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Armour Residential REIT, Inc.
Form 10-Q/A
August 24, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q/A

(Amendment No. 1)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended June 30, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

ARMOUR RESIDENTIAL REIT, INC.
(Exact name of registrant as specified in its charter)

Maryland	001-34766	26-1908763
(State or other jurisdiction of incorporation or organization)	(Commission File Number)	(I.R.S. Employer Identification No.)

3001 Ocean Drive, Suite 201, Vero Beach, FL 32963
(Address of principal executive offices)(zip code)

(772) 617-4340
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer" "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer Accelerated filer Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company Emerging growth company

If an emerging growth company, indicate by a check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

The number of outstanding shares of the Registrant's common stock as of July 24, 2018 was 41,928,133.

EXPLANATORY NOTE

This Form 10-Q/A is being filed for the purposes of amending and refiling the Management's Discussion and Analysis of Financial Condition and Results of Operations (the "MD&A") in Part I, Item 2 of Armour Residential REIT, Inc.'s (the "Company") Quarterly Report on Form 10-Q for the three months ended on June 30, 2018 (the "Original Form 10-Q"), filed with the Securities and Exchange Commission on July 25, 2018, to correct the average securities portfolio for the six months ended June 30, 2018 from \$9,939,789 to \$10,117,741, and to correct the related percentages presented for the Company's asset yield and net interest margin for the three months ended June 30, 2018 from 3.30% and 1.73%, respectively, to 3.13% and 1.56%, respectively. We have also made conforming changes to the MD&A to reflect these corrections. The Company's net income under Generally Accepted Accounting Principles and book value as of June 30, 2018 and for the three and six month periods then ended, as previously reported, are unaffected.

In connection with this Form 10-Q/A, we are including in Part II, Item 6, the currently dated certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, which are attached hereto as Exhibits 31.1, 31.2 and 31.3. Because no financial statements are included in this Form 10-Q/A and this Form 10-Q/A does not contain or amend any disclosure with respect to Items 307 and 308 of Regulation S-K, paragraphs 3, 4 and 5 of the certifications have been omitted. No other changes have been made to the Original Form 10-Q. Except as described above, this Form 10-Q/A does not reflect events that may have occurred subsequent to the date of the Original Form 10-Q.

ARMOUR Residential REIT, Inc.
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PART I. FINANCIAL INFORMATION

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

ARMOUR Residential REIT, Inc.

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report.

References to “we,” “us,” “our,” or the “Company” are to ARMOUR Residential REIT, Inc. (“ARMOUR”) and its subsidiaries. References to “ACM” are to ARMOUR Capital Management LP, a Delaware limited partnership. Refer to the Glossary of Terms for definitions of capitalized terms and abbreviations used in this report.

U.S. dollar amounts are presented in thousands, except per share data or as otherwise noted.

Overview

ARMOUR is a Maryland corporation formed to invest in and manage a leveraged portfolio of MBS and mortgage loans. We invest in residential mortgage backed securities issued or guaranteed by a U.S. GSE, such as Fannie Mae, Freddie Mac, or a government agency such as Ginnie Mae (collectively, Agency Securities). Interest-Only Securities are the interest portion of Agency Securities, which is separated and sold individually from the principal portion of the same payment. Other securities backed by residential mortgages in which we invest, for which the payment of principal and interest is not guaranteed by a GSE or government agency (collectively, Credit Risk and Non-Agency Securities and together with Agency Securities and Interest-Only Securities, MBS), may benefit from credit enhancement derived from structural elements such as subordination, over collateralization or insurance. The Company is managed by ACM, an investment advisor registered with the SEC. See Note 10 and Note 15 to the consolidated financial statements for further details.

We seek to create shareholder value through thoughtful investment and risk management that produces current yield and superior risk adjusted returns over the long term. Our focus on residential real estate finance supports home ownership for a broad and diverse spectrum of Americans by bringing private capital into the mortgage markets.

We earn returns on the spread between the yield on our assets and our costs, including the interest cost of the funds we borrow, after giving effect to our hedges. We identify and acquire MBS, finance our acquisitions with borrowings under a series of short-term repurchase agreements at the most competitive interest rates available to us and then cost-effectively hedge our interest rate and other risks based on our entire portfolio of assets, liabilities and derivatives and our management's view of the market. Successful implementation of this approach requires us to address interest rate risk, maintain adequate liquidity and effectively hedge interest rate risks. We believe that the residential mortgage market will undergo significant changes in the coming years as the role of GSEs, such as Fannie Mae and Freddie Mac, is diminished, which we expect will create attractive investment opportunities for us. We execute our business plan in a manner consistent with our intention of qualifying as a REIT under the Code and avoiding regulation as an investment company under the 1940 Act.

We have elected to be taxed as a REIT under the Code. We will generally not be subject to federal income tax to the extent that we distribute our taxable income to our stockholders and as long as we satisfy the ongoing REIT requirements under the Code including meeting certain asset, income and stock ownership tests.

Factors that Affect our Results of Operations and Financial Condition

Our results of operations and financial condition are affected by various factors, many of which are beyond our control, including, among other things, our net interest income, the market value of our assets and the supply of and demand for such assets. Recent events, such as those discussed below, can affect our business in ways that are

difficult to predict and may produce results outside of typical operating variances. Our net interest income varies primarily as a result of changes in interest rates, borrowing costs and prepayment speeds, the behavior of which involves various risks and uncertainties. We look to invest across the spectrum of mortgage investments, from Agency Securities, for which the principal and interest payments are guaranteed by a GSE, to Credit Risk and Non-Agency Securities, non-prime mortgage loans and unrated equity tranches of CMBS. As such, we expect our investments to be subject to risks arising from delinquencies and foreclosures, thereby exposing our investment portfolio to potential losses. We are exposed to changing credit spreads, which could result in declines in the fair value of our investments. We believe ACM's in-depth investment expertise across multiple sectors of the mortgage market, prudent asset selection and our hedging strategy enable us to minimize our credit losses, our market value losses and financing

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

costs. Prepayment rates, as reflected by the rate of principal pay downs and interest rates vary according to the type of investment, conditions in financial markets, government actions, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment rates on our assets that are purchased at a premium increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. Because changes in interest rates may significantly affect our activities, our operating results depend, in large part, upon our ability to manage interest rate risks and prepayment risks effectively while maintaining our status as a REIT.

For any period during which changes in the interest rates earned on our assets do not coincide with interest rate changes on our borrowings, such assets will tend to reprice more slowly than the corresponding liabilities. Consequently, changes in interest rates, particularly short-term interest rates, may significantly influence our net interest income. With the maturities of our assets generally of a longer term than those of our liabilities, interest rate increases will tend to decrease our net interest income and the market value of our assets (and therefore our book value). Such rate increases could possibly result in operating losses or adversely affect our ability to make distributions to our stockholders.

Prepayments on MBS and the underlying mortgage loans may be influenced by changes in market interest rates and a variety of economic and geographic factors, policy decisions by regulators, as well as other factors beyond our control. To the extent we hold MBS acquired at a premium or discount to par, or face value, changes in prepayment rates may impact our anticipated yield. In periods of declining interest rates, prepayments on our MBS will likely increase. If we are unable to reinvest the proceeds of such prepayments at comparable yields, our net interest income may decline. The climate of government intervention in the mortgage markets significantly increases the risk associated with prepayments.

