \sqrt{\frac{1}{N} \sum_{i=1}^N (\psi - \hat{\psi}_i^x)^2}, \\ RMSE_{\Sigma}^x &= \sqrt{\frac{1}{N} \sum_{i=1}^N (\Sigma_{i,i} - \hat{\Sigma}_{i,i}^x)^2}, \end{aligned}$$

where a lower RMSE indicates a more accurate estimation method.¹⁰ To measure the precision of the common factor estimates in each Monte Carlo run, we follow [Doz et al. \(2012\)](#) and [Bańbura and Modugno \(2014\)](#) by using the trace R^2 of a (multivariate) regression of $\hat{\mathbf{F}}_x$ on \mathbf{F} as proposed by [Stock and Watson \(2002a\)](#), that is,

$$R_{F,x}^2 = \frac{\text{Tr}(\mathbf{F}' \hat{\mathbf{F}}_x (\hat{\mathbf{F}}_x' \hat{\mathbf{F}}_x)^{-1} \hat{\mathbf{F}}_x' \mathbf{F})}{\text{Tr}(\mathbf{F}' \mathbf{F})},$$

⁹Indeed, the stopping rule and tolerance level of [Doz et al. \(2012\)](#) employed by [Bańbura and Modugno \(2014\)](#) indicate convergence after only a few iterations, while it is clear from equation (6) that we need a substantial number of iterations for small κ .

¹⁰Since \mathbf{F} and $\mathbf{\Lambda}$ are identified up to sign changes, we follow the same identification scheme as [Despois and Doz \(2023\)](#) and impose that each simulated factor is positively correlated with its estimated version.

where $\hat{\mathbf{F}}_x$ is obtained by the Kalman smoother for $x \in \{2S, EM, AEM\}$ and a value of $R_{F,x}^2$ closer to one indicates a better approximation of the true factors. In a similar fashion, we compute the trace statistics for the idiosyncratic component estimates, resulting in $R_{E,x}^2$ for $x \in \{2S, EM, AEM\}$.

3.2 Simulation results

Table 1 shows the average RMSEs for the AEM parameter estimates and the average trace statistics for the AEM factor and idiosyncratic component estimates based on 500 Monte Carlo replications. Moreover, we show the relative RMSEs and relative trace statistics of the AEM algorithm compared to the ones of the two-step approach and the standard EM algorithm. A value smaller than one for the relative RMSEs indicates more accurate parameter estimates for the AEM algorithm compared to its benchmark, while a value larger than one for the relative R^2 's indicates more accurate factor and idiosyncratic component estimates for the AEM algorithm compared to its benchmark.

We find that the AEM algorithm produces more accurate estimates of the factor loadings than the standard EM algorithm for all sample sizes, with reductions in RMSEs ranging from a somewhat modest 11% for $N = 50$ and $T = 100$ to an impressive 57% for $N = 10$ and $T = 100$. Overall, we see that larger cross-sections worsen the absolute RMSEs of the loading estimates from the AEM algorithm and make the outperformance compared to the EM algorithm less pronounced. This is due to the fact that the improvements in AEM accuracy over the iterations become slower for larger cross-sections, requiring more iterations to obtain convergence (see, for example, the convergence plots of the RMSEs of the loadings over the $J = 1,000$ iterations in Figure 1). The same observation applies to the time series dimension, albeit in the opposite direction (with improvements generally becoming larger for larger T , except for $N = 50$) and with considerably smaller effects compared to changes in N .

It is also noteworthy that the estimation accuracy of the two-step approach for the loadings is comparable to the one of the baseline EM algorithm, highlighting that, even after 1,000 EM iterations, the factor loading estimates are still about the same as the initialization. Indeed, this also becomes clear from the convergence plots in Figure 1. To quantify the movement of the (A)EM estimates away from the initialization, we compute RMSEs in which we replace the true loadings with the 2S estimates. These RMSEs are

Table 1: Monte Carlo results: RMSEs for model parameters and trace statistics for factor estimates and idiosyncratic component estimates

| | | $T = 50$ | | | $T = 100$ | | |
|---|--------|----------|----------|----------|-----------|----------|----------|
| | | $N = 10$ | $N = 20$ | $N = 50$ | $N = 10$ | $N = 20$ | $N = 50$ |
| <i>Panel A: Average and relative RMSEs</i> | | | | | | | |
| Λ | AEM | 0.35 | 0.50 | 0.76 | 0.29 | 0.49 | 0.77 |
| | AEM/2S | 0.50 | 0.64 | 0.87 | 0.42 | 0.61 | 0.88 |
| | AEM/EM | 0.50 | 0.64 | 0.88 | 0.43 | 0.62 | 0.89 |
| ϕ | AEM | 0.11 | 0.10 | 0.11 | 0.07 | 0.08 | 0.08 |
| | AEM/2S | 0.99 | 1.04 | 1.34 | 0.70 | 0.98 | 1.30 |
| | AEM/EM | 0.43 | 0.46 | 0.54 | 0.26 | 0.32 | 0.48 |
| ψ | AEM | 0.17 | 0.14 | 0.14 | 0.11 | 0.10 | 0.10 |
| | AEM/2S | 1.32 | 1.12 | 1.05 | 1.19 | 1.15 | 1.10 |
| | AEM/EM | 1.07 | 0.98 | 0.96 | 0.93 | 0.93 | 0.93 |
| Σ | AEM | 0.91 | 1.01 | 1.22 | 0.68 | 0.83 | 0.97 |
| | AEM/2S | 0.27 | 0.34 | 0.57 | 0.21 | 0.28 | 0.52 |
| | AEM/EM | 0.82 | 0.86 | 0.96 | 0.71 | 0.78 | 0.95 |
| <i>Panel B: Average and relative trace statistics</i> | | | | | | | |
| R_F^2 | AEM | 0.90 | 0.95 | 0.97 | 0.92 | 0.95 | 0.98 |
| | AEM/2S | 1.36 | 1.18 | 1.06 | 1.35 | 1.14 | 1.03 |
| | AEM/EM | 1.23 | 1.15 | 1.10 | 1.23 | 1.17 | 1.08 |
| R_E^2 | AEM | 0.96 | 0.98 | 1.00 | 0.96 | 0.98 | 0.99 |
| | AEM/2S | 1.00 | 0.99 | 1.00 | 1.00 | 0.99 | 1.00 |
| | AEM/EM | 1.01 | 1.00 | 1.00 | 1.01 | 1.00 | 1.00 |

Notes: This table displays average root mean squared errors (RMSE) of the estimation of Λ , ϕ , ψ and Σ and the average trace statistics of the factor and idiosyncratic component estimates in the exact dynamic factor model as given in equations (2) and (3) based on the overrelaxed adaptive EM (AEM) algorithm of Salakhutdinov and Roweis (2003). The model is estimated with $\kappa = 10^{-4}$. We also include the relative RMSEs and relative trace statistics of the AEM algorithm compared to the two-step (2S) approach of Doz et al. (2011) and the EM algorithm employed in Bańbura and Modugno (2014). The AEM algorithm is more (less) accurate compared to its benchmark for a value lower (higher) than one for the relative RMSEs and a value higher (lower) than one for the relative trace statistics. The averages and relative statistics are based on 500 Monte Carlo simulation runs. The values T and N denote the sample size and cross-sectional dimension, respectively. The data is generated with an exact factor model with $R = 1$, $\phi = 0.7$, $\psi = 0.5$, $\tau = 0$ and $u = 0.1$.

about 0.13-0.48 for the AEM algorithm, whereas they are only about 0.01-0.02 for the EM algorithm, indicating almost no movement away from the initialization. This slow movement of the EM estimates clearly illustrates the low-noise issue that arises in the standard EM algorithm.

Moving to the other parameter estimates, we again find that the AEM algorithm is

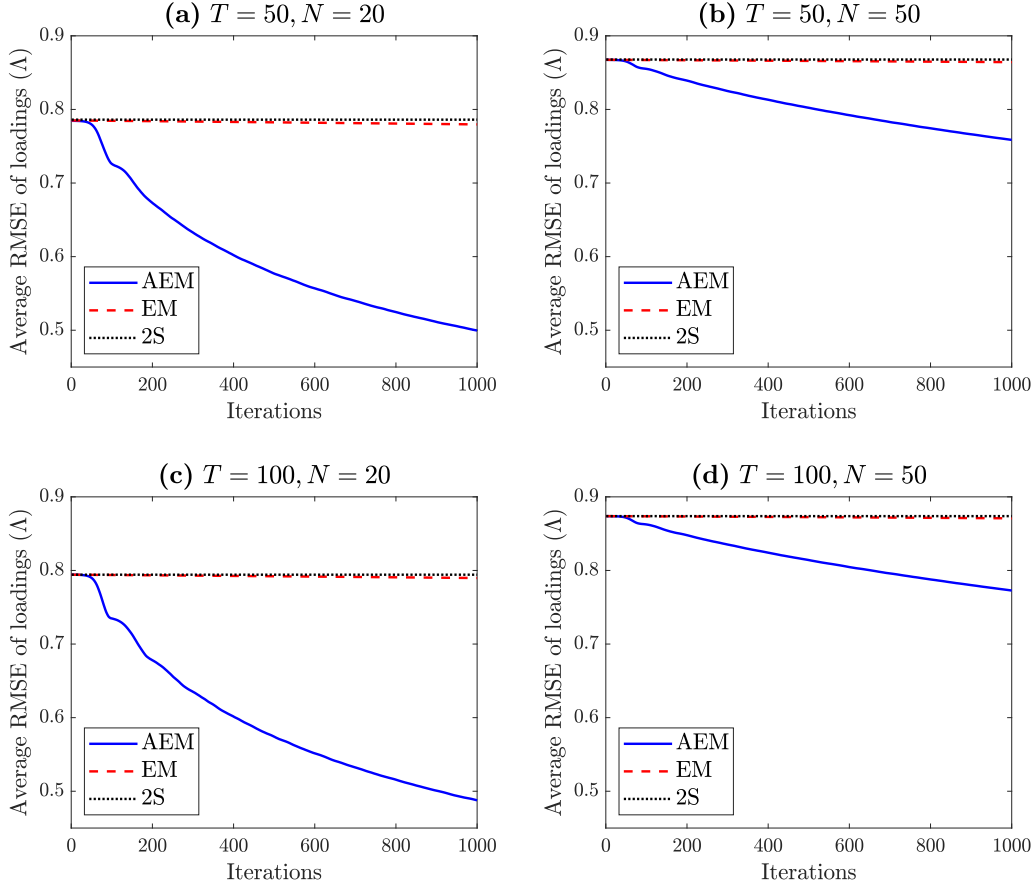


Figure 1: Convergence plots of average RMSEs of factor loading estimates (Λ) based on the AEM algorithm, EM algorithm and 2S approach for various sample sizes and cross-sectional dimensions

substantially more accurate than the EM algorithm, particularly for estimating the persistence of the latent factor. This follows from the fact that inaccurate factor loading estimates, lead to inaccurate factor estimates and consequently inaccurate factor persistence estimates. Indeed, the AEM algorithm produces a better approximation of the true factors than the EM algorithm for all sample sizes, where the increase in R^2 is about 23% for small N and 8-10% for large N . For large N , we even see that the trace statistics of the EM algorithm deteriorate compared to the two-step approach, implying that sticking with the two-step approach for large enough N results in more accurate factor estimates than by using the EM algorithm.

