

The TIPS-Treasury Bond Puzzle

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ABSTRACT

We show that the price of a Treasury bond and an inflation-swapped Treasury Inflation-Protected Securities (TIPS) issue exactly replicating the cash flows of the Treasury bond can differ by more than \$20 per \$100 notional. Treasury bonds are almost always overvalued relative to TIPS. Total TIPS-Treasury mispricing has exceeded \$56 billion, representing nearly 8% of the total amount of TIPS outstanding. We find direct evidence that the mispricing narrows as additional capital flows into the markets. This provides strong support for the slow-moving-capital explanation of arbitrage persistence.