While we use strategies to economically hedge some of our interest rate risk, we do not hedge all of our exposure to changes in interest rates and prepayment rates, as there are practical limitations on our ability to insulate our securities portfolio from all potential negative consequences associated with changes in short-term interest rates in a manner that will allow us to seek attractive net spreads on our securities portfolio. Also, since we have not elected to use cash flow hedge accounting, earnings reported in accordance with GAAP will fluctuate even in situations where our derivatives are operating as intended. As a result of this mark-to-market accounting treatment, our results of operations are likely to fluctuate far more than if we were to designate our derivative activities as cash flow hedges. Comparisons with companies that use cash flow hedge accounting for all or part of their derivative activities may not be meaningful. For these and other reasons more fully described under the section captioned "Derivative Instruments" below, no assurance can be given that our derivatives will have the desired beneficial impact on our results of operations or financial condition.

In addition to the use of derivatives to hedge interest rate risk, a variety of other factors relating to our business may also impact our financial condition and operating performance; these factors include

- our degree of leverage;
- our access to funding and borrowing capacity;
- the REIT requirements under the Code; and
- the requirements to qualify for an exclusion under the 1940 Act and other regulatory and accounting policies related to our business.

Our Manager

See Note 10 and Note 15 to the consolidated financial statements.

Market and Interest Rate Trends and the Effect on our securities portfolio

Developments at Fannie Mae and Freddie Mac

The payments we receive on the Agency Securities in which we invest depend upon a steady stream of payments by borrowers on the underlying mortgages and the fulfillment of guarantees by GSEs. There can be no assurance that the U.S. Government's intervention in Fannie Mae and Freddie Mac will continue to be adequate or assured for the longer-term viability

Management's Discussion and Analysis (continued)

of these GSEs. These uncertainties may lead to concerns about the availability of and trading market for Agency Securities in the long term. Accordingly, if the GSEs defaulted on their guaranteed obligations, suffered losses or ceased to exist, the value of our Agency Securities and our business, operations and financial condition could be materially and adversely affected.

The passage of any new federal legislation affecting Fannie Mae and Freddie Mac may create market uncertainty and reduce the actual or perceived credit quality of securities issued or guaranteed by them. If Fannie Mae and Freddie Mac were reformed or wound down, it is unclear what effect, if any, this would have on the value of the existing Fannie Mae and Freddie Mac Agency Securities. The foregoing could materially adversely affect the pricing, supply, liquidity and value of the Agency Securities in which we invest and otherwise materially adversely affect our business, operations and financial condition.

On June 3, 2019, Fannie Mae and Freddie Mac are scheduled to start issuing a new common security, the Uniform MBS, in place of their current offerings of MBS. The new Uniform MBS will be issued using a new Common Securitization Platform ("CSP"). The Uniform MBS will more closely resemble current Fannie Mae MBS than current Freddie Mac MBS and will become the basis for the TBA MBS market place. Existing Freddie Mac MBS will be eligible for exchange into new Uniform MBS. We are unable to predict what impact the introduction of the new Uniform MBS and CSP will have on our existing MBS or the MBS market in the future.

Short-term Interest Rates and Funding Costs

On January 31, 2018, the Fed raised its target range for the Federal Funds Rate to between 1.25% and 1.50%. After its March 2018 meeting, the Fed raised its target range to between 1.50% and 1.75%. At its June 2018 meeting, the Fed raised its target range to between 1.75% and 2.00%. Changes in Fed policy affect our financial results, since our cost of funds is largely dependent on short-term rates. An increase in our cost of funds without a corresponding increase in interest income earned on our MBS would cause our net income to decline.

Historically, 30-day LIBOR has closely tracked movements in the Federal Funds Rate and the Effective Federal Funds Rate. The Effective Federal Funds Rate can differ from the Federal Funds Rate in that the Effective Federal Funds Rate represents the volume weighted average of interest rates at which depository institutions lend balances at the Fed to other depository institutions overnight (actual transactions, rather than target rate).

Our borrowings in the repurchase market have also historically closely tracked the Federal Funds Rate and LIBOR. Traditionally, a lower Federal Funds Rate has indicated a time of increased net interest margin and higher asset values. The difference between 30-day LIBOR and the Effective Federal Funds Rate can be quite volatile, with the spread alternately returning to more normal levels and then widening out again. Volatility in these rates and divergence from the historical relationship among these rates could negatively impact our ability to manage our securities portfolio. If rates were to increase as a result, our net interest margin and the value of our securities portfolio might suffer as a result.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

The following graph shows 30-day LIBOR as compared to the Effective Federal Funds Rate on a monthly basis from June 30, 2016 to June 30, 2018.

Long-term Interest Rates and Mortgage Spreads

Our Agency Securities are valued at an interest rate spread versus long-term interest rates (mortgage spread). This mortgage spread varies over time and can be above or below long-term averages, depending upon market participants' current desire to own Agency Securities over other investment alternatives. When the mortgage spread gets smaller (or negative) versus long-term interest rates, our book value will be positively affected. When this spread gets larger (or positive), our book value will be negatively affected.

Mortgage spreads can vary due to movements in Agency Securities valuations, movements in long-term interest rates or a combination of both. Since 2015, the interest rate swap spread has been negative to U.S. Treasury interest rates for certain longer tenors, an inversion of longstanding market norms. We mainly use interest rate swap contracts (including swaptions) to economically hedge against changes in the valuation of our MBS. We do not use such hedging contracts for speculative purposes. As of June 30, 2018 and December 31, 2017, we have not entered into any contract or purchased any asset specifically designed to offset the impact of mortgage spreads on our book value.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

Results of Operations

Net Income Summary

The following is a summary of our consolidated results of operations for the periods presented:

Interest income for the three and six months ended June 30, 2018, increased due to a larger average securities portfolio and an increase in asset yields compared to the three and six months ended June 30, 2017. The increases in our securities portfolio and asset yields, in the aggregate, were not enough to offset the increase in interest expense on our repurchase agreements, which led to the decrease in net interest income for the three and six months ended June 30, 2018 compared to the three and six months ended June 30, 2017.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

Net Interest Income

Net interest income is a function of both our securities portfolio size and net interest rate spread.

2018 vs. 2017

• Our average securities portfolio (including TBA Agency Securities) increased by 13.5% from \$8,916,626 for the six months ended June 30, 2017 to \$10,117,741 for the six months ended June 30, 2018.

Our asset yields increased by 0.06% and our interest expense on our repurchase agreements increased by 0.75% for the six months ended June 30, 2018, compared to the six months ended June 30, 2017. The asset yield increase was mainly due to the change in the composition of our securities portfolio and slower prepayment speeds. The change in interest expense on our repurchase agreements was due to a larger average securities portfolio and an increase in short-term rates by the Fed.

- Our net interest rate spread decreased by 0.13% basis points from 1.67% for the six months ended June 30, 2017 to 1.54% for the six months ended June 30, 2018.