To illustrate this further, Figure 2 displays the convergence of the average trace statistics of the factor estimates (R_F^2) based on the different estimation methods over the $J = 1,000$ iterations. Here we clearly see that the trace statistics of the EM algorithm are well below the ones of the 2S approach for all cases (except $T = 50$ and $N = 20$), whereas the ones of the AEM algorithm all reach values above the 2S approach. In addi-

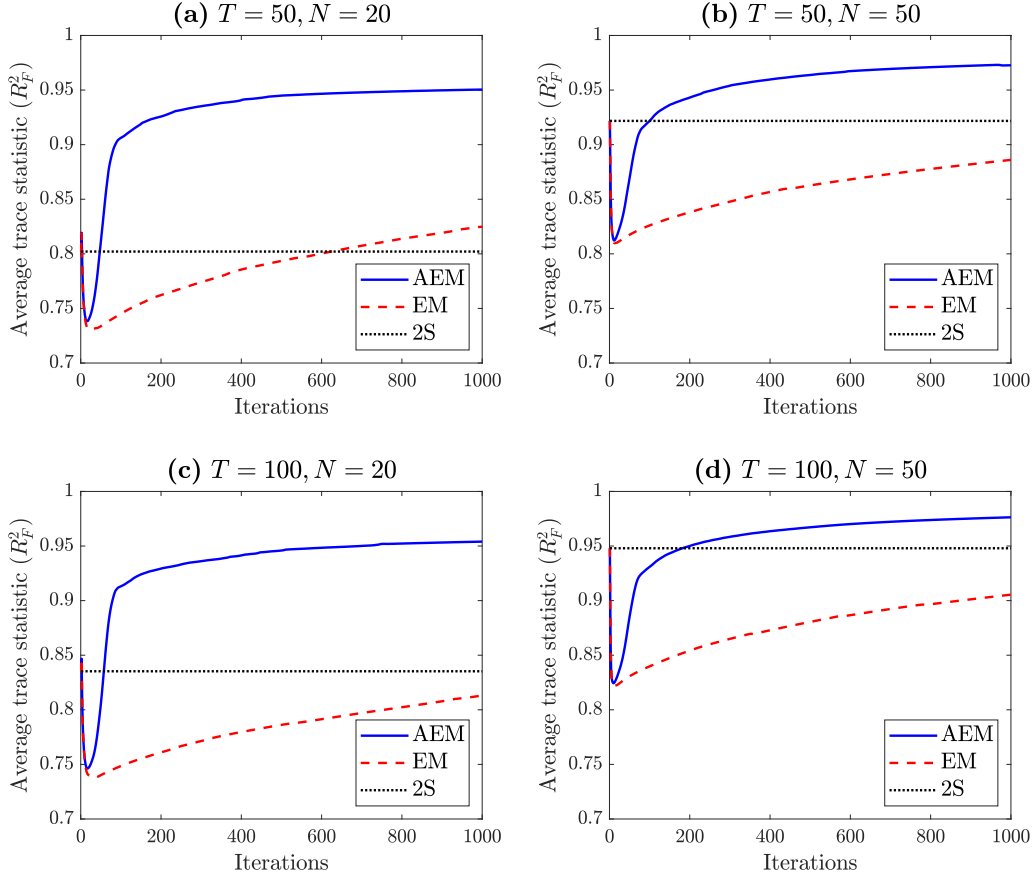


Figure 2: Convergence plots of average trace statistics of factor estimates (R_F^2) based on the AEM algorithm, EM algorithm and 2S approach for various sample sizes and cross-sectional dimensions

tion, the AEM algorithm reaches these higher values at a much faster speed than the EM algorithm, again illustrating the slow convergence of the EM algorithm in the low-noise environment.

Finally, according to Table 1, the accuracy of the idiosyncratic component estimates are not affected by the low-noise setting or sample size, and only marginally by the cross-sectional dimension. Yet, the parameter estimates related to these components (ψ and Σ) are generally more poorly estimated with the EM algorithm compared to the AEM algorithm, albeit to a lesser extent than for the factor estimates.

As a robustness check, we also consider other model (mis)specifications in Appendix A. In particular, we look at set-ups with cross-sectional dependence ($\tau = 0.5$), stronger factor persistence ($\phi = 0.9$), more factors ($R = 3$), no serial correlation in the idiosyncratic components ($\psi = 0$) and missing data issues. Overall, we find results that are qualitatively similar as the baseline results in Table 1, indicating that the superiority of the AEM algorithm over the EM algorithm persists under alternative model (mis)specifications.

3.3 Noise-level analysis

So far, we considered the setting where the noise parameter is set equal to $\kappa = 10^{-4}$. To examine how the performance of the (A)EM algorithm varies across different levels of noise, we also conduct the Monte Carlo simulations for different values of $\kappa = 10^z$ with $z \in \{-6, \dots, -1, 0, 1\}$. We use the same parameter settings as for Table 1, but we restrict ourselves to $N = 10$ and $T = 50$ due to computational costs. Note that we do not include the results of the two-step approach anymore as its parameter estimates do not depend on the level of κ .

Table 2 shows the absolute RMSEs and trace statistics for the AEM algorithm and the relative ones for the EM algorithm based again on 500 Monte Carlo replications. We find that the accuracy of the factor loading estimates based on the AEM algorithm declines for low and high values of κ , where the minimum RMSE is attained around $\kappa = 10^{-1}$ or $\kappa = 10^{-2}$. The same holds for the factor persistence, albeit to a lesser extent. For the parameters related to the idiosyncratic components, the absolute RMSEs for the AEM algorithm are rather stable for small values of κ , whereas they start to increase for larger values. Similarly for both the factor estimates and idiosyncratic component estimates, we find stable absolute trace statistics for the AEM algorithm that hover around 0.90-0.92 and 0.95-0.96, respectively, for values of κ smaller than 10^{-1} . Yet, for $\kappa = 10^0$ and $\kappa = 10^1$, the trace statistics start to decrease, indicating poorer performance. Indeed, [Barigozzi and Luciani \(2019\)](#) argue that the larger the value of κ , the larger the misspecification of the model and thus the more it affects the factor estimates. Overall, we find that for small and moderate values of κ , the performance of the AEM algorithm is rather stable and not substantially influenced by the level of noise (except perhaps for the factor loadings), whereas for larger values of κ the performance deteriorates for all parameter and factor estimates.

Moving to the relative performance of the standard EM algorithm, Table 2 shows that increasing the level of κ makes the performance of the EM algorithm come closer to the one of the AEM algorithm for all parameter and factor estimates. Hence, using a slightly higher value of κ (say, 10^{-2}) results in more accurate EM estimates than a low value of κ (say, 10^{-4}), where the latter has been used by [Bańbura and Modugno \(2014\)](#) and is used by subsequent applications of their approach (see, among others, [Coroneo et al., 2016](#); [Alvarez et al., 2016](#); [Bańbura et al., 2013](#)). On the other hand, a too high value of

Table 2: Monte Carlo results for different values of κ : RMSEs for model parameters and trace statistics for factor estimates and idiosyncratic component estimates

| | | κ | | | | | | | |
|---|--------|-----------|-----------|-----------|-----------|-----------|-----------|--------|--------|
| | | 10^{-6} | 10^{-5} | 10^{-4} | 10^{-3} | 10^{-2} | 10^{-1} | 10^0 | 10^1 |
| <i>Panel A: Average and relative RMSEs</i> | | | | | | | | | |
| Λ | AEM | 0.40 | 0.38 | 0.35 | 0.32 | 0.25 | 0.25 | 0.27 | 0.47 |
| | AEM/EM | 0.55 | 0.53 | 0.50 | 0.48 | 0.62 | 1.02 | 1.00 | 1.00 |
| ϕ | AEM | 0.11 | 0.11 | 0.11 | 0.10 | 0.09 | 0.09 | 0.09 | 0.14 |
| | AEM/EM | 0.31 | 0.31 | 0.43 | 0.53 | 0.91 | 1.00 | 0.99 | 1.00 |
| ψ | AEM | 0.16 | 0.16 | 0.17 | 0.17 | 0.18 | 0.23 | 0.31 | 0.37 |
| | AEM/EM | 1.17 | 1.11 | 1.07 | 1.03 | 1.02 | 1.00 | 1.00 | 1.00 |
| Σ | AEM | 0.97 | 0.93 | 0.91 | 0.98 | 0.98 | 0.93 | 1.48 | 3.90 |
| | AEM/EM | 0.79 | 0.77 | 0.82 | 0.84 | 1.02 | 1.01 | 1.00 | 1.00 |
| <i>Panel B: Average and relative trace statistics</i> | | | | | | | | | |
| R_F^2 | AEM | 0.90 | 0.90 | 0.90 | 0.91 | 0.92 | 0.90 | 0.85 | 0.60 |
| | AEM/EM | 1.38 | 1.40 | 1.23 | 1.12 | 1.00 | 1.00 | 1.00 | 0.99 |
| R_E^2 | AEM | 0.95 | 0.96 | 0.96 | 0.95 | 0.95 | 0.95 | 0.90 | 0.79 |
| | AEM/EM | 1.02 | 1.02 | 1.01 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |

Notes: This table displays average root mean squared errors (RMSE) of the estimation of Λ , ϕ , ψ and Σ and the average trace statistics of the factor and idiosyncratic component estimates in the exact dynamic factor model as given in equations (2) and (3) based on the overrelaxed adaptive EM (AEM) algorithm of [Salakhutdinov and Roweis \(2003\)](#). The model is estimated with a variety of different values for κ . We also include the relative RMSEs and relative trace statistics of the AEM algorithm compared to the EM algorithm employed in [Bańbura and Modugno \(2014\)](#). The AEM algorithm is more (less) accurate compared to its benchmark for a value lower (higher) than one for the relative RMSEs and a value higher (lower) than one for the relative trace statistics. The averages and relative statistics are based on 500 Monte Carlo simulation runs. The values T and N denote the sample size and cross-sectional dimension, respectively. The data is generated with an exact factor model with $R = 1$, $\phi = 0.9$, $\psi = 0.5$, $\tau = 0$ and $u = 0.1$.

κ (say, 10^1) produces poor absolute RMSEs and trace statistics. Therefore, in practice, one should carefully set the arbitrary noise level of κ to be able to improve the accuracy of the (A)EM algorithm.

To illustrate the convergence speed of the different algorithms for different noise levels, Figure 3 shows the average RMSEs of the factor loading estimates over the 1,000 iterations for $\kappa = 10^{-4}$ and $\kappa = 10^{-2}$. Clearly, the RMSEs of the EM and AEM algorithms lie closer to each other after 1,000 iterations for $\kappa = 10^{-2}$ than for $\kappa = 10^{-4}$, although the accuracy and convergence speed is still much better for the AEM algorithm.

Similar results are also found for the convergence plots of the average trace statistics of the factor estimates, which are given in Figure 4, where the setting of $\kappa = 10^{-2}$ even seems to generate comparable factor estimates for EM and AEM after 1,000 iterations. The finding that higher values of arbitrary noise speed up the convergence of the (A)EM algorithm corroborates with [Osoba et al. \(2013\)](#), who more generally show that careful additive noise injection can accelerate EM convergence. Overall, we conclude that using the AEM algorithm in combination with the right amount of arbitrary noise results in the fastest convergence, implying that these two manipulations of the traditional EM framework of [Bańbura and Modugno \(2014\)](#) are complementary in improving the estimation performance of low-noise dynamic factor models.

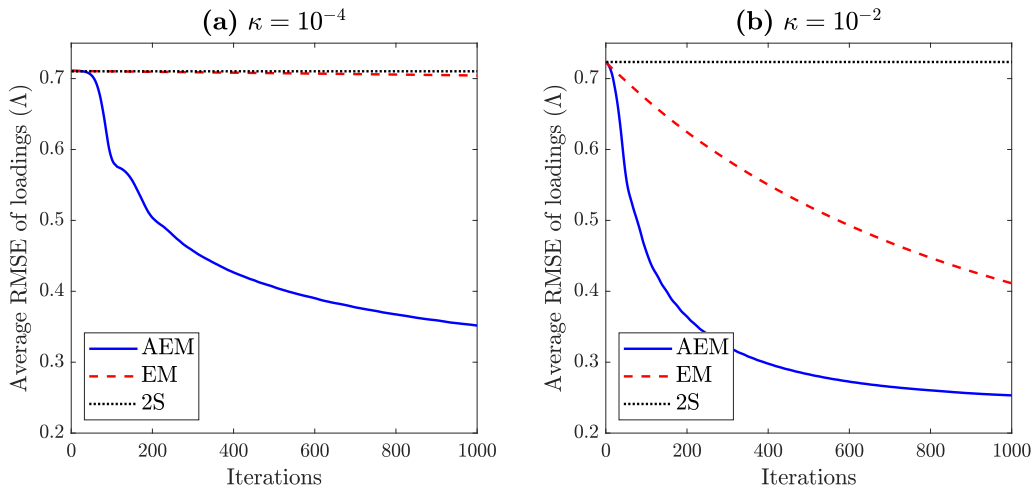


Figure 3: Convergence plots of average RMSEs of factor loading estimates (Λ) based on the AEM algorithm, EM algorithm and 2S approach for various noise levels

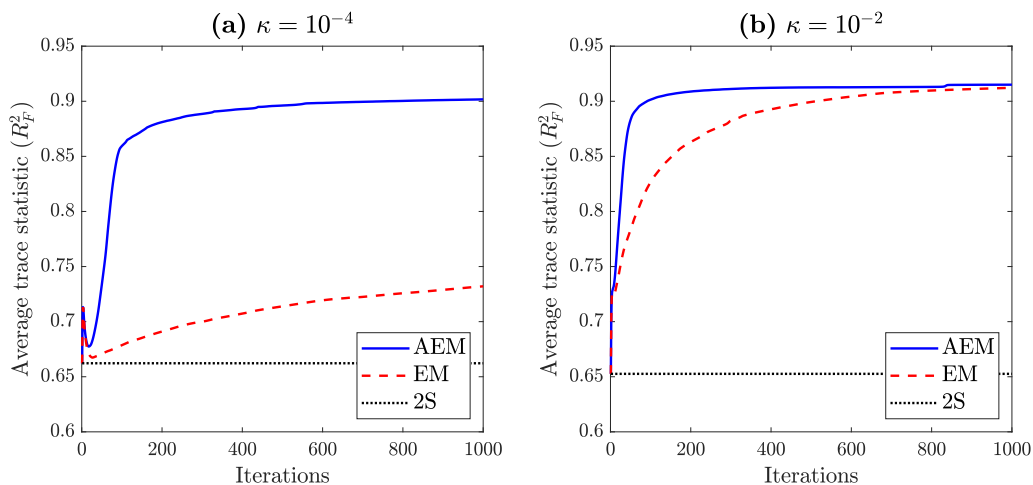


Figure 4: Convergence plots of average trace statistics of factor estimates (R_F^2) based on the AEM algorithm, EM algorithm and 2S approach for various noise levels

4 Empirical application

In this section we conduct a nowcasting exercise of euro area GDP growth to examine the effect of the slow EM convergence in an empirical setting. We construct a similar euro area macroeconomic dataset as is used by [Bańbura and Rünstler \(2011\)](#) and [Bańbura and Modugno \(2014\)](#), which consists of real economic, survey-based and financial variables. The resulting dataset contains 78 monthly series and one quarterly series, namely euro area GDP, and runs from January 1991 to December 2022. All series are transformed into stationary time series by taking the natural logarithm and/or first differences. Similarly as [Bańbura and Modugno \(2014\)](#), the series belong to a small ($N = 10$), medium ($N = 36$) or large ($N = 79$) dataset composition, making it possible to compare the estimation and nowcasting performance for different cross-sectional dimension sizes N . A complete description of all the series, their composition, transformations, publication delays and sources is given in [Appendix B](#).

For each data set, we estimate the exact factor model given in [equation \(2\)](#) and [\(3\)](#) with serial correlation in the idiosyncratic components and with the noise parameter fixed at $\kappa = 10^{-4}$ or $\kappa = 10^{-2}$. Moreover, to handle the mixed-frequency nature of the data, we impose the temporal aggregation framework of [Mariano and Murasawa \(2003\)](#) to link the monthly factor and idiosyncratic component to the quarterly variable, just as in [Bańbura and Modugno \(2014\)](#). Both the EM and AEM algorithm are initialized with the two-step (2S) approach of [Doz et al. \(2011\)](#). All series are normalized before estimation.

Before we move to the nowcasting exercise, we first show in [Figure 5](#) the maximization of the log-likelihood over the EM and AEM iterations for the complete sample period, where we estimate the mixed-frequency dynamic factor model with the small, medium and large dataset. Clearly, for both values of κ and all N , the AEM algorithm leads to much larger increments and much faster convergence of the log-likelihood than the EM algorithm. The AEM algorithm for $\kappa = 10^{-4}$ generally converges somewhere in the range of 100-200 iterations, while the EM algorithm has not converged after 1,000 iterations. In fact, [Figure C.1](#) shows that the EM algorithm has not even converged after 10,000 iterations, where the slope of the increments declines over the iterations. On the other hand, [Figure 5](#) also illustrates that we could considerably speed up the convergence of both the EM and AEM algorithm by increasing the artificial noise level to $\kappa = 10^{-2}$, although AEM still converges faster than the usual EM. The initial increase

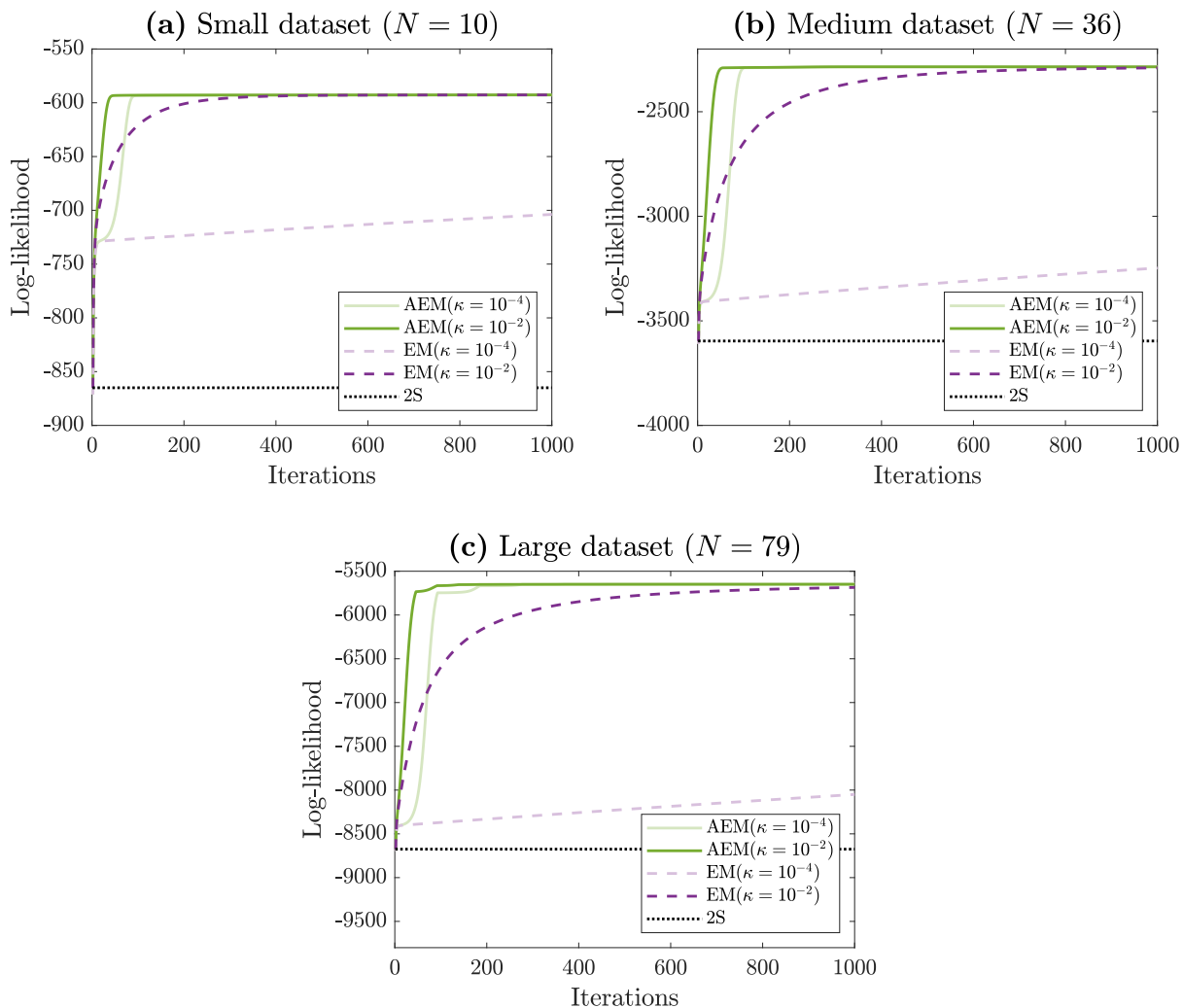


Figure 5: Log-likelihood values over 1,000 iterations of the EM and AEM algorithm in estimating a mixed-frequency dynamic factor models for various cross-sectional dimensions N

in the likelihood over the first EM and AEM iterations that is observed under $\kappa = 10^{-4}$ is due to the M-steps of all but the factor loading parameter estimates. Indeed, Figure C.2 shows that keeping the estimates of \mathbf{A} fixed in the M-step of the EM algorithm generates a similar initial increase in likelihood, where its subsequent likelihood values remain rather close to the ones of the EM algorithm in which \mathbf{A} is updated. This again confirms the slow EM convergence of the loading estimates, where not updating them leads to similar results.

Next, we conduct an expanding-window nowcasting exercise, where at each point in time we take into account the publication delays of the series (which are given in Appendix B) and impose this ragged edge structure onto the data.¹¹ For each target quarter,

¹¹This exercise is pseudo real-time, though, as the real-time vintages are not available for all series

we construct a similar sequence of nowcasts and forecasts as in [Bańbura and Modugno \(2014\)](#), starting in the first month of the previous quarter (that is, Q(-1)M1) up to the first month of the subsequent quarter (that is, Q(+1)M1), which leads to seven predictions for each quarter. We use the evaluation sample from 2006Q1 to 2022Q3, such that the first estimation sample runs from January 1991 to October 2005 to produce Q(-1)M1 for 2006Q1. Just as in the simulation study, we run a fixed number of iterations to make the comparison of the EM and AEM algorithm insensitive to the stopping rule.¹² Specifically, we employ 1,000 iterations for the small dataset, 500 iterations for the medium dataset and 100 iterations for the large dataset, which is motivated by the fact that the filtering/smoothing recursions become slower for large N . Beside the nowcasts from EM and AEM, we also include nowcasts based on the two-step approach of [Doz et al. \(2011\)](#), a first-order autoregression for GDP growth, and the historical mean of past GDP growth.¹³

Table 3 shows the relative root mean squared forecast errors (RMSFEs) compared to the historical mean of the sequence of nowcasts for the various methods, as well as the absolute RMSFEs for the historical mean in the last column. For all models and estimation methods, we observe gains in accuracy when more information becomes available, even for the simple benchmarks. Zooming in on the small-scale model in Panel A that excludes the pandemic period, we find that both the EM and AEM algorithm perform better than the two-step approach, emphasizing the added value of increasing the number of iterations. In fact, their nowcasts are also more accurate than the ones produced by an autoregressive model or the historical mean. Still, we find that the AEM algorithm performs better than the EM algorithm for all projections with improvements in accuracy up to 13%. On the other hand, for the medium- and large-scale models, the performance of the EM and AEM algorithm is worse than for the small-scale model, where EM seems to perform better than AEM. This result is largely driven by the financial crisis period (see Figure D.2), in which the slower EM convergence seems to be beneficial

over the full period. The current vintage that is used is January 2023.