At June 30, 2018 and December 31, 2017, our Agency Securities in our securities portfolio were carried at a net premium to par value with a weighted average amortized cost of 103.9% and 104.4%, respectively, due to the average interest rates on these securities being higher than prevailing market rates.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

The following table presents the components of the yield earned on our securities portfolio (including TBA Agency Securities) for the quarterly periods ended on the dates shown below:

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

The yield on our assets is most significantly affected by the rate of repayments on our Agency Securities. The following graph shows the annualized CPR on a monthly basis for the quarterly periods ended on the dates shown below.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

Other Income

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

2018 vs. 2017

Losses on Agency Securities resulted from the sales of Agency Securities during the three and six months ended June 30, 2018 of \$1,236,423 and \$2,373,507, including \$216,292 of unsettled sales in the second quarter. Sales were \$660,971 and \$2,687,595, including \$639,258 of unsettled sales from the first quarter for the three and six months ended June 30, 2017.

At June 30, 2018 and June 30, 2017, we also considered whether we intended to sell Agency Securities and whether it was more likely than not that we could meet our liquidity requirements and contractual obligations without selling Agency Securities. During the second quarter of 2017, we identified certain low yielding Agency Securities that were replaced with securities having more attractive returns. For those securities that were previously identified, we recognized additional losses totaling \$12,090 for the six months ended June 30, 2018 in our consolidated financial statements of operations. We determined that there was no other than temporary impairment of our remaining Agency Securities as of June 30, 2018. We recognized a loss of \$10,338 in our consolidated financial statements of operations for the three and six months ended June 30, 2017 on certain of our low yielding Agency Securities that were determined to represent an other than temporary impairment because we planned to replace these low yielding securities with securities that had more attractive returns, as market conditions permitted. A new cost basis was established for those Agency Securities with an aggregate fair value of \$1,113,815 as of June 30, 2017. We determined that there was no other than temporary impairment of our remaining Agency Securities as of June 30, 2017.

Gain (loss) on Credit Risk and Non-Agency Securities resulted from the change in fair value of the securities.

Gain (loss) on Interest-Only Securities resulted from the change in the fair value of these securities.

Loss on U.S. Treasury Securities resulted from the loss on the sale of these in the second quarter of 2018. We did not have any U.S. Treasury Securities remaining at June 30, 2018.

Gains (losses) on Derivatives resulted from a combination of the following:

Changes in interest rates and TBA prices.

The increase in our total interest rate swap contracts aggregate notional balance from \$5,200,000 at June 30, 2017 to \$6,750,000 at June 30, 2018.

The decrease in our total TBA Agency Securities aggregate notional balance from \$2,350,000 at June 30, 2017 to \$2,100,000 at June 30, 2018.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

Expenses

The Company is managed by ACM, pursuant to management agreements with ARMOUR and JAVELIN. The ARMOUR management fees are determined based on gross equity raised. Therefore, management fees increase when we raise capital and decline when we repurchase previously issued stock and liquidate distributions as approved and so designated by a majority of the Board. However, because the ARMOUR management fee rate decreased to 0.75% per annum for gross equity raised in excess of \$1.0 billion pursuant to the ARMOUR management agreement, the effective average management fee rate declines as equity is raised. Gross equity raised was \$2,620,693 at June 30, 2018 and \$2,586,188 at June 30, 2017, respectively.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

Professional fees include securities clearing, legal, audit and consulting costs and are generally driven by the size and complexity of our securities portfolio, the volume of transactions we execute and the extent of research and due diligence activities we undertake on potential transactions.

Insurance includes premiums for both general business and directors and officers liability coverage. The fluctuation from year to year is due to changes in premiums.

Compensation includes both non-executive director compensation as well as the restricted stock units awarded to our executive officers and other ACM employees through ACM. The fluctuation from year to year is due to a combination of the change in our stock price and the number of awards vesting to our executive officers and other ACM employees.

Other expenses include fees for market and pricing data, analytics and risk management systems and portfolio related data processing costs as well as stock exchange listing fees and similar stockholder related expenses.

Taxable Income

As a REIT that regularly distributes all of its taxable income, we are generally not required to pay federal income tax. See Note 14 to the consolidated financial statements.

Other Comprehensive Income (Loss)

Comprehensive income (loss) includes all changes in equity during a period, except those resulting from investments by owners and distributions to owners. For the three and six months ended June 30, 2018 and June 30, 2017, other comprehensive (loss) income totaled \$(24,271) and \$(124,988) and \$25,980 and \$43,248, respectively, reflecting net unrealized gain (loss) on available for sale Agency Securities net of amounts reclassified upon sale.

Financial Condition

Our securities portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our Agency Securities may be backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by GSEs, U.S. Treasury Securities and money market instruments, subject to certain income tests we must satisfy for our qualification as a REIT. Our charter permits us to invest in these asset classes.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

The charts below present the breakout by percentage of our securities portfolio, at fair value as of the dates indicated.

Agency Securities, Interest-Only Securities and TBA Agency Securities

Security purchase and sale transactions, including purchases and sales for forward settlement, are recorded on the trade date to the extent it is probable that we will take or make timely physical delivery of the related securities. Gains or losses realized from the sale of securities are included in income and are determined using the specific identification method. We typically purchase Agency Securities at premium prices. The premium price paid over par value on those assets is expensed as the underlying mortgages experience repayment or prepayment. The lower the constant prepayment rate, the lower the amount of amortization expense for a particular period. Accordingly, the yield on an asset and earnings are higher. If prepayment rates increase, the amount of amortization expense for a particular period will go up. These increased prepayment rates would act to decrease the yield on an asset and would decrease earnings.

We account for TBA Agency Securities as derivative instruments if it is reasonably possible that we will not take or make physical delivery of the Agency Security upon settlement of the contract. TBA Agency Securities are forward contracts for the purchase ("long position") or sale ("short position") of Agency Securities at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date. The specific Agency Securities delivered pursuant to the contract upon the settlement date, published each month by the Securities Industry and Financial Markets Association, are not known at the time of the transaction. We estimate the fair value of TBA Agency Securities based on similar methods used to value our Agency Securities. TBA Agency Securities are included in the table below on a gross basis as they can be used to establish and finance portfolio positions in Agency Securities.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

The tables below summarize certain characteristics of our Agency Securities, Interest-Only Securities and TBA Agency Securities at June 30, 2018 and December 31, 2017.

June 30, 2018

Asset Type	Principal Amount	Fair Value	Weighted Average Coupon	CPR ⁽¹⁾	Weighted Average Month to Reset or Maturity
ARMs & Hybrids	\$55,053	\$56,932	3.18 %	10.95 %	9
Multi-Family MBS	1,441,797	1,429,449	3.19 %	0.00 %	81
10 Year Fixed	27,100	27,691	4.04 %	6.41 %	86
15 Year Fixed	101,901	105,198	4.03 %	12.38 %	153
20 Year Fixed	5,923	6,115	4.16 %	0.59 %	196
25 Year Fixed	52,392	52,857	3.64 %	5.81 %	284
30 Year Fixed	4,475,612	4,575,070	4.01 %	5.88 %	347
Total or Weighted Average	\$6,159,778	\$6,253,312	3.81 %	4.65 %	278
TBA Agency Securities 15 Year ⁽²⁾	300,000	307,621	4.00 %	0.00 %	180
TBA Agency Securities 30 Year ⁽²⁾	1,800,000	1,885,336	4.72 %	0.00 %	360
Total or Weighted Average	8,259,778	8,446,269			
Interest-Only Securities ⁽³⁾	119,459	23,415	4.83 %	15.18 %	268
Total or Weighted Average		\$8,469,684			

(1) Weighted average for all prepayments during the three and six months ended June 30, 2018, including prepayments related to Agency Securities purchased during the quarter.