¹²In Appendix D.1 we show the nowcasting results for different convergence criteria ϵ in the stopping rule in equation (8), highlighting that these results are indeed sensitive to the chosen value of ϵ . For $\epsilon = 10^{-4}$, both the EM and AEM algorithm generally indicate convergence after only 20 iterations, leading to poor nowcasting performance. For $\epsilon = 10^{-5}$ and $\epsilon = 10^{-6}$, the number of iterations needed increases, especially during the financial crisis and covid pandemic, leading to pronounced nowcast gains for AEM and only marginal gains for EM.

¹³We have chosen the number of lags in the autoregressive model with the Akaike and Schwarz information criteria, where one lag is always optimal for both criteria.

Table 3: Relative nowcasting performance of euro area GDP growth based on mixed-frequency dynamic factor models with $\kappa = 10^{-4}$

| | Small | | | Medium | | | Large | | | Benchmarks | |
|--|-------|------|------|--------|------|------|-------|------|------|------------|-------|
| | 2S | EM | AEM | 2S | EM | AEM | 2S | EM | AEM | AR | Mean |
| <i>Panel A: Evaluation period excluding covid pandemic (2006Q3 - 2019Q4)</i> | | | | | | | | | | | |
| Q(-1)M1 | 0.98 | 0.94 | 0.82 | 0.96 | 0.84 | 0.88 | 0.97 | 0.86 | 0.87 | 1.13 | 71.0 |
| Q(-1)M2 | 0.95 | 0.89 | 0.79 | 0.90 | 0.76 | 0.81 | 0.92 | 0.79 | 0.82 | 1.05 | 70.5 |
| Q(-1)M3 | 0.84 | 0.73 | 0.66 | 0.83 | 0.72 | 0.77 | 0.84 | 0.73 | 0.76 | 1.05 | 70.5 |
| Q(0)M1 | 0.76 | 0.68 | 0.61 | 0.80 | 0.74 | 0.82 | 0.80 | 0.73 | 0.81 | 1.05 | 70.5 |
| Q(0)M2 | 0.63 | 0.60 | 0.54 | 0.68 | 0.68 | 0.73 | 0.68 | 0.67 | 0.73 | 0.98 | 69.7 |
| Q(0)M3 | 0.52 | 0.49 | 0.43 | 0.61 | 0.61 | 0.66 | 0.59 | 0.58 | 0.57 | 0.98 | 69.7 |
| Q(+1)M1 | 0.50 | 0.49 | 0.45 | 0.58 | 0.59 | 0.63 | 0.56 | 0.55 | 0.51 | 0.98 | 69.7 |
| Average | 0.74 | 0.69 | 0.62 | 0.77 | 0.71 | 0.76 | 0.77 | 0.70 | 0.73 | 1.03 | 70.2 |
| <i>Panel B: Evaluation period including covid pandemic (2006Q3 - 2022Q3)</i> | | | | | | | | | | | |
| Q(-1)M1 | 1.02 | 1.17 | 1.39 | 1.29 | 1.93 | 1.87 | 1.15 | 1.64 | 5.08 | 1.07 | 223.3 |
| Q(-1)M2 | 1.02 | 1.11 | 1.01 | 0.98 | 0.98 | 0.94 | 1.01 | 1.05 | 0.96 | 1.39 | 223.4 |
| Q(-1)M3 | 0.91 | 0.89 | 0.84 | 0.86 | 0.81 | 0.78 | 0.90 | 0.88 | 0.80 | 1.39 | 223.4 |
| Q(0)M1 | 0.76 | 0.64 | 0.46 | 0.63 | 0.57 | 0.50 | 0.70 | 0.63 | 1.24 | 1.39 | 223.4 |
| Q(0)M2 | 0.57 | 0.57 | 0.41 | 0.64 | 0.66 | 0.44 | 0.68 | 0.61 | 0.41 | 1.19 | 223.9 |
| Q(0)M3 | 0.58 | 0.61 | 0.49 | 0.62 | 0.65 | 0.48 | 0.64 | 0.58 | 0.45 | 1.19 | 223.9 |
| Q(+1)M1 | 0.62 | 0.66 | 0.53 | 0.66 | 0.68 | 0.52 | 0.69 | 0.64 | 0.54 | 1.19 | 223.9 |
| Average | 0.78 | 0.81 | 0.73 | 0.81 | 0.90 | 0.79 | 0.82 | 0.86 | 1.35 | 1.26 | 223.6 |

Notes: This table displays the relative root mean squared forecast errors (RMFSEs) of nowcasting euro area GDP growth from 2006Q1 to 2022Q4 compared to a historical mean nowcast for which the absolute RMSFEs are shown in basis points. Panel A shows the results excluding the covid pandemic, while Panel B includes this period. The small, medium and large mixed-frequency dynamic factor models are estimated with $\kappa = 10^{-4}$ based on either the two-step (2S) approach of [Doz et al. \(2011\)](#), the EM algorithm employed in [Bańbura and Modugno \(2014\)](#) or the AEM algorithm of [Salakhutdinov and Roweis \(2003\)](#). We also include a first-order autoregression for GDP growth as benchmark. For each target quarter, the nowcasts/forecasts construction dates range from the first month of the previous quarter (that is, Q(-1)M1) up to the first month of the subsequent quarter (that is, Q(+1)M1).

compared to the faster AEM convergence. In other words, for medium and large datasets, the initial factor loading estimates of the two-step approach, which are close to the ones of EM due to slow convergence, lead to more accurate nowcasts than the factor loading estimates based on maximum likelihood with the AEM algorithm. Table [D.2](#) indeed shows that the nowcasting performance is similar for the EM algorithm when the factor loadings are kept fixed instead of estimated. Yet, adopting the (A)EM algorithm for larger N does not necessarily lead to better nowcasting performance compared to a small-scale model, which concurs with the notion that more data is not always better ([Boivin and Ng, 2006](#)).

Moving to Panel B that also includes the pandemic period, we find that the absolute RMSFEs of the historical mean increases by a factor of three, just as for the other methods. The AEM algorithm still returns more accurate nowcasts than the EM algorithm

with the small-scale model. In fact, over this complete evaluation sample, the AEM algorithm is also more accurate than the EM algorithm in the medium and large models, except for Q(-1)M1 and Q(0)M1 in the large model (see also Figure D.2). This latter is mainly due to the nowcasts made on the first month of the quarter in the covid pandemic (that is, April 2020), which largely influences the corresponding nowcasts based on the AEM algorithm. Nevertheless, based on the other nowcasts, the adoption of the AEM could still have helped to better monitor the current state of the economy during and after the covid pandemic.

Finally, we also construct nowcasts based on a model with $\kappa = 10^{-2}$. Table 4 shows the corresponding relative RMSFEs compared to the historical mean. For both evalua-

Table 4: Relative nowcasting performance of euro area GDP growth based on mixed-frequency dynamic factor models with $\kappa = 10^{-2}$

| | Small | | Medium | | Large | |
|--|-------|------|--------|------|-------|-------|
| | EM | AEM | EM | AEM | EM | AEM |
| <i>Panel A: Evaluation period excluding covid pandemic (2006Q1 - 2019Q4)</i> | | | | | | |
| Q(-1)M1 | 0.83 | 0.82 | 0.87 | 0.88 | 0.82 | 0.87 |
| Q(-1)M2 | 0.79 | 0.80 | 0.81 | 0.82 | 0.79 | 0.81 |
| Q(-1)M3 | 0.66 | 0.66 | 0.77 | 0.77 | 0.73 | 0.75 |
| Q(0)M1 | 0.61 | 0.61 | 0.81 | 0.82 | 0.77 | 0.84 |
| Q(0)M2 | 0.55 | 0.54 | 0.73 | 0.73 | 0.69 | 0.78 |
| Q(0)M3 | 0.43 | 0.43 | 0.66 | 0.66 | 0.59 | 0.51 |
| Q(+1)M1 | 0.46 | 0.46 | 0.63 | 0.63 | 0.56 | 0.44 |
| Average | 0.62 | 0.62 | 0.75 | 0.76 | 0.71 | 0.71 |
| <i>Panel B: Evaluation period including covid pandemic (2006Q1 - 2022Q3)</i> | | | | | | |
| Q(-1)M1 | 1.39 | 1.39 | 1.89 | 1.86 | 1.89 | 10.90 |
| Q(-1)M2 | 1.01 | 1.01 | 0.94 | 0.94 | 1.02 | 0.96 |
| Q(-1)M3 | 0.84 | 0.84 | 0.78 | 0.78 | 0.84 | 0.78 |
| Q(0)M1 | 0.46 | 0.46 | 0.51 | 0.50 | 0.52 | 2.13 |
| Q(0)M2 | 0.41 | 0.41 | 0.47 | 0.44 | 0.44 | 0.47 |
| Q(0)M3 | 0.49 | 0.49 | 0.50 | 0.49 | 0.47 | 0.42 |
| Q(+1)M1 | 0.53 | 0.53 | 0.54 | 0.52 | 0.58 | 0.51 |
| Average | 0.73 | 0.73 | 0.80 | 0.79 | 0.82 | 2.31 |

Notes: This table displays the relative root mean squared forecast errors (RMFSEs) of nowcasting euro area GDP growth from 2006Q1 to 2022Q4 compared to a historical mean nowcast. Panel A shows the results excluding the covid pandemic, while Panel B includes this period. The small, medium and large mixed-frequency dynamic factor models are estimated with $\kappa = 10^{-2}$ based on either the EM algorithm employed in Bańbura and Modugno (2014) or the AEM algorithm of Salakhutdinov and Roweis (2003). For each target quarter, the nowcasts/forecasts construction dates range from the first month of the previous quarter (that is, Q(-1)M1) up to the first month of the subsequent quarter (that is, Q(+1)M1).

tion periods, the accuracy of the EM algorithm is much closer to the AEM algorithm, especially for the small and medium datasets. Meanwhile, the performance of the AEM algorithm is comparable to the performance of the models with $\kappa = 10^{-4}$ in Table 3. This highlights that AEM is less sensitive to κ , while using a slightly higher value of κ for EM leads to more accurate nowcasts, at least for the small-scale model.

5 Conclusion

In this paper we address the slow EM convergence issue that emerges in the estimation of low-noise dynamic factor models. Specifically, we show analytically and with Monte Carlo simulations that the popular framework of [Bańbura and Modugno \(2014\)](#), developed to explicitly model serially correlated idiosyncratic components under arbitrary missing data patterns by including them as latent states and by introducing artificial small noise, slows down the convergence speed and deteriorates the accuracy of the EM factor loading estimates. Moreover, our Monte Carlo simulations indicate that this also considerably influences the EM convergence speed and estimation accuracy for the latent factors and other model parameters.

To remedy these slow EM convergence issues, we advocate to employ the Adaptive Overrelaxed EM (AEM) algorithm of [Salakhutdinov and Roweis \(2003\)](#), as also suggested by [Petersen et al. \(2005\)](#), which is a simple and straightforward adaptation of the basic EM. Our simulation study shows that the AEM algorithm substantially increases the convergence speed and leads to gains up to 57% in accuracy for the loadings and 23% for the factors. At the same time, carefully choosing the appropriate level of arbitrary noise could lead to even faster convergence for both the EM and AEM algorithms. In practice, the right choice of noise depends on the scale of the data (and the latent factors) and could properly be determined based on Monte Carlo simulations. Still, for all levels of noise, the AEM algorithm remains faster in convergence than the EM algorithm, making the adaptive extension complementary to using the right amount of artificial noise. Finally, we show in an empirical application that a mixed-frequency dynamic factor model estimated with the AEM algorithm is able to produce more accurate euro area GDP nowcasts than when it is estimated with the standard EM algorithm with gains in accuracy up to 13%.

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A Alternative Monte Carlo simulation set-ups

A.1 Cross-sectional dependence

Table A.1: Monte Carlo results under cross-sectional dependence: RMSEs for model parameters and trace statistics for factor estimates

| | | $T = 50$ | | | $T = 100$ | | |
|---|--------|----------|----------|----------|-----------|----------|----------|
| | | $N = 10$ | $N = 20$ | $N = 50$ | $N = 10$ | $N = 20$ | $N = 50$ |
| <i>Panel A: Average and relative RMSEs</i> | | | | | | | |
| Λ | AEM | 0.40 | 0.52 | 0.76 | 0.34 | 0.50 | 0.76 |
| | AEM/2S | 0.55 | 0.65 | 0.88 | 0.48 | 0.63 | 0.88 |
| | AEM/EM | 0.55 | 0.66 | 0.88 | 0.48 | 0.63 | 0.88 |
| ϕ | AEM | 0.11 | 0.10 | 0.11 | 0.08 | 0.07 | 0.08 |
| | AEM/2S | 0.88 | 1.07 | 1.34 | 0.81 | 0.95 | 1.35 |
| | AEM/EM | 0.37 | 0.41 | 0.56 | 0.32 | 0.36 | 0.44 |
| ψ | AEM | 0.18 | 0.15 | 0.14 | 0.12 | 0.10 | 0.10 |
| | AEM/2S | 1.41 | 1.16 | 1.06 | 1.37 | 1.15 | 1.10 |
| | AEM/EM | 1.11 | 0.98 | 0.96 | 0.99 | 0.94 | 0.91 |
| Σ | AEM | 1.04 | 1.06 | 1.24 | 0.82 | 0.84 | 0.95 |
| | AEM/2S | 0.29 | 0.32 | 0.56 | 0.22 | 0.27 | 0.43 |
| | AEM/EM | 0.90 | 0.88 | 0.96 | 0.83 | 0.81 | 0.94 |
| <i>Panel B: Average and relative trace statistics</i> | | | | | | | |
| R_F^2 | AEM | 0.85 | 0.94 | 0.97 | 0.87 | 0.95 | 0.97 |
| | AEM/2S | 1.38 | 1.23 | 1.06 | 1.35 | 1.17 | 1.04 |
| | AEM/EM | 1.23 | 1.18 | 1.09 | 1.24 | 1.16 | 1.09 |

Notes: This table displays average root mean squared errors (RMSE) of the estimation of Λ , ϕ , ψ and Σ and the average trace statistics of the factor estimates in the exact dynamic factor model as given in equations (2) and (3) based on the overrelaxed adaptive EM (AEM) algorithm of [Salakhutdinov and Roweis \(2003\)](#). The model is estimated with $\kappa = 10^{-4}$. We also include the relative RMSEs and relative trace statistics of the AEM algorithm compared to the two-step (2S) approach of [Doz et al. \(2011\)](#) and the EM algorithm employed in [Bańbura and Modugno \(2014\)](#). The AEM algorithm is more (less) accurate compared to its benchmarks for a value lower (higher) than one for the relative RMSEs and a value higher (lower) than one for the relative trace statistics. The averages and relative statistics are based on 500 Monte Carlo simulation runs. The values T and N denote the sample size and cross-sectional dimension, respectively. The data is generated with an approximate factor model with $R = 1$, $\phi = 0.7$, $\psi = 0.5$, $\tau = 0.5$ and $u = 0.1$.

A.2 Stronger factor persistence

Table A.2: Monte Carlo results under stronger factor persistence: RMSEs for model parameters and trace statistics for factor estimates

| | | $T = 50$ | | | $T = 100$ | | |
|---|--------|----------|----------|----------|-----------|----------|----------|
| | | $N = 10$ | $N = 20$ | $N = 50$ | $N = 10$ | $N = 20$ | $N = 50$ |
| <i>Panel A: Average and relative RMSEs</i> | | | | | | | |
| Λ | AEM | 0.43 | 0.57 | 0.79 | 0.36 | 0.53 | 0.78 |
| | AEM/2S | 0.58 | 0.70 | 0.90 | 0.50 | 0.67 | 0.90 |
| | AEM/EM | 0.58 | 0.70 | 0.90 | 0.50 | 0.67 | 0.90 |
| ϕ | AEM | 0.09 | 0.08 | 0.08 | 0.07 | 0.06 | 0.06 |
| | AEM/2S | 0.47 | 0.49 | 0.69 | 0.38 | 0.42 | 0.68 |
| | AEM/EM | 0.43 | 0.53 | 0.67 | 0.34 | 0.39 | 0.51 |
| ψ | AEM | 0.16 | 0.15 | 0.14 | 0.11 | 0.10 | 0.10 |
| | AEM/2S | 1.17 | 1.12 | 1.05 | 1.06 | 1.06 | 1.07 |
| | AEM/EM | 1.05 | 1.05 | 1.06 | 0.92 | 0.97 | 1.03 |
| Σ | AEM | 2.27 | 2.99 | 3.17 | 1.82 | 1.82 | 2.37 |
| | AEM/2S | 0.24 | 0.32 | 0.47 | 0.17 | 0.25 | 0.37 |
| | AEM/EM | 0.89 | 0.92 | 0.95 | 0.84 | 0.87 | 0.94 |
| <i>Panel B: Average and relative trace statistics</i> | | | | | | | |
| R_F^2 | AEM | 0.88 | 0.91 | 0.93 | 0.90 | 0.94 | 0.94 |
| | AEM/2S | 1.46 | 1.26 | 1.11 | 1.43 | 1.18 | 1.08 |
| | AEM/EM | 1.35 | 1.25 | 1.17 | 1.32 | 1.22 | 1.15 |

Notes: This table displays average root mean squared errors (RMSE) of the estimation of Λ , ϕ , ψ and Σ and the average trace statistics of the factor estimates in the exact dynamic factor model as given in equations (2) and (3) based on the overrelaxed adaptive EM (AEM) algorithm of [Salakhutdinov and Roweis \(2003\)](#). The model is estimated with $\kappa = 10^{-4}$. We also include the relative RMSEs and relative trace statistics of the AEM algorithm compared to the two-step (2S) approach of [Doz et al. \(2011\)](#) and the EM algorithm employed in [Bańbura and Modugno \(2014\)](#). The AEM algorithm is more (less) accurate compared to its benchmarks for a value lower (higher) than one for the relative RMSEs and a value higher (lower) than one for the relative trace statistics. The averages and relative statistics are based on 500 Monte Carlo simulation runs. The values T and N denote the sample size and cross-sectional dimension, respectively. The data is generated with an exact factor model with $R = 1$, $\phi = 0.9$, $\psi = 0.5$, $\tau = 0$ and $u = 0.1$.

A.3 No serial correlation in idiosyncratic components

Table A.3: Monte Carlo results under no serial correlation in idiosyncratic components: RMSEs for model parameters and trace statistics for factor estimates

| | | $T = 50$ | | | $T = 100$ | | |
|---|--------|----------|----------|----------|-----------|----------|----------|
| | | $N = 10$ | $N = 20$ | $N = 50$ | $N = 10$ | $N = 20$ | $N = 50$ |
| <i>Panel A: Average and relative RMSEs</i> | | | | | | | |
| Λ | AEM | 0.37 | 0.54 | 0.80 | 0.32 | 0.52 | 0.79 |
| | AEM/2S | 0.52 | 0.69 | 0.92 | 0.46 | 0.67 | 0.92 |
| | AEM/EM | 0.53 | 0.69 | 0.92 | 0.46 | 0.67 | 0.92 |
| ϕ | AEM | 0.13 | 0.13 | 0.16 | 0.09 | 0.10 | 0.15 |
| | AEM/2S | 0.40 | 0.50 | 0.97 | 0.32 | 0.45 | 1.17 |
| | AEM/EM | 0.43 | 0.46 | 0.68 | 0.31 | 0.38 | 0.65 |
| ψ | AEM | 0.17 | 0.16 | 0.16 | 0.12 | 0.12 | 0.11 |
| | AEM/2S | 0.98 | 0.97 | 1.08 | 0.78 | 0.91 | 1.07 |
| | AEM/EM | 0.88 | 0.92 | 1.04 | 0.73 | 0.86 | 1.04 |
| Σ | AEM | 1.20 | 1.35 | 1.63 | 0.93 | 1.08 | 1.27 |
| | AEM/2S | 0.27 | 0.34 | 0.54 | 0.20 | 0.26 | 0.47 |
| | AEM/EM | 0.87 | 0.87 | 0.92 | 0.74 | 0.82 | 0.96 |
| <i>Panel B: Average and relative trace statistics</i> | | | | | | | |
| R_F^2 | AEM | 0.90 | 0.94 | 0.93 | 0.92 | 0.94 | 0.93 |
| | AEM/2S | 1.35 | 1.18 | 1.04 | 1.33 | 1.15 | 1.04 |
| | AEM/EM | 1.23 | 1.19 | 1.10 | 1.24 | 1.19 | 1.10 |

Notes: This table displays average root mean squared errors (RMSE) of the estimation of Λ , ϕ , ψ and Σ and the average trace statistics of the factor and idiosyncratic component estimates in the exact dynamic factor model as given in equations (2) and (3) based on the overrelaxed adaptive EM (AEM) algorithm of [Salakhutdinov and Roweis \(2003\)](#). The model is estimated with $\kappa = 10^{-4}$. We also include the relative RMSEs and relative trace statistics of the AEM algorithm compared to the two-step (2S) approach of [Doz et al. \(2011\)](#) and the EM algorithm employed in [Bańbura and Modugno \(2014\)](#). The AEM algorithm is more (less) accurate compared to its benchmarks for a value lower (higher) than one for the relative RMSEs and a value higher (lower) than one for the relative trace statistics. The averages and relative statistics are based on 500 Monte Carlo simulation runs. The values T and N denote the sample size and cross-sectional dimension, respectively. The data is generated with an exact factor model with $R = 1$, $\phi = 0.9$, $\psi = 0$, $\tau = 0$ and $u = 0.1$.