(2) Our TBA Agency Securities are recorded as derivative instruments in our accompanying consolidated financial statements. As of June 30, 2018, our TBA Agency Securities had a net carrying value of \$3,222, reported as a derivative asset and \$(177), reported as a derivative liability on our accompanying consolidated balance sheets. The net carrying value represents the difference between the fair value of the underlying Agency Security in the TBA Agency Security and the cost basis or the forward price to be paid or received for the underlying Agency Security. The weighted average months to maturity represents the maximum maturity acceptable within the delivery standards. Securities actually delivered may have shorter maturities.

(3) Interest-Only Securities principal amount represents the outstanding balance of the underlying Agency Securities from which the Interest-Only Security is derived. We are not entitled to receive any of those principal amounts.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

December 31, 2017

Asset Type	Principal Amount	Fair Value	Weighted Average Coupon	CPR ⁽¹⁾	Weighted Average Month to Reset or Maturity
ARMs & Hybrids	\$63,675	\$66,048	2.87 %	11.40%	9
Multi-Family MBS	1,764,840	1,811,555	3.15 %	0.00 %	88
10 Year Fixed	94,262	98,018	4.00 %	9.44 %	93
15 Year Fixed	1,315,191	1,379,921	3.80 %	10.87%	161
20 Year Fixed	27,405	29,211	4.42 %	17.10%	202
25 Year Fixed	47,875	49,753	3.69 %	5.49 %	281
30 Year Fixed	3,872,423	4,044,460	3.88 %	6.56 %	349
Total or Weighted Average	\$7,185,671	\$7,478,966	3.68 %	5.85 %	244
TBA Agency Securities 15 Year ⁽²⁾	500,000	509,278	3.00 %	0.00 %	180
TBA Agency Securities 30 Year ⁽²⁾	1,100,000	1,163,836	4.37 %	0.00 %	360
Total or Weighted Average	\$8,785,671	\$9,152,080			
Interest-Only Securities ⁽³⁾	132,029	25,752	4.84 %	13.28%	276
Total or Weighted Average		\$9,177,832			

(1) Weighted average for all prepayments during the year ended December 31, 2017, including prepayments related to Agency Securities purchased during the quarter.

(2) Our TBA Agency Securities are recorded as derivative instruments in our accompanying consolidated financial statements. As of December 31, 2017, our TBA Agency Securities had a carrying value of \$934, reported as derivative assets and a carrying amount of \$(2,258), reported as a derivative liability on our accompanying consolidated balance sheets. The net carrying value represents the difference between the fair value of the underlying Agency Security in the TBA Agency Security and the cost basis or the forward price to be paid or received for the underlying Agency Security. The weighted average months to maturity represents the maximum maturity acceptable within the delivery standards. Securities actually delivered may have shorter maturities.

(3) Interest-Only Securities principal amount represents the outstanding balance of the underlying Agency Securities from which the Interest-Only Security is derived. We are not entitled to receive any of those principal amounts.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

The charts below present the percentage of our Agency Securities, Interest-only Securities and TBA Agency Securities by type each at fair value as of the dates indicated.

Recognition of interest income commences on the settlement date of the purchase transaction and continues through the settlement date of the sale transaction. At June 30, 2018, we had investment related receivables of \$216,292 with respect to unsettled sales and investment related payables of \$462,325 with respect to unsettled purchases. At December 31, 2017 we did not have any investment related receivables or payables with respect to unsettled sales and purchases of our Agency Securities.

Our net interest income is primarily a function of the difference between the yield on our assets and the financing (borrowing and hedging) cost of owning those assets. Since we tend to purchase Agency Securities at a premium to par, the main item that can affect the yield on our Agency Securities after they are purchased is the rate at which the mortgage borrowers

Management's Discussion and Analysis (continued)

repay the loan. While the scheduled repayments, which are the principal portion of the homeowners' regular monthly payments, are fairly predictable, the unscheduled repayments, which are generally refinancing of the mortgage but can also result from repurchases of delinquent, defaulted, or modified loans, are less so. Being able to accurately estimate and manage these repayment rates is a critical portion of the management of our securities portfolio, not only for estimating current yield but also for considering the rate of reinvestment of those proceeds into new securities, the yields which those new securities may add to our securities portfolio and our hedging strategy.

At June 30, 2018 and December 31, 2017, the adjustable and hybrid adjustable rate mortgage loans underlying our Agency Securities have fixed-interest rates for an average period of approximately 9 months and 9 months, respectively, after which time the interest rates reset and become adjustable. After a reset date, interest rates on our adjustable and hybrid adjustable Agency Securities float based on spreads over various indices, typically LIBOR or the one-year constant maturity treasury rate. These interest rates are subject to caps that limit the amount the applicable interest rate can increase during any year, known as an annual cap and through the maturity of the security, known as a lifetime cap.

Credit Risk and Non-Agency Securities

We purchase Credit Risk and Non-Agency Securities at prices which incorporate our expectations for prepayment speeds, defaults, delinquencies and severities. These expectations determine the yields we receive on our assets. If actual prepayment speeds, defaults, delinquencies and severities are different from our expectations, our actual yields could be higher or lower.

The table below summarizes certain characteristics of our Credit Risk and Non-Agency Securities at June 30, 2018.

Asset Type	Principal Amount	Fair Value	Weighted Average Coupon	Weighted Average Month to Maturity
Credit Risk Transfer	\$752,694	\$859,562	6.59 %	106
Legacy Prime Fixed	17,980	15,529	6.03 %	223
Legacy ALTA Fixed	62,166	51,126	5.85 %	230
Legacy Prime Hybrid	10,389	9,512	3.34 %	222
Legacy ALTA Hybrid	4,518	4,288	3.85 %	210
New Issue Prime Fixed	18,353	17,735	3.69 %	310
Total or Weighted Average	\$866,100	\$957,752	6.45 %	120

The table below summarizes certain characteristics of our Credit Risk and Non-Agency Securities at December 31, 2017.

Asset Type	Principal Amount	Fair Value	Weighted Average Coupon	Weighted Average Month to Maturity
Credit Risk Transfer	\$764,172	\$870,494	6.05 %	112
Legacy Prime Fixed	19,237	16,778	6.03 %	230
Legacy ALTA Fixed	65,920	54,727	5.85 %	237
Legacy Prime Hybrid	11,452	10,469	3.17 %	229
Legacy ALTA Hybrid	4,901	4,660	3.47 %	217

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New Issue Prime Fixed	19,025	18,701	3.69	%	317
Total or Weighted Average	\$884,707	\$975,829	5.95	%	127

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

Our Credit Risk and Non-Agency Securities are subject to risk of loss with regard to principal and interest payments and at June 30, 2018 and December 31, 2017, have generally either been assigned below investment grade ratings by rating agencies, or have not been rated. We evaluate each investment based on the characteristics of the underlying collateral and securitization structure, rather than relying on the ratings assigned by rating agencies. The table below summarizes the credit ratings of our Credit Risk and Non-Agency Securities.

	Investment Grade	Non-Investment Grade	Non-Rated	Total
June 30, 2018	\$ 337,094	\$ 570,959	\$ 49,699	\$957,752
December 31, 2017	\$ 21,452	\$ 931,327	\$ 23,050	\$975,829

Recognition of interest income commences on the settlement date of the purchase transaction and continues through the settlement date of the sale transaction. We did not have any investment related receivables or payables on Credit Risk and Non-Agency Securities at June 30, 2018 or December 31, 2017.

The charts below present the percentage of our Credit Risk and Non-Agency Securities, at fair value, by type at June 30, 2018 and at December 31, 2017.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

U.S. Treasury Securities

From time to time we may purchase U.S. Treasury Securities to tailor the overall risk characteristics of our investment securities portfolio. While U.S. Treasury Securities provide overall interest rate exposure, they are generally not sensitive to the other risks inherent in MBS. We did not have any U.S. Treasury Securities at June 30, 2018 and December 31, 2017.

Repurchase Agreements

We have entered into repurchase agreements to finance most of our Agency Securities. Our repurchase agreements are secured by our Agency Securities and bear interest at rates that have historically moved in close relationship to the Federal Funds Rate and LIBOR. We have established borrowing relationships with numerous investment banking firms and other lenders, 26 and 32 of which had open repurchase agreements with us at June 30, 2018 and December 31, 2017, respectively. We had outstanding balances under our repurchase agreements at June 30, 2018 and December 31, 2017 of \$6,254,189 and \$7,555,917, respectively, consistent with the decrease in our Agency Securities in our securities portfolio.

Our repurchase agreements require excess collateral, known as a "haircut." At June 30, 2018, the average haircut percentage was 6.12% compared to 6.39% at December 31, 2017. The change in the average haircut percentage reflects the financing of our Credit Risk and Non-Agency Securities.

Derivative Instruments

We use various interest rate contracts to manage our interest rate risk as we deem prudent in light of market conditions and the associated costs with counterparties that have a high quality credit rating and with futures exchanges. We generally pay a fixed rate and receive a floating rate with the objective of fixing a portion of our borrowing costs and hedging the change in our book value to some degree. The floating rate we receive is generally the Federal Funds Rate or LIBOR. Our policies do not contain specific requirements as to the percentages or amount of interest rate risk that we are required to hedge. At June 30, 2018 and December 31, 2017, the notional value of our interest rate swap contracts was 108.9% and 70.8%, respectively, of the fair market value of the non-adjustable rate mortgages of our Agency Securities. For interest rate risk mitigation purposes, we consider Agency Securities to be ARMs if their interest rate is either currently subject to adjustment according to prevailing rates or if they are within 18 months of the period where such adjustments will occur. No assurance can be given that our derivatives will have the desired beneficial impact on our results of operations or financial condition. We have not elected cash flow hedge accounting treatment as allowed by GAAP. Since we do not designate our derivative activities as cash flow hedges, realized as well as unrealized gains/losses from these transactions will impact our GAAP earnings.

Use of derivative instruments may fail to protect or could adversely affect us because, among other things:

- available derivatives may not correspond directly with the interest rate risk for which protection is sought (e.g., the difference in interest rate movements for long-term U.S. Treasury Securities compared to Agency Securities);
- the duration of the derivatives may not match the duration of the related liability;
- the counterparty to a derivative agreement with us may default on its obligation to pay or not perform under the terms of the agreement and the collateral posted may not be sufficient to protect against any consequent loss;

- we may lose collateral we have pledged to secure our obligations under a derivative agreement if the associated counterparty becomes insolvent or files for bankruptcy;
 - we may experience a termination event under one or more of our derivative agreements related to our REIT status, equity levels and performance, which could result in a payout to the associated counterparty and a taxable loss to us;
 - the credit-quality of the party owing money on the derivatives may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
 - the value of derivatives may be adjusted from time to time in accordance with GAAP to reflect changes in fair value; downward adjustments, or “mark-to-market losses,” would reduce our net income or increase any net loss.
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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

The following graphs present the notional and weighted average interest rate of our hedging portfolio by year of maturity.

Management's Discussion and Analysis (continued)

At June 30, 2018 and December 31, 2017, we had derivatives with a net fair value of \$173,686 and \$29,263, respectively. At June 30, 2018 and December 31, 2017, we had interest rate swap contracts with an aggregate notional balance of \$6,750,000 and \$5,250,000. We also had TBA Agency Securities with an aggregate notional balance of \$2,100,000 and \$1,600,000 at June 30, 2018 and December 31, 2017, respectively. Counterparty risk of interest rate swap contracts and interest rate swaptions are limited to some degree because of daily mark-to-market and collateral requirements. These derivative transactions are designed to lock in a portion of funding costs for financing activities associated with our assets in such a way as to help assure the realization of attractive net interest margins and to vary inversely in value with our Agency Securities. Such contracts are based on assumptions about prepayments which, if not realized, will cause results to differ from expectations.

Although we attempt to structure our derivatives to offset the changes in asset prices, the complexity of the actual and expected pre-payment characteristics of the underlying mortgages as well as the volatility in mortgage interest rates relative to U.S. Treasury and interest rate swap contract rates makes achieving high levels of off-set difficult. We recognized net gains of \$30,713 and \$89,310, related to our derivatives for the three and six months ended June 30, 2018 and losses of \$(21,148) and \$(9,629) at June 30, 2017, respectively. For the three and six months ended June 30, 2018, the net unrealized gain (loss) of our Agency Securities decreased by \$(49,587) and \$(194,997), respectively. For the three and six months ended June 30, 2017, the net unrealized gain (loss) of our Agency Securities increased by \$15,182 and \$21,296, respectively. The net unrealized gain (loss) on Agency Securities is due to market price fluctuations.

As required by the Dodd-Frank Act, the Commodity Futures Trading Commission has adopted rules requiring certain interest rate swap contracts to be cleared through a derivatives clearing organization. We are required to clear certain new interest rate swap contracts. Cleared interest rate swaps may have higher margin requirements than un-cleared interest rate swaps we previously had. We have established an account with a futures commission merchant for this purpose. To date, we have not entered into any cleared interest rate swap contracts.

We are required to account for our TBA Agency Securities as derivatives when it is reasonably possible that we will not take or make timely physical delivery of the related securities. However, from time to time, we use TBA Agency Securities primarily to effectively establish and finance portfolio positions. See the section, Agency Securities, Interest-Only Securities and TBA Agency Securities above.

Contractual Obligations and Commitments

We had the following contractual obligations at June 30, 2018:

Obligations	Payments Due By Period				
	Total	Less Than 1 Year	2-3 Years	4-5 Years	Greater Than 5 Years
Repurchase agreements	\$6,254,189	\$6,254,189	\$—	\$—	\$—
Interest expense on repurchase agreements	14,551	14,551	—	—	—
Related Party Fees ⁽¹⁾	190,085	27,155	54,310	54,310	54,310
Board of Directors fees ⁽²⁾	8,288	1,184	2,368	2,368	2,368
Total	\$6,467,113	\$6,297,079	\$56,678	\$56,678	\$56,678

(1) Represents fees to be paid to ACM under the terms of the Management Agreements (Refer to Note 10 and Note 15 to the consolidated financial statements).