A.4 Missing data

Table A.4: Monte Carlo results under missing data: RMSEs for model parameters and trace statistics for factor estimates

| | | $T = 50$ | | | $T = 100$ | | |
|---|--------|----------|----------|----------|-----------|----------|----------|
| | | $N = 10$ | $N = 20$ | $N = 50$ | $N = 10$ | $N = 20$ | $N = 50$ |
| <i>Panel A: Average and relative RMSEs</i> | | | | | | | |
| Λ | AEM | 0.36 | 0.52 | 0.77 | 0.32 | 0.52 | 0.75 |
| | AEM/2S | 0.50 | 0.65 | 0.88 | 0.46 | 0.65 | 0.87 |
| | AEM/EM | 0.51 | 0.66 | 0.89 | 0.46 | 0.66 | 0.88 |
| ϕ | AEM | 0.10 | 0.11 | 0.12 | 0.08 | 0.09 | 0.10 |
| | AEM/2S | 1.08 | 1.26 | 1.41 | 0.92 | 1.27 | 1.34 |
| | AEM/EM | 0.43 | 0.51 | 0.58 | 0.36 | 0.40 | 0.48 |
| ψ | AEM | 0.21 | 0.19 | 0.18 | 0.14 | 0.12 | 0.12 |
| | AEM/2S | 1.12 | 1.00 | 0.91 | 1.04 | 0.88 | 0.81 |
| | AEM/EM | 1.12 | 1.02 | 0.97 | 1.01 | 0.93 | 0.90 |
| Σ | AEM | 1.05 | 1.22 | 1.46 | 0.84 | 0.97 | 1.10 |
| | AEM/2S | 0.29 | 0.41 | 0.59 | 0.22 | 0.29 | 0.55 |
| | AEM/EM | 0.81 | 0.88 | 0.96 | 0.74 | 0.79 | 0.91 |
| <i>Panel B: Average and relative trace statistics</i> | | | | | | | |
| R_F^2 | AEM | 0.88 | 0.93 | 0.95 | 0.90 | 0.94 | 0.96 |
| | AEM/2S | 1.48 | 1.29 | 1.15 | 1.52 | 1.28 | 1.12 |
| | AEM/EM | 1.30 | 1.21 | 1.13 | 1.29 | 1.23 | 1.14 |

Notes: This table displays average root mean squared errors (RMSE) of the estimation of Λ , ϕ , ψ and Σ and the average trace statistics of the factor estimates in the exact dynamic factor model as given in equations (2) and (3) based on the overrelaxed adaptive EM (AEM) algorithm of [Salakhutdinov and Roweis \(2003\)](#). The model is estimated with $\kappa = 10^{-4}$. We also include the relative RMSEs and relative trace statistics of the AEM algorithm compared to the two-step (2S) approach of [Doz et al. \(2011\)](#) and the EM algorithm employed in [Bańbura and Modugno \(2014\)](#). The AEM algorithm is more (less) accurate compared to its benchmarks for a value lower (higher) than one for the relative RMSEs and a value higher (lower) than one for the relative trace statistics. The averages and relative statistics are based on 500 Monte Carlo simulation runs. The values T and N denote the sample size and cross-sectional dimension, respectively. The data is generated with an exact factor model with $R = 1$, $\phi = 0.9$, $\psi = 0$, $\tau = 0$ and $u = 0.1$, where 25% of the data is set as missing (these points are chosen at random).

B Description of data

Table B.1: Description of euro area macroeconomic dataset

| | Group | Series | Composition | | | Transform | | Publ. lag | Source |
|----|-------|--|-------------|---|---|-----------|-------|-----------|--------|
| | | | S | M | L | Log | Diff. | | |
| 1 | Real | GDP | ✓ | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 2 | Real | IP Total | | | ✓ | ✓ | ✓ | 2 | SDW |
| 3 | Real | IP Total (excluding construction) | ✓ | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 4 | Real | IP Total (excluding construction and energy) | | | ✓ | ✓ | ✓ | 2 | SDW |
| 5 | Real | IP Construction | | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 6 | Real | IP Intermediate goods industry | | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 7 | Real | IP Capital goods industry | | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 8 | Real | IP Durable consumer goods industry | | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 9 | Real | IP Non-durable consumer goods | | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 10 | Real | IP Energy | | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 11 | Real | IP Manufacturing | | | ✓ | ✓ | ✓ | 2 | SDW |
| 12 | Real | IP Manufacture of basic metals | | | ✓ | ✓ | ✓ | 2 | SDW |
| 13 | Real | IP Manufacture of chemicals and chemical products | | | ✓ | ✓ | ✓ | 2 | SDW |
| 14 | Real | IP Manufacture of electrical equipment | | | ✓ | ✓ | ✓ | 2 | SDW |
| 15 | Real | IP Manufacture of machinery and equipment | | | ✓ | ✓ | ✓ | 2 | SDW |
| 16 | Real | IP Manufacture of paper and paper products | | | ✓ | ✓ | ✓ | 2 | SDW |
| 17 | Real | IP Manufacture of rubber and plastic products | | | ✓ | ✓ | ✓ | 2 | SDW |
| 18 | Real | New passenger car registration | ✓ | ✓ | ✓ | ✓ | ✓ | 1 | SDW |
| 19 | Real | Industrial new orders (total) | ✓ | ✓ | ✓ | ✓ | ✓ | 1 | SDW |
| 20 | Real | Retail trade turnover (deflated, incl. fuel, except of motor vehicles and motorcycles) | ✓ | ✓ | ✓ | ✓ | ✓ | 1 | SDW |
| 21 | Real | Unemployment rate | ✓ | ✓ | ✓ | | ✓ | 1 | SDW |
| 22 | Real | Extra euro area trade (export value) | ✓ | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 23 | Real | Extra euro area trade (import value) | | ✓ | ✓ | ✓ | ✓ | 2 | SDW |
| 24 | Real | Intra euro area trade (export value) | | | ✓ | ✓ | ✓ | 2 | SDW |
| 25 | Real | Intra euro area trade (import value) | | | ✓ | ✓ | ✓ | 2 | SDW |
| 26 | Real | US IP Total | | ✓ | ✓ | ✓ | ✓ | 1 | FRED |
| 27 | Real | US Manufacturing and trade industry sales | | | ✓ | ✓ | ✓ | 1 | FRED |
| 28 | Real | US Unemployment rate | | | ✓ | | ✓ | 1 | FRED |
| 29 | Real | US Employment level | | | ✓ | ✓ | ✓ | 1 | FRED |

Table B.1: Continued

| | Group | Series | Composition | | | Transform | | Publ. lag | Source |
|----|-----------|---|-------------|---|---|-----------|-------|-----------|--------|
| | | | S | M | L | Log | Diff. | | |
| 30 | Survey | Economic sentiment indicator | ✓ | ✓ | ✓ | | ✓ | 0 | EC |
| 31 | Survey | Employment expectations indicator | | ✓ | ✓ | | ✓ | 0 | EC |
| 32 | Survey | Industrial confidence indicator | | ✓ | ✓ | | ✓ | 0 | EC |
| 33 | Survey | Industry survey: Production trend observed in recent months | | | ✓ | | ✓ | 0 | EC |
| 34 | Survey | Industry survey: Assessment of order-book levels | | | ✓ | | ✓ | 0 | EC |
| 35 | Survey | Industry survey: Assessment of export order-book levels | | | ✓ | | ✓ | 0 | EC |
| 36 | Survey | Industry survey: Assessment of stocks of finished products | | | ✓ | | ✓ | 0 | EC |
| 37 | Survey | Industry survey: Production expectations for the months ahead | | ✓ | ✓ | | ✓ | 0 | EC |
| 38 | Survey | Industry survey: Employment expectations for the months ahead | | ✓ | ✓ | | ✓ | 0 | EC |
| 39 | Survey | Services confidence indicator | | ✓ | ✓ | | ✓ | 0 | EC |
| 40 | Survey | Service survey: Business situation development over the past 3 months | | | ✓ | | ✓ | 0 | EC |
| 41 | Survey | Service survey: Evolution of the demand over the past 3 months | | | ✓ | | ✓ | 0 | EC |
| 42 | Survey | Service survey: Expectation of the demand over the next 3 months | | ✓ | ✓ | | ✓ | 0 | EC |
| 43 | Survey | Service survey: Evolution of the employment over the past 3 months | | | ✓ | | ✓ | 0 | EC |
| 44 | Survey | Service survey: Expectations of the employment over the next 3 months | | ✓ | ✓ | | ✓ | 0 | EC |
| 45 | Survey | Consumer confidence indicator | | ✓ | ✓ | | ✓ | 0 | EC |
| 46 | Survey | Consumer survey: General economic situation over last 12 months | | | ✓ | | ✓ | 0 | EC |
| 47 | Survey | Consumer survey: General economic situation over next 12 months | | | ✓ | | ✓ | 0 | EC |
| 48 | Survey | Consumer survey: Unemployment expectations over next 12 months | | | ✓ | | ✓ | 0 | EC |
| 49 | Survey | Consumer survey: Major purchases at present | | | ✓ | | ✓ | 0 | EC |
| 50 | Survey | Consumer survey: Major purchases over next 12 months | | | ✓ | | ✓ | 0 | EC |
| 51 | Survey | Retail trade confidence indicator | | ✓ | ✓ | | ✓ | 0 | EC |
| 52 | Survey | Retail survey: Business activity (sales) development over the past 3 months | | | ✓ | | ✓ | 0 | EC |
| 53 | Survey | Retail survey: Orders expectations over the next 3 months | | | ✓ | | ✓ | 0 | EC |
| 54 | Survey | Retail survey: Business activity expectations over the next 3 months | | | ✓ | | ✓ | 0 | EC |
| 55 | Survey | Retail survey: Employment expectations over the next 3 months | | | ✓ | | ✓ | 0 | EC |
| 56 | Survey | Construction confidence indicator | | ✓ | ✓ | | ✓ | 0 | EC |
| 57 | Survey | Construction survey: Building activity development over the past 3 months | | | ✓ | | ✓ | 0 | EC |
| 58 | Survey | Construction survey: Evolution of your current overall order books | | | ✓ | | ✓ | 0 | EC |
| 59 | Survey | Construction survey: Employment expectations over the next 3 months | | | ✓ | | ✓ | 0 | EC |
| 60 | Survey | US Consumer sentiment index | | ✓ | ✓ | | ✓ | 1 | FRED |
| 61 | Financial | Money aggregate M3 (index of notional stocks) | | ✓ | ✓ | | ✓ | 1 | SDW |

Table B.1: Continued

| | Group | Series | Composition | | | Transform | | Publ. lag | Source | |
|----|-----------|---|-------------|---|---|-----------|-------|-----------|--------|------|
| | | | S | M | L | Log | Diff. | | | |
| 62 | Financial | 3-month interest rate (Euribor) | | ✓ | ✓ | | ✓ | 0 | SDW | |
| 63 | Financial | 1-year government bond yield | | | ✓ | | ✓ | 0 | SDW | |
| 64 | Financial | 2-year government bond yield | | | ✓ | | ✓ | 0 | SDW | |
| 65 | Financial | 5-year government bond yield | | | ✓ | | ✓ | 0 | SDW | |
| 66 | Financial | 10-year government bond yield | | ✓ | ✓ | | ✓ | 0 | SDW | |
| 67 | Financial | Nominal effective exchange rate (Euro against Narrow EER) | | ✓ | ✓ | | ✓ | 0 | SDW | |
| 68 | Financial | Real effective exchange rate CPI deflated (Euro against Narrow EER) | | | ✓ | | ✓ | 0 | SDW | |
| 69 | Financial | Real effective exchange rate producer prices deflated (Euro against Narrow EER) | | | ✓ | | ✓ | 0 | SDW | |
| 70 | Financial | Exchange rate USD/EUR | | ✓ | ✓ | | ✓ | 0 | SDW | |
| 71 | Financial | Exchange rate GBP/EUR | | | ✓ | | ✓ | 0 | SDW | |
| 72 | Financial | Exchange rate YEN/EUR | | | ✓ | | ✓ | 0 | SDW | |
| 73 | Financial | Eurostoxx 50 index | ✓ | ✓ | ✓ | | ✓ | ✓ | 0 | INV |
| 74 | Financial | Gold price | | | ✓ | | ✓ | ✓ | 0 | INV |
| 75 | Financial | Brent crude oil price | | ✓ | ✓ | | ✓ | ✓ | 0 | INV |
| 76 | Financial | Global price index of all commodities | ✓ | ✓ | ✓ | | ✓ | ✓ | 1 | FRED |
| 77 | Financial | US S&P500 composite index | | ✓ | ✓ | | ✓ | ✓ | 0 | FRED |
| 78 | Financial | US 3-month Treasury bill | | | ✓ | | ✓ | ✓ | 0 | FRED |
| 79 | Financial | US 10-year Treasury rate | | | ✓ | | ✓ | ✓ | 0 | FRED |

Notes: This table describes the details of each series in the constructed euro area macroeconomic dataset. Specifically, it indicates the group it belongs to (that is, real, survey or financial), the dataset composition it corresponds to (that is, small (S), medium (M) or large (L)), the data transformation that is conducted on the original series (that is, taking the natural logarithm (log) and/or the first differences (diff.)), the publication lag in months, and the data source. The sources are the European Central Bank Statistical Data Warehouse (SDW), the Federal Reserve Economic Data (FRED), the European Commission (EC) and Investing.com (INV).

C Additional log-likelihood convergence plots

C.1 Log-likelihood convergence for 10,000 iterations

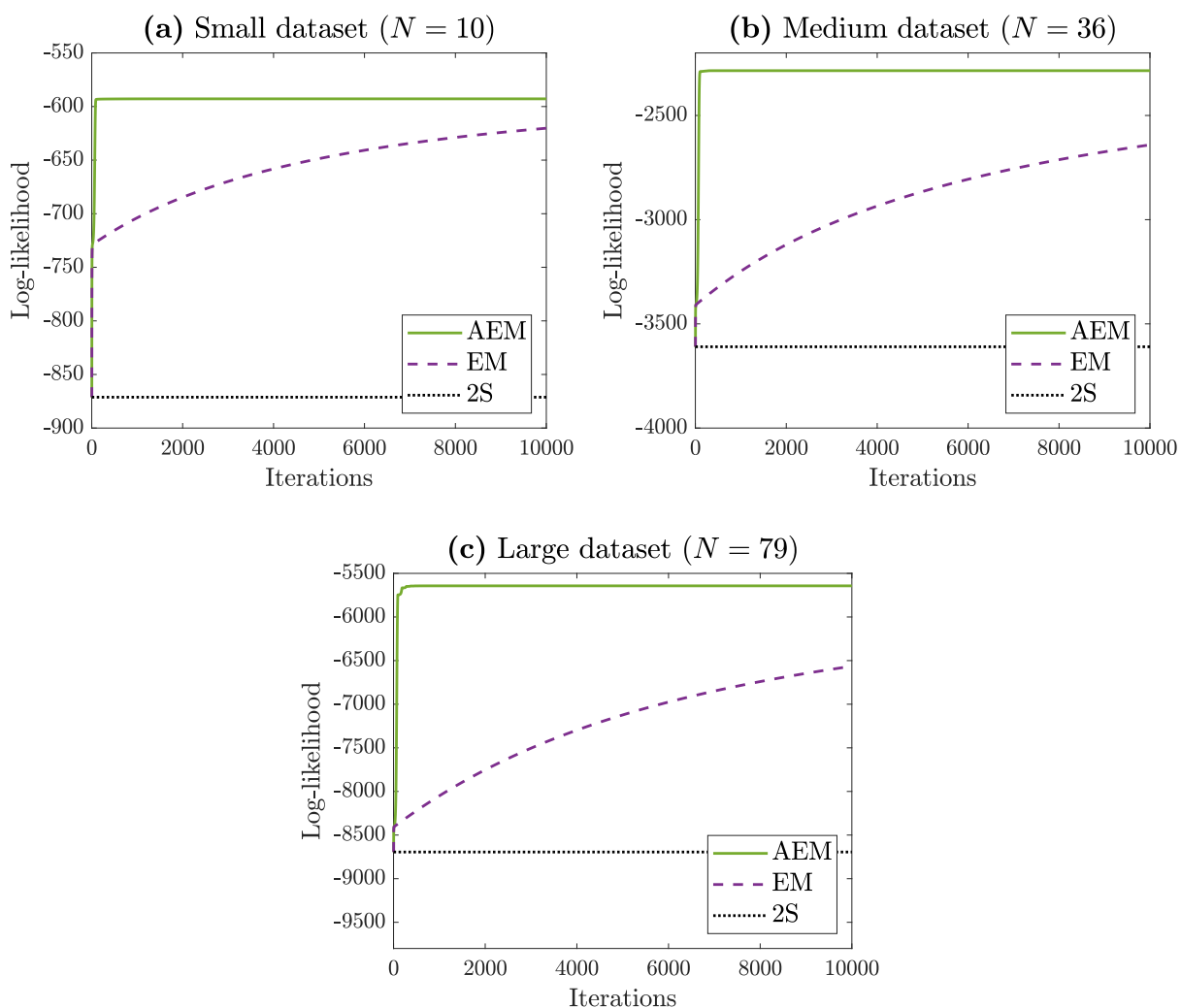


Figure C.1: Log-likelihood values over 10,000 iterations of the EM and AEM algorithm in estimating a mixed-frequency dynamic factor model with $\kappa = 10^{-4}$ for various cross-sectional dimension sizes N

C.2 Log-likelihood convergence under fixed factor loadings

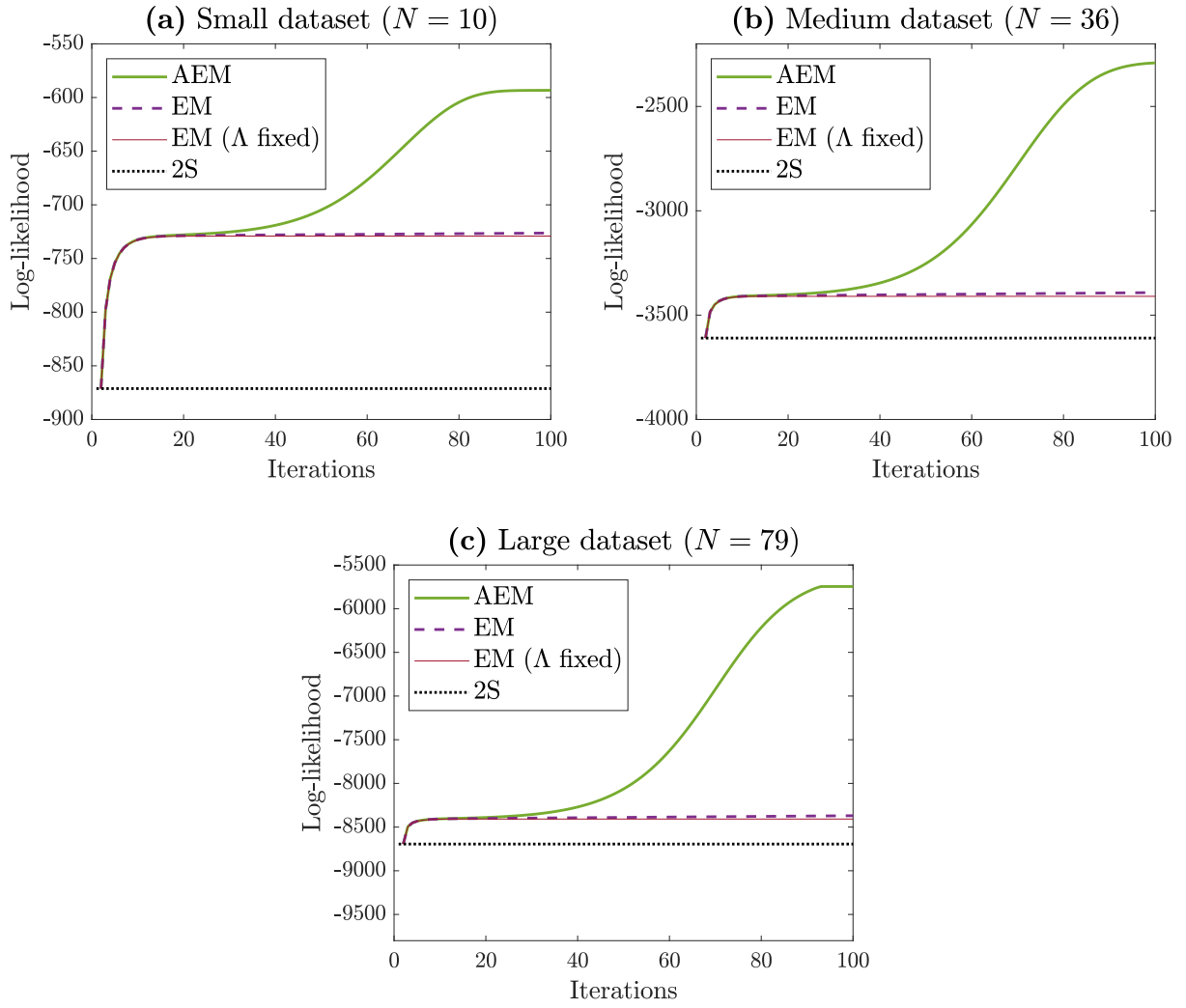


Figure C.2: Log-likelihood values over 100 iterations of the EM and AEM algorithm (including the EM under fixed factor loadings Λ) in estimating a mixed-frequency dynamic factor model with $\kappa = 10^{-4}$ for various cross-sectional dimension sizes N

D Additional nowcasting results

D.1 Nowcasting results for different convergence criteria

Table D.1: Relative nowcasting performance of euro area GDP growth based on a small mixed-frequency dynamic factor model for various convergence criteria

| | $\epsilon = 10^{-4}$ | | $\epsilon = 10^{-5}$ | | $\epsilon = 10^{-6}$ | |
|--|----------------------|------|----------------------|------|----------------------|------|
| | EM | AEM | EM | AEM | EM | AEM |
| <i>Panel A: Evaluation period excluding covid pandemic (2006Q1 - 2019Q4)</i> | | | | | | |
| Q(-1)M1 | 0.95 | 0.95 | 0.95 | 0.82 | 0.94 | 0.82 |
| Q(-1)M2 | 0.90 | 0.90 | 0.90 | 0.79 | 0.89 | 0.79 |
| Q(-1)M3 | 0.75 | 0.75 | 0.75 | 0.66 | 0.73 | 0.66 |
| Q(0)M1 | 0.69 | 0.70 | 0.69 | 0.61 | 0.68 | 0.61 |
| Q(0)M2 | 0.62 | 0.63 | 0.62 | 0.55 | 0.60 | 0.55 |
| Q(0)M3 | 0.51 | 0.53 | 0.51 | 0.43 | 0.49 | 0.43 |
| Q(+1)M1 | 0.51 | 0.52 | 0.51 | 0.46 | 0.49 | 0.46 |
| Average | 0.71 | 0.71 | 0.71 | 0.62 | 0.69 | 0.62 |
| <i>Panel B: Evaluation period including covid pandemic (2006Q1 - 2022Q3)</i> | | | | | | |
| Q(-1)M1 | 1.14 | 1.14 | 1.17 | 1.39 | 1.17 | 1.39 |
| Q(-1)M2 | 1.11 | 1.11 | 1.11 | 1.01 | 1.11 | 1.01 |
| Q(-1)M3 | 0.91 | 0.86 | 0.90 | 0.85 | 0.89 | 0.84 |
| Q(0)M1 | 0.67 | 0.60 | 0.64 | 0.46 | 0.64 | 0.46 |
| Q(0)M2 | 0.50 | 0.44 | 0.58 | 0.40 | 0.57 | 0.40 |
| Q(0)M3 | 0.56 | 0.47 | 0.62 | 0.46 | 0.61 | 0.49 |
| Q(+1)M1 | 0.59 | 0.50 | 0.66 | 0.50 | 0.66 | 0.53 |
| Average | 0.78 | 0.73 | 0.81 | 0.72 | 0.81 | 0.73 |

Notes: This table displays the relative root mean squared forecast errors (RMFSEs) of nowcasting euro area GDP growth from 2006Q1 to 2022Q4 compared to a historical mean nowcast for different convergence criteria in stopping rule in equation (8). Panel A shows the results excluding the covid pandemic, while Panel B includes this period. The small mixed-frequency dynamic factor model is estimated with $\kappa = 10^{-4}$ based on either the EM algorithm employed in [Bańbura and Modugno \(2014\)](#) or the AEM algorithm of [Salakhutdinov and Roweis \(2003\)](#). For each target quarter, the nowcasts/forecasts construction dates range from the first month of the previous quarter (that is, Q(-1)M1) up to the first month of the subsequent quarter (that is, Q(+1)M1).