(2) Represents compensation to be paid to the Board in the form of cash and common equity.

We had contractual commitments under derivatives at June 30, 2018. We had interest rate swap contracts with an aggregate notional balance of \$6,750,000, a weighted average swap rate of 1.91% and a weighted average term of 63 months at June 30, 2018.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

Liquidity and Capital Resources

Net cash provided by operating activities was \$17,277 and \$59,532, respectively, for the six months ended June 30, 2018 and June 30, 2017. Our average securities portfolio was \$10,117,741 and \$8,916,626, respectively, for the six months ended June 30, 2018 and June 30, 2017, respectively.

At June 30, 2018, we financed our securities portfolio with \$6,254,189 of borrowings under repurchase agreements. Our leverage ratio at June 30, 2018, was 5.18:1. At June 30, 2018, we had a leverage ratio of 6.56:1 including TBA Agency Securities purchased forward and excluding debt related to forward settling sales. At June 30, 2018, our liquidity totaled \$676,125, consisting of \$335,548 of cash plus \$340,577 of unpledged Agency Securities (including securities received as collateral). Our primary sources of funds are borrowings under repurchase arrangements, monthly principal and interest payments on our Agency Securities and cash generated from our operating results. Other sources of funds may include proceeds from equity and debt offerings and asset sales. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of our borrowings can be adjusted on a daily basis, the level of cash carried on our consolidated balance sheet is significantly less important than our potential liquidity available under our borrowing arrangements.

In addition to the repurchase agreement financing discussed above, from time to time we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities back in the future. We then sell such U.S. Treasury Securities to third parties and recognize a liability to return the securities to the original borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same MRA, settlement through the same brokerage or clearing account and maturing on the same day. The practical effect of these transactions is to replace a portion of our repurchase agreement financing of our Agency Securities in our securities portfolio with short positions in U.S. Treasury Securities. We believe that this helps to reduce interest rate risk, and therefore counterparty credit and liquidity risk. We did not have any reverse repurchase agreements outstanding at June 30, 2018 and December 31, 2017.

Both parties to the repurchase and reverse repurchase transactions have the right to make daily margin calls based on changes in the value of the collateral obtained and/or pledged.

We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on repurchase borrowings, reacquisition of securities to be returned to borrowers and the payment of cash dividends as required for continued qualification as a REIT.

Our primary uses of cash are to purchase MBS, pay interest and principal on our borrowings, fund our operations and pay dividends. From time to time, we purchase or sell assets for forward settlement up to 90 days in the future to lock in purchase prices or sales proceeds.

During the six months ended June 30, 2018, we purchased \$2,360,577 of securities using proceeds from repurchase agreements and principal repayments. Of this amount, \$462,325 was payable at June 30, 2018. During the six months ended June 30, 2018, we received cash of \$348,226 from prepayments and scheduled principal payments on our

securities. We had a net cash decrease from our repurchase agreements of \$1,301,728 for the six months ended June 30, 2018 and made cash interest payments of approximately \$91,941 on our liabilities for the six months ended June 30, 2018. Part of funding our operations includes providing margin cash to offset liability balances on our derivatives. We recovered \$7,509 of cash collateral posted to counterparties at June 30, 2018 and increased our liability by \$132,341 for cash collateral posted by counterparties at June 30, 2018.

During the six months ended June 30, 2017, we purchased \$3,493,256 of securities using proceeds from repurchase agreements and principal repayments. Of this amount, \$828,642 was payable at June 30, 2017. During the six months ended June 30, 2017, we received cash of \$518,094 from prepayments and scheduled principal payments on our securities. We had a net cash increase from our repurchase agreements of \$522,651 for the six months ended June 30, 2017 and made cash

Management's Discussion and Analysis (continued)

interest payments of approximately \$57,131 on our liabilities for the six months ended June 30, 2017. Part of funding our operations includes providing margin cash to offset liability balances on our derivatives. We recovered \$21,849 of cash collateral posted to counterparties at June 30, 2017 and decreased our liability by \$1,425 for cash collateral posted by counterparties at June 30, 2017.

We have continued to pursue additional lending counterparties in order to help increase our financial flexibility and ability to withstand periods of contracting liquidity in the credit markets.

Repurchase Agreements

Declines in the value of our Agency securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event under the standard MRA would give our counterparty the option to terminate all repurchase transactions existing with us and require any amount due to be payable immediately.

Changing capital or other financial market regulatory requirements may cause our lenders to exit the repurchase market, increase financing rates, tighten lending standards or increase the amount of required equity capital or haircut we post, any of which could make it more difficult or costly for us to obtain financing.

Financial sector volatility can also lead to increased demand and prices for high quality debt securities, including Agency Securities. While increased prices may increase the value of our Agency Securities, higher values may also reduce the return on reinvestment of capital, thereby lowering our future profitability.

The following graph represents the outstanding balances of our repurchase agreements (before the effect of netting reverse repurchase agreements), which finance most of our Agency Securities. Our repurchase agreements balance will fluctuate based on our change in capital, leverage targets and the market prices of our assets. The balance of repurchase agreements outstanding will fluctuate within any given month based on changes in the market value of the particular Agency Security pledged as collateral (including the effects of principal paydowns) and the level and timing of investment and reinvestment activity.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

At June 30, 2018 and December 31, 2017, BUCKLER Securities LLC, ("BUCKLER") accounted for 49.0% and 38.4% of our aggregate borrowings and had an amount at risk of 10.6% and 9.0%, respectively, of our total stockholders' equity with a weighted average maturity of 25 days and 70 day, respectively, on repurchase agreements.

We have purchased a 10% equity ownership interest in BUCKLER and additionally, provided it with an aggregate of \$105.0 million in subordinated loans which qualify as regulatory capital. Our Audit Committee reviewed, approved and authorized these BUCKLER agreements as related party transactions under Item 404 of Regulation S-K, which approval was subject to approval by our independent directors. Our independent directors separately and simultaneously authorized and approved these agreements and transactions. Our borrowings from BUCKLER and BUCKLER's operating results are periodically reviewed by our Audit Committee and independent directors.

The primary purpose of our investment in BUCKLER is to facilitate our access to repurchase financing, on potentially attractive terms (considering rate, term, size, haircut, relationship and funding commitment) compared to other suitable repurchase financing counterparties.

See Note 8 and Note 15 to the consolidated financial statements for more information.

Management's Discussion and Analysis (continued)

Effects of Margin Requirements, Leverage and Credit Spreads

Our MBS have values that fluctuate according to market conditions and, as discussed above, the market value of our MBS will decrease as prevailing interest rates or credit spreads increase. When the value of the securities pledged to secure a repurchase agreement decreases to the point where the positive difference between the collateral value and the loan amount is less than the haircut, our lenders may issue a margin call, which means that the lender will require us to pay the margin call in cash or pledge additional collateral to meet that margin call. Under our repurchase facilities, our lenders have full discretion to determine the value of the MBS we pledge to them. Most of our lenders will value securities based on recent trades in the market. Lenders also issue margin calls as the published current principal balance factors change on the pool of mortgages underlying the securities pledged as collateral when scheduled and unscheduled principal repayments are announced monthly.

We experience margin calls in the ordinary course of our business and under certain conditions, such as during a period of declining market value for MBS and we may experience margin calls as frequently as daily. In seeking to effectively manage the margin requirements established by our lenders, we maintain a position of cash and unpledged securities. We refer to this position as our liquidity. The level of liquidity we have available to meet margin calls is directly affected by our leverage levels, our haircuts and the price changes on our securities. If interest rates increase as a result of a yield curve shift or for another reason or if credit spreads widen, the prices of our collateral (and our unpledged assets that constitute our liquidity) will decline and we may experience margin calls. We will use our liquidity to meet such margin calls. There can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls. If our haircuts increase, our liquidity will proportionately decrease. If we increase our borrowings, our liquidity will decrease by the amount of additional haircut on the increased level of indebtedness. In addition, certain of our MRAs contain a restriction that prohibits our leverage from exceeding twelve times our stockholders' equity as well as termination events in the case of significant reductions in equity capital.

We intend to maintain a level of liquidity in relation to our assets that enables us to meet reasonably anticipated margin calls but that also allows us to be substantially invested in MBS. We may misjudge the appropriate amount of our liquidity by maintaining excessive liquidity, which would lower our investment returns, or by maintaining insufficient liquidity, which would force us to involuntarily liquidate assets into unfavorable market conditions and harm our results of operations and financial condition.

We generally seek to borrow (on a recourse basis) between six and ten times the amount of our total stockholders' equity. At June 30, 2018 and December 31, 2017, our total borrowings were \$6,254,189 and \$7,555,917 (excluding accrued interest), respectively. At June 30, 2018 and December 31, 2017, we had a leverage ratio of approximately 5.18:1 and 5.70:1, respectively. At June 30, 2018, we had a leverage ratio of 6.56:1 including TBA Agency Securities purchased forward and excluding debt related to forward settling sales. At December 31, 2017, we had a leverage ratio of 6.96:1 including TBA Agency Securities purchased forward and excluding debt related to forward settling sales.

Forward-Looking Statements Regarding Liquidity

Based on our current portfolio, leverage rate and available borrowing arrangements, we believe that our cash flow from operations and our ability to make timely portfolio adjustments, will be sufficient to enable us to meet anticipated short-term (one year or less) liquidity requirements such as to fund our investment activities, meet our

financing obligations, pay fees under the management agreements and fund our distributions to stockholders and pay general corporate expenses.

We may increase our capital resources by obtaining long-term credit facilities or making public or private offerings of equity or debt securities, including classes of preferred stock, common stock and senior or subordinated notes to meet our long-term (greater than one year) liquidity. Such financing will depend on market conditions for capital raises and for the investment of any proceeds and there can be no assurances that we will successfully obtain any such financing.

Stockholders' Equity

See Note 12 to the consolidated financial statements.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

Off-Balance Sheet Arrangements

At June 30, 2018 and December 31, 2017, we had not maintained any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, or special purpose or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Furthermore, at June 30, 2018 and December 31, 2017, we had not guaranteed any obligations of any unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

Critical Accounting Policies

See Note 3 to the consolidated financial statements for our significant accounting policies.

Valuation of Investments in Securities

We carry our MBS and derivatives at fair value. Our Agency Securities are classified as available for sale, and therefore unrealized changes in fair value are reflected directly in total stockholders' equity as accumulated other comprehensive income or loss. Our Credit Risk and Non-Agency Securities and Interest-Only Securities are classified as trading securities, and therefore changes in fair value are reported in the consolidated statements of operations as income or loss. We do not use hedge accounting for our derivatives for financial reporting purposes and therefore changes in fair value are reflected in net income as other gain or loss. To the extent that fair value changes on derivatives offset fair value changes in our MBS, the fluctuation in our stockholders' equity will be lower. For example, rising interest rates may tend to result in an overall increase in our reported net income even while our total stockholders' equity declines.

Fair value for the Agency Securities and Interest-Only Securities in our securities portfolio is based on obtaining a valuation for each Agency Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Agency Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Agency Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model.

The fair values of our derivatives are valued using information provided by third party pricing services that incorporate common market pricing methods that may include current interest rate curves, forward interest rate curves and market spreads to interest rate curves. Management compares pricing information received to dealer quotes to ensure that the current market conditions are properly reflected.

Fair value for the Credit Risk and Non-Agency Securities in our securities portfolio is based on obtaining a valuation for each Credit Risk and Non-Agency Security from third party pricing services and/or dealer quotes. The third party pricing services incorporate such factors as collateral type, bond structure and priority of payments, coupons, prepayment speeds, defaults, delinquencies and severities. If the fair value of a Credit Risk and Non-Agency Security

is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Credit Risk and Non-Agency Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model.

Fair value for the U.S. Treasury Securities in our securities portfolio is based on obtaining a valuation for each U.S. Treasury Securities from third party pricing services and/or dealer quotes.

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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

Realized Gains and Losses on Agency Securities

Security purchase and sale transactions, including purchases and sales for forward settlement, are recorded on the trade date to the extent it is probable that we will take or make timely physical delivery of the related securities. Gains or losses realized from the sale of securities are included in income and are determined using the specific identification method. We realize gains and losses on our Agency Securities upon their sale. At that time, previously unrealized amounts included in accumulated other comprehensive income are reclassified and reported in net income as other gain or loss. To the extent that we sell Agency Securities in later periods after changes in the fair value of those Agency Securities have occurred, we may report significant net income or net loss without a corresponding change in our total stockholders' equity.

Declines in the fair values of our Agency Securities that represent other than temporary impairments are also treated as realized losses and reported in net income as other loss. We evaluate Agency Securities for other than temporary impairment at least on a quarterly basis and more frequently when economic or market concerns warrant such evaluation. We consider an impairment to be other than temporary if we (1) have the intent to sell the Agency Securities, (2) believe it is more likely than not that we will be required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations), or (3) a credit loss exists. Impairment losses recognized establish a new cost basis for the related Agency Securities. Gains or losses on subsequent sales are determined by reference to such new cost basis.

Gains and Losses on Credit Risk and Non-Agency Securities, Interest-Only Securities and U.S. Treasury Securities

We carry our Credit Risk and Non-Agency Securities and Interest-Only Securities at fair value and reflect changes in those fair values in net income as other gains and losses.

We carry our U.S. Treasury Securities at fair value and reflect changes in those fair values in net income as other gains and losses.

Inflation

Virtually all of our assets and liabilities are interest rate-sensitive in nature. As a result, interest rates and other factors influence our performance far more than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and any distributions we may make will be determined by our Board based in part on our REIT taxable income as calculated according to the requirements of the Code; in each case, our activities and balance sheet are measured with reference to fair value without considering inflation.

Subsequent Events

See Note 17 to the consolidated financial statements.

Cautionary Note Regarding Forward-Looking Statements

This report contains various “forward-looking statements.” Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology such as “believes,” “expects,” “may,” “will,” “would,” “could,” “should,” “seeks,” “approximately,” “intends,” “p,” “estimates” or “anticipates” or the negative of these words and phrases or similar words or phrases. All forward-looking statements may be impacted by a number of risks and uncertainties, including statements regarding the following subjects:

- our business and investment strategy;
 - our anticipated results of operations;
 - statements about future dividends;
 - our ability to obtain financing arrangements;
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ARMOUR Residential REIT, Inc.

Management's Discussion and Analysis (continued)

our understanding of our competition and ability to compete effectively;
 market, industry and economic trends; and
 interest rates.

The forward-looking statements in this report are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. You should carefully consider these risks before you make an investment decision with respect to our stock, along with the following factors that could cause actual results to vary from our forward-looking statements:

- the impact of the federal conservatorship of Fannie Mae and Freddie Mac and related efforts, along with any changes in laws and regulations affecting the relationship between Fannie Mae and Freddie Mac and the federal government and the Fed system;
- the possible material adverse effect on our business if the U.S. Congress passed legislation reforming or winding down Fannie Mae or Freddie Mac;
- mortgage loan modification programs and future legislative action;
- actions by the Fed which could cause a flattening of the yield curve, which could materially adversely affect our business, financial condition and results of operations and our ability to pay distributions to our stockholders;
- the impact of a delay or failure of the U.S. Government in reaching an agreement on the national debt ceiling;
- availability, terms and deployment of capital;
- changes in economic conditions generally;
- changes in interest rates, interest rate spreads and the yield curve or prepayment rates;
- general volatility of the financial markets, including markets for mortgage securities;
- the downgrade of the U.S. Government's or certain European countries' credit ratings and future downgrades of the U.S. Government's or certain European countries' credit ratings may materially adversely affect our business, financial condition and results of operations;
- inflation or deflation;
- availability of suitable investment opportunities;
- the degree and nature of our competition, including competition for MBS;
- changes in our business and investment strategy;
- our failure to maintain an exemption from being regulated as a commodity pool operator;
- our dependence on ACM and ability to find a suitable replacement if ACM was to terminate its management relationship with us;
 - the existence of conflicts of interest in our relationship with ACM, certain of our directors and our officers, which could result in decisions that are not in the best interest of our stockholders;
- our management's competing duties to other affiliated entities, which could result in decisions that are not in the best interest of our stockholders;
- changes in personnel at ACM or the availability of qualified personnel at ACM;
- limitations imposed on our business by our status as a REIT under the Code;
- the potential burdens on our business of maintaining our exclusion from the 1940 Act and possible consequences of losing that exemption;
- changes in GAAP, including interpretations thereof; and

•changes in applicable laws and regulations.

We cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on forward-looking statements, which apply only as of the date of this report. We do not intend and disclaim any duty or obligation to update or revise any industry information or forward-looking statements set forth in this report to reflect new information, future events or otherwise, except as required by law.

Management's Discussion and Analysis (continued)

Glossary of Terms:

“Agency Securities” means securities issued or guaranteed by a GSE, such as Fannie Mae, Freddie Mac or a government agency such as Ginnie Mae

“ARMs” means Adjustable Rate Mortgage backed securities.

“Basis swap contracts” means derivative contracts that allow us to exchange one floating interest rate basis for another, for example, 3 month LIBOR and Fed Funds Rates, thereby allowing us to diversify our floating rate basis exposures.

“Board” means ARMOUR’s Board of Directors.

“BUCKLER” means BUCKLER Securities, LLC, a Delaware limited liability company, and a FINRA-regulated broker-dealer. The primary purpose of our investment in BUCKLER is to facilitate our access to repurchase financing, on potentially attractive terms (considering rate, term, size, haircut, relationship and funding commitment) compared to other suitable repurchase financing counterparties.

“CMBS” means commercial mortgage backed securities.

“Code” means the Internal Revenue Code of 1986.

“Common stock DRIP” means the Company's dividend reinvestment and stock purchase plan

“CPR” means constant prepayment rate.

“Dodd-Frank Act” means the Dodd-Frank Wall Street Reform and Consumer Protection Act.

“Exchange Act” means the Securities Exchange Act of 1934.

“Fannie Mae” means the Federal National Mortgage Association.

“Fed” means the U.S. Federal Reserve.

“FINRA” means the Financial Industry Regulatory Authority

“Freddie Mac” means the Federal Home Loan Mortgage Corporation.

“GAAP” means accounting principles generally accepted in the United States of America.

“Ginnie Mae” means the Government National Mortgage Administration.

“GSE” means U.S. Government Sponsored Entity. Obligations of agencies originally established or chartered by the U.S. government to serve public purposes as specified by the U.S. Congress; these obligations are not explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government.

“Haircut” means the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount. Among other things, it is a measure of our unsecured credit risk to our lenders.

“Hybrid” means a mortgage that has a fixed rate for an initial term after which the rate becomes adjustable according to a specific schedule.

“Interest-Only Securities” means the interest portion of Agency Securities, which is separated and sold individually from the principal portion of the same payment.

“JAVELIN” means JAVELIN Mortgage Investment Corp., formerly a publicly-traded REIT. Since its acquisition on April 6, 2016, JAVELIN became a wholly-owned, qualified REIT subsidiary of ARMOUR and continues to be managed by ACM pursuant to the pre-existing management agreement between JAVELIN and ACM.

Management's Discussion and Analysis (continued)

“LIBOR” means the London Interbank Offered Rate.

“MBS” means mortgage backed securities, a security representing a direct interest in a pool of mortgage loans. The pass-through issuer or servicer collects the payments on the loans in the pool and “passes through” the principal and interest to the security holders on a pro rata basis.

“Merger” means the merger of JMI Acquisition Corporation, a wholly-owned subsidiary that was formed for the purpose of acquiring JAVELIN.

“MRA” means master repurchase agreement. A document that outlines standard terms between the Company and counterparties for repurchase agreement transactions.

“Multi-Family MBS” means MBS issued under Fannie Mae's Delegated Underwriting System (DUS) program.

“Credit Risk and Non-Agency Securities” means securities backed by residential mortgages in which we may invest, for which are not guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae.

“REIT” means Real Estate Investment Trust. A special purpose investment vehicle that provides investors with the ability to participate directly in the ownership or financing of real-estate related assets by pooling their capital to purchase and manage mortgage loans and/or income property.

“Repurchase Program” means the Company's common stock repurchase program authorized by our Board.

“SEC” means the Securities and Exchange Commission.

“TBA Agency Securities” means forward contracts for the purchase (“long position”) or sale (“short position”) of Agency Securities at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date.

“Tender Offer” means the tender offer by Acquisition to purchase all of the outstanding common stock of JAVELIN.

“U.S.” means United States.

“1940 Act” means the Investment Company Act of 1940.

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PART II. OTHER INFORMATION

ARMOUR Residential REIT, Inc.

Item 6. Exhibits

EXHIBIT INDEX

Exhibit Number Description

31.1 Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14(a)/15d-14(a) (1)

31.2 Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14(a)/15d-14(a) (1)

31.3 Certification of Chief Financial Officer Pursuant to SEC Rule 13a14(a)/15d-14(a) (1)

(1) Filed herewith.

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

August 24, 2018 ARMOUR RESIDENTIAL REIT, INC.

/s/ James R. Mountain

James R. Mountain

Chief Financial Officer, Duly Authorized Officer and Principal Financial Officer