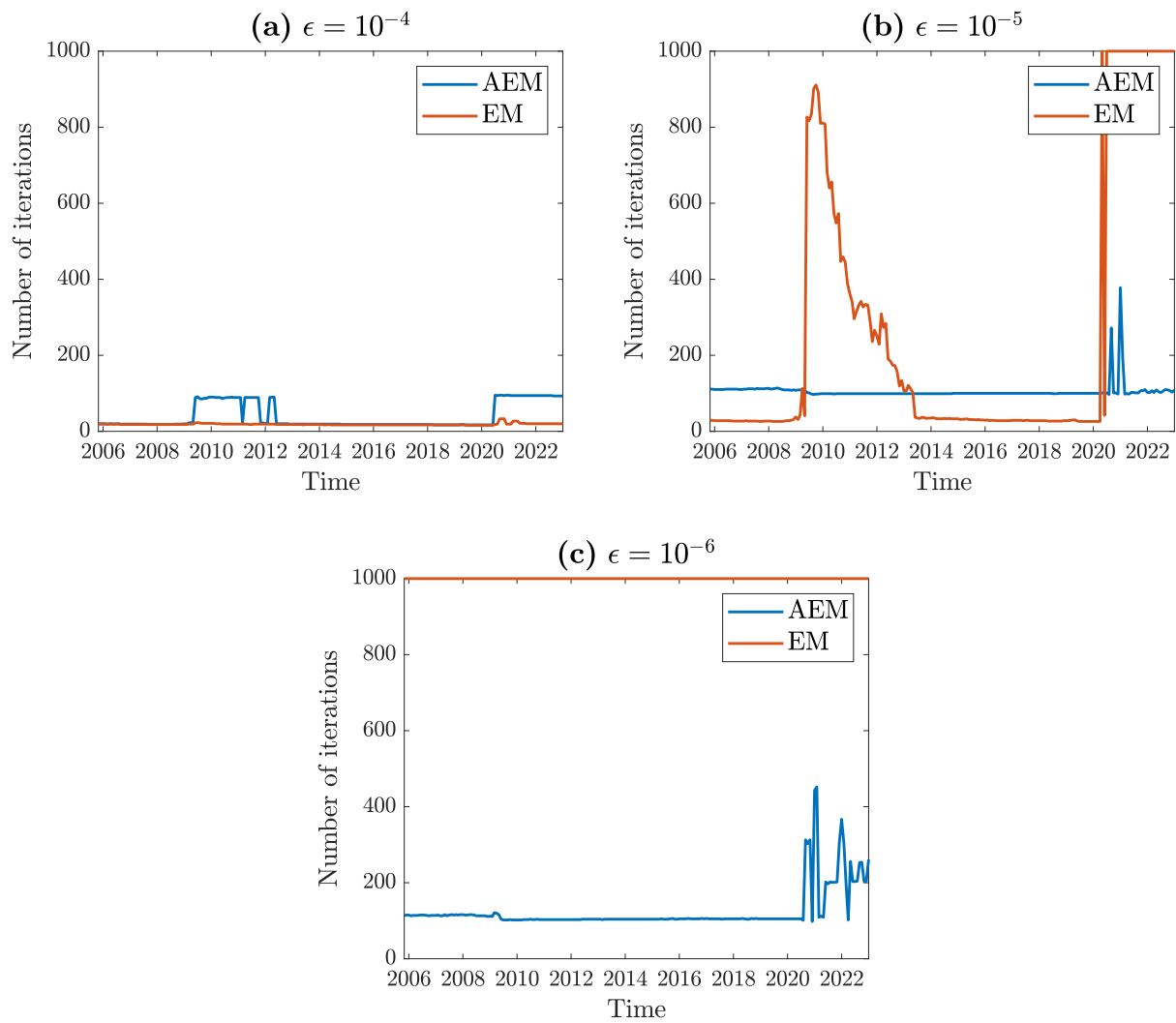


Figure D.1: Number of iterations until convergence for different convergence criteria of the expanding-window estimation of the small mixed-frequency dynamic factor model estimated with $\kappa = 10^{-4}$

D.2 Cumulative sum of squared error difference plots

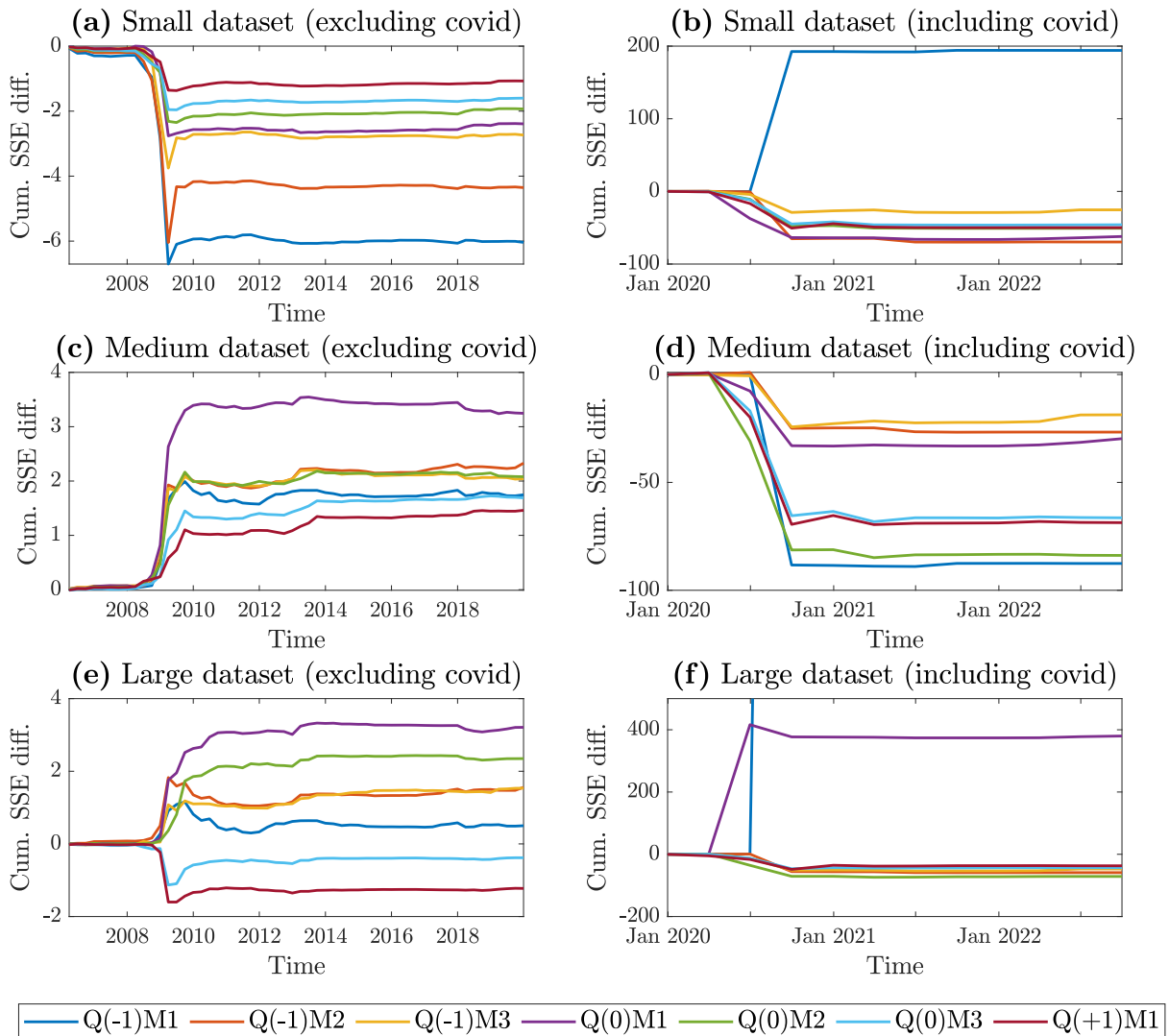


Figure D.2: Cumulative sum of squared forecast error (SSE) difference plots between the AEM and EM algorithm. A positive (negative) value indicates that EM produces more (less) accurate nowcasts than the AEM.

D.3 Nowcast results under fixed factor loadings

Table D.2: Relative nowcasting performance of euro area GDP growth based on the EM algorithm with either fixed or estimated factor loadings

| | Small | | Medium | | Large | |
|--|-------------------------|--------------------------|-------------------------|--------------------------|-------------------------|--------------------------|
| | EM (Λ est.) | EM (Λ fixed) | EM (Λ est.) | EM (Λ fixed) | EM (Λ est.) | EM (Λ fixed) |
| <i>Panel A: Evaluation period excluding covid pandemic (2006Q1 - 2019Q4)</i> | | | | | | |
| Q(-1)M1 | 0.94 | 0.95 | 0.84 | 0.85 | 0.85 | 0.86 |
| Q(-1)M2 | 0.89 | 0.90 | 0.76 | 0.77 | 0.78 | 0.79 |
| Q(-1)M3 | 0.73 | 0.75 | 0.72 | 0.72 | 0.72 | 0.73 |
| Q(0)M1 | 0.68 | 0.69 | 0.74 | 0.74 | 0.73 | 0.73 |
| Q(0)M2 | 0.60 | 0.62 | 0.68 | 0.68 | 0.67 | 0.67 |
| Q(0)M3 | 0.49 | 0.51 | 0.61 | 0.61 | 0.58 | 0.58 |
| Q(+1)M1 | 0.49 | 0.51 | 0.59 | 0.59 | 0.55 | 0.56 |
| Average | 0.69 | 0.70 | 0.71 | 0.71 | 0.70 | 0.70 |
| <i>Panel B: Evaluation period including covid pandemic (2006Q1 - 2022Q3)</i> | | | | | | |
| Q(-1)M1 | 1.17 | 1.14 | 1.93 | 1.93 | 1.64 | 1.64 |
| Q(-1)M2 | 1.11 | 1.11 | 0.98 | 0.98 | 1.05 | 1.05 |
| Q(-1)M3 | 0.89 | 0.90 | 0.81 | 0.81 | 0.88 | 0.88 |
| Q(0)M1 | 0.64 | 0.67 | 0.57 | 0.57 | 0.62 | 0.63 |
| Q(0)M2 | 0.57 | 0.60 | 0.66 | 0.67 | 0.69 | 0.70 |
| Q(0)M3 | 0.61 | 0.63 | 0.65 | 0.66 | 0.66 | 0.67 |
| Q(+1)M1 | 0.66 | 0.67 | 0.68 | 0.69 | 0.72 | 0.72 |
| Average | 0.81 | 0.82 | 0.90 | 0.90 | 0.89 | 0.90 |

Notes: This table displays the relative root mean squared forecast errors (RMFSEs) of nowcasting euro area GDP growth from 2006Q1 to 2022Q4 compared to a historical mean nowcast based on the EM algorithm with either fixed or estimates factor loadings Λ . Panel A shows the results excluding the covid pandemic, while Panel B includes this period. The small, medium and large mixed-frequency dynamic factor models are estimated with $\kappa = 10^{-4}$ based on the EM algorithm employed in Bańbura and Modugno (2014). For each target quarter, the nowcasts/forecasts construction dates range from the first month of the previous quarter (that is, Q(-1)M1) up to the first month of the subsequent quarter (that is, Q(+1)M1).